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Mobile wallets at the POS: success is not a foregone conclusion

(mk) In October 2014, Apple Pay was launched in the US. Ever since, we have been showered with a steady flow of press releases making public that this and that merchant now accepts Apple Pay, another bank offers Apple Pay to its customers and that Apple Pay is available in yet another country. According to information provided on the Apple website, Apple Pay is currently available in 21 countries:

Australia, Canada, China, Denmark, Finland, France, Guernsey, Hong Kong, Ireland, Italy, Japan, New Zealand, Russia, Singapore, Spain, Sweden, Switzerland, Taiwan, United Arab Emirates, United Kingdom, United States.[1]

Meanwhile, others have jumped on the bandwagon. Samsung with Samsung Pay, Alphabet with Android Pay and Walmart with Walmart Pay. Mobile payments seem to be heading towards a bright future. This may not only reduce the market share of cash but also of plastic cards. Moreover, to the extent that payments are still processed by the large payment networks (Mastercard, Visa and the like) it would imply that issuer revenues increasingly have to be shared with a new partner who does not come cheap.

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It looks as if the enthusiasm of Apple Pay users is slowly declining.

There is some evidence that customers might prefer plastic cards.

Our Comment:

More than anything else, the introduction and spread of Apple Pay has fuelled the current m-payment hype. For instance, in March 2017 the Business Insider wrote that "Mobile wallets are on fire". Research by Mastercard reveals that mobile payments are a hot topic in social media.

"Digital wallets continued to gain prominence in smartphones and laptops across the globe and dominated the discussion of new ways to pay, with the topic now topping 75 percent of conversations tracked in the 2017 edition of the Mastercard Digital Payments Study."

M-payments are also a key topic in payment journals, newsletters, blogs etc. Thus, there is no doubt, m-payments are a hot topic at the moment and many experts see enormous potential for m-payments.

Interestingly, however, when looking at the prime showcase, Apple Pay, it is difficult to get information. Apple appears highly restrictive. In its latest annual report, we learn that *"Apple Pay is the Company's cashless payment service available in certain countries that offers an easy, secure and private way to pay"*. The report also announces that there will be an update allowing "peer-to-peer payments using Apple Pay".[2] But there is nothing on usage, no numbers of users, no transaction figures, and no turnover figures. One wonders, if it really is a big success, why are there so few figures?

According to survey results published by pymnts.com (a payment information platform) and InfoScout (a consumer research company), use of Apple Pay is rather subdued. The same applies to the other "Pays" who have, however, had less time to establish themselves in the market.[3] Some of the key estimates of pymnts.com:

- From March 2016 to June 2017 the share of iPhone users who tried Apple Pay was basically flat, oscillating around 24%.
- In June 2017, only 5.5% of iPhone users paid via Apple Pay at stores accepting Apple Pay.
- Of those few users of Apple Pay, 18.3% say they are using it every time they can, 41.7% say they are using it whenever they remember that they can use it, 27.1% rarely consider Apple Pay and 2.9% have stopped using it.
- Of those who had not tried Apple Pay, around 50% said that they were satisfied with the available payment options, approx. 25% said that they did not know how it worked and more than 20% had security concerns.

European regulations make it very hard for mobile payment providers to succeed, in particular for Apple.

When it comes to ease of use, convenience, speed at the checkout, and security Apple Pay is rated fairly well.

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Many respondents find Apple Pay "much better" than alternatives (see Table 1). Given that the other survey participants mostly see Apple Pay "as good as alternative means of payment" this still looks pretty good. But within less than two years Apple Pay's ratings have dropped dramatically. This downward trend must be truly worrying for Apple. It looks as if the enthusiasm of Apple Pay users is slowly declining.

	Oct 2015	June 2017
Ease of use	47.4	28.6
Speed at checkout	50.8	32.0
Security	51.1	29.5
Convenience	55.7	35.5

Table 1 Percentage of users who said that Apple Pay is "much better" than alternatives
Source: www.pymnets.com

So, while initially it looked as if Apple Pay could take the market by storm, it now appears like an uphill battle. The average iPhone user does not seem to be all that fascinated by Apple Pay and a number of strong competitors are trying their luck with similar products.

When it comes to mobile payments at the POS there is also the question whether a mobile phone really is the best device. There is some evidence that customers might prefer plastic cards. For instance, in Australia, contactless cards have been in use for quite some time and the rules (like maximum amounts) are fairly liberal, making contactless card use relatively convenient. Under these circumstances it has been difficult for mobile payments to gain market share. According to market surveys, less than 27% of consumers in Australia are ready to adopt mobile payments.[4]

In Europe, there are still large differences in contactless card use. That might improve the likelihood of mobile payment success – at least in some countries. However, European regulations make it very hard for mobile payment providers to succeed, in particular for Apple.

As discussed already in the September 2015 edition of this newsletter ("Apple Pay: Difficulties outside the US") European interchange regulation makes it impossible for European card issuers to pay fees comparable to the fees paid by US banks (0.15%). Moreover, Apple's policy of blocking competing means of payment may run fowl of European rules governing application selection at the POS.

In Denmark, the Consumer Council (Forbrugerrådet Tænk) has complained to anti-trust authorities (the Danish Competition and Consumer Authority) that Apple Pay is breaching anti-trust law and the Interchange Regulation.[5] It points out that the Interchange Regulation prescribes that in cases with two brands on one card, consumers should have the final say when it comes to selecting the brand that is used. However, when Danish consumers link their Visa/Dankort card with the Apple wallet, Apple selects on behalf of consumers that payments are made with the Visa portion of consumer cards instead of the Dankort. As the Consumer Council argues, this constitutes a case of pre-selection and as such violates European rules. According to the Consumer Council Visa costs about 1.5% whereas Dankort costs merchants around 0.15%. Therefore, a shift away from Dankort could lead to higher costs for merchants (and ultimately for consumers) to the tune of over 100 million EUR.

The Consumer Council also criticises that only payment applications from banks that have signed a collaboration agreement with Apple can access the NFC chip on iPhones.[6] This matters particularly because Apple has a very strong market position in Denmark. According to TDC, the largest telephone company in Denmark, about 75% of their smart phone customers use Apple.[7]

At first sight, it looks as if the Consumer Council has a valid case. Still, at the moment we do not know how Danish anti-trust authorities will decide. But their decision may be important for the EU as a whole. Apple may face the un-attractive choice between withdrawing from the European market and opening up the iPhone.

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E-Loyalty Currency: A Regulatory Gap

(hg) As a child I occasionally got a lollypop at the bakery. I always urged my mother to shop in this bakery. Loyalty through incentives obviously works. Today loyalty schemes are based on apps on cards or mobiles. By integrating loyalty into mobile wallets, innovations like geo-targeting could add high tech to the simple model of producing incentives.

For consumers it is much more attractive to earn and spend the same loyalty points at more than one single merchant. Multi-partner or multi-merchant loyalty schemes are therefore very popular to create more ubiquity of the points. Downtown merchant groups create local loyalty schemes based on city cards to promote local spending in reaction to the huge supermarket chains in the suburbs. On the other hand, nationwide loyalty schemes create cross-industry partnerships for retail chains by offering the consumer the ability to earn and burn the loyalty points by card or app at any participating retailer. To create more ubiquity for consumers in spending their loyalty points, some loyalty schemes have started to offer cross-acceptance between the schemes ("coalition loyalty").

Payback is probably Europe´s largest multi-merchant loyalty scheme, owned by American Express. The scheme is successful in Germany, Poland and Italy and even outside Europe in India and Mexico. In Germany about 30 million consumers are collecting Payback points with a total value of 354 m € (2016). Other competing schemes are "DeutschlandCard" and "Miles & More" (Lufthansa). In the UK Nectar is the largest multi-merchant scheme which started in 2002 by merging the loyalty programs of Sainsbury´s, BP and Barclaycard. Currently Air Miles has over 3.8 million active users, making it the largest loyalty scheme in the Netherlands.

Our Comment:

The basics of the local and nationwide card-based multi-merchant schemes are the same. The points are created by a central issuer, who sells the points to the participating merchant at a specific selling rate. The merchant gives the points away to its customers, who can redeem the points directly at the issuer for premiums or cash or to use the points as a currency when shopping at other participating retailers. At the end of the day, the retailer will redeem the earned points at the issuer, probably at another exchange rate than the selling rate.

The similarities with a traditional three-party payment scheme are obvious: There is a card issuer (who also acts as an acquirer), a payment instrument (card or mobile app), a payer (consumer) and a payee (merchant). Over and above that the monetary funds (points or miles) are not held at a credit institution or at another supervised institution but at a non-regulated private entity. These non-legally ring fenced funds owned by consumers are probably much higher than outstanding e-money funds in Europe (except PayPal), which are strongly regulated by the E-Money-Directive. To date none of the issuers of these loyalty funds have been regulated as a Payment Institution (PI) or as an E-Money-Institution (EMI). There seems to be a regulatory gap. However the financial regulators have this phenomenon on their radar screens, having a hard time with its classification. Is it e-money? Is it a virtual currency (VC)?

A few years ago, the ECB considered frequent-flyer programmes as virtual currency with characteristics of "Type 2" with unidirectional flow.[8] The VC can be purchased by a real currency, but it cannot be exchanged back to the original currency. It could apply to most of the frequent-flyer schemes as a specific kind of e-loyalty scheme. Other schemes are offering the option of

redeemability in traditional currency (e.g. Payback) for the consumer. However, if the loyalty scheme extends to a multi-partner scheme, the merchant who accepts the loyalty points for payments can always redeem the points at the issuer for real currency. Otherwise he would not accept the points. The redeemability could be restricted or excluded for consumers, but not for the participating merchants as payees. Therefore a multi-merchant loyalty scheme is according to the classification of the ECB by definition a VC scheme with bidirectional flow (Type 3).

There seems to be a regulatory gap.

As a consequence of the new EU Anti Money Laundering Directive (5AMLD), proposed by the Commission in July 2016, the providers of exchange services (platforms and wallet providers) between VC and fiat money (a common expression for traditional state or central bank issued currency) will become "obliged entities" subject to the AML-requirements, like identification of the VC-users.

In December 2017 the long trilogue-process of the 5AMLD between EP, Council and Commission was terminated. The parties finally agreed on a wide definition of VC: "*a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency, and does not possess a legal status of currency or money, but is accepted by natural or legal persons, as a means of exchange, and which can be transferred, stored and traded electronically*." This wide definition should cover all the potential uses of VC, according to the trilogue negotiators. Only the so-called in-games currencies would be excluded, if the units of value cannot be transferred between the players.

According to this definition of the 5AMLD, e-loyalty points in multi-merchant schemes, which can be used as a means of exchange, are VC. However, there will probably be an exemption for local loyalty-schemes according to recital 8 of the Directive. "*Local currencies (also known as complementary currencies) used in very limited networks such as a city or a region and among a small number of users should not be considered as virtual currencies.*" This exemption obviously refers to the "limited network" exemption of the PSD2 according to Art. 3 (k), however it is much narrower defined.

The consequence would be far-reaching. The issuer of the nation-wide e-loyalty currency would become an obliged entity as provider of exchange services. The participating merchants are usually identified traders of the loyalty VC. Would it be necessary to identify the consumers too, who collect the points? At least the consumer, who wants to convert the VC at the issuer into traditional currency, should be identified. It is in the nature of things that loyalty schemes want to identify their users. However, full KYC seems to be overdone.

It is of course questionable, how this requirement would prevent AML or terrorist financing. Furthermore, the classification of e-loyalty currency as VC will not protect the user against insolvency of the issuer.

There are good reasons to classify e-loyalty points as e-money.

As stated in the 5AMLD, VC should not be confused with e-money. There are good reasons to classify e-loyalty points as e-money. Based on the definition of e-money (EU Directive 2009/110/EC – EMD2) most of the e-loyalty points fulfill the legal criteria of e-money:

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In a recent document the Commission considers multi-merchant loyalty schemes, where the loyalty value points can be used as payment instruments, as e-money, which should be issued by regulated institutions, like banks or e-money institutions: “*e-money can be pre-paid by the user (payer) or by a third-party on behalf of or in favour of the payer (e.g. company in case of business-to-business (B2B) cards or by a merchant in multi-merchant loyalty schemes)*”.[9]

By implementing the PSD2, local competent authorities like the Austrian FMA[10] and the German BaFin[11], stated that such schemes are considered as e-money or at least as PSD2-relevant payment services. The FMA indicates such loyalty schemes could be only exempted as “limited network” if the usage is “sufficiently limited” (p. 4). A nation-wide scheme is – according to the examples given by the FMA - probably not limited enough. The BaFin stated that these schemes could be exempted as “limited network”, even if they are operated nation-wide, if they fulfilled some specific requirements:

- Any possibility of purchasing the points should be excluded,
- The points of acceptance should also actively issue value points to their customers,
- Points can only be given away in the context of the purchase of goods and services.

However, the first requirement is not clear. Is the requirement only relevant for the consumer or also for the participating merchant? A core characteristic of multi-merchant schemes is the participating merchant who is purchasing and selling the points from the issuer.

The consequence of the regulation of e-loyalty schemes as e-money will cause some essential problems for the issuer. Being e-money, the points should be, according to Art. 11 of the EMD2, issued at par value on the receipt of funds and able to be redeemed any moment at par value! This would strikingly change the business model of the schemes.

Within nationwide loyalty schemes the payment transaction volume made by loyalty points will doubtless exceed 1 million € p.a. If these schemes are considered by the regulator or by themselves as being exempted as a limited network, they have to send a notification to the local competent authority. The EBA will collect all notifications and the list of these service providers will be published. This list will be interesting reading. To be exempted as a limit network might be the better option as than being regulated as virtual currency. In any case, multi-merchant loyalty schemes are on the radar of the regulators.

Definition of e-money according to Art. 2 No. 2 of the EMD2	Multi-merchant e-loyalty schemes
electronically, including magnetically, stored monetary value	Points are monetary value stored in accounts
as represented by a claim on the issuer	Merchants, who accept points for payments, and sometimes account-holders have a claim on the issuer for redemption in cash
which is issued on receipt of funds	The issuer sells the points to the merchant who distributes the points to his clients
for the purpose of making payment transactions as defined in point 5 of Article 4 of Directive 2007/64/EC	Points can be used directly as means of payment, like cash or a debit card
which is accepted by a natural or legal person other than the electronic money issuer	Points are accepted as means of payment by merchants who are not identical with the issuer

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Threatened anonymity of internet payments: 5AMLD updated

(hg) The EU Directive 2015/849 on the prevention of the use of the financial system for the purpose of money laundering or terrorist financing, better known as “4AMLD”, should have been implemented in all Member States since the end of June 2017. Because of the terrorist attacks in the winter of 2015/2016 in Paris and Brussels the Commission started a unique process by proposing a far-reaching amendment of the Directive in July 2016 (5AMLD) with an effective start date after a few months (1 January 2017). Such a short timeline might have been realistic in a strongly centralized political regime shocked by a terrorist attack, but unfortunately not within the EU with 28 Member States. Prudence is always better than political actionism especially in hard times of terroristic menace. The proposal took its usual political course, which ended in a long trilogue process (almost 7 months) between Commission, Council and Parliament. In December 2017, the parties agreed on a provisional compromise, which was presented by the Presidency on December 20. It seems to be a realistic scenario, that this compromise will be approved by the Council and the European Parliament at a first reading within the next months. However, the proposed implementation date has been extended to 18 months. The 5AMLD will not be effective before the middle of 2019 (instead of January 2017). Within the comprehensive proposal (65 pages) the payment related regulation is a minor part. However, the implications for the payment industry already being discussed in this report[12] are far-reaching.

Our Comment:

What are the main adjustments?

The issuing of anonymous prepaid cards, which are regulated as e-money, is still possible if the product has a value threshold of 150 € as stored electronically and as maximum monthly payment volume (in case of reloadable cards). This threshold is today 250 € (requirement of the 4AMLD).

The originally proposed termination of online internet payments by these anonymous prepaid cards was a lengthy discussion point during the negotiations. The European Parliament kicked out this requirement without replacement in March 2017, however without lasting success. In the opinion of the European Data Protection Supervisor (EDPS), who was consulted after the publication of the Proposal (not before as stated by the Commission in Recital 42), the issue of anonymity of payments was not explicitly mentioned. The EDPS criticized a general violation of the proportionality principle between the targets (prevention of AML and terrorist financing and the fundamental rights to privacy and data protection).[13] The termination of the possibility of anonymous payments as a fundamental right to privacy is disproportional to the target of preventing terrorist attacks.

Despite the intensive public discussion on restricting or banning cash, the proposed banning of anonymous online payments was not discussed at all during the legislative process in public. Only the German social democratic party SPD mentioned the issue in its election program 2017: “*We support a right to anonymous cashless payments, taking into account the general legal provisions, for example on the protection of minors and the fight against money laundering and terrorism*." At the end of the day the Council, EP and Commission agreed on a

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threshold of 50 Euros per transaction in case of remote payment transactions as defined in the PSD2 (art. 4 point 6). It seems to be a satisfactory compromise.

However, there is a pitfall. The original target of the Commission was to prevent anonymous online payments generated by e-money products over the internet. Within the evolution of the Commission´s Proposal the term "online payments" has been changed by the Presidency (Compromise of 14 November 2016) to "remote payment transactions". According to this definition remote payments are not only "online payments":

"'remote payment transaction' means a payment transaction initiated via internet or through a device that can be used for distance communication."

Is a card which can be used contactless (NFC) a device that can be used for a distance communication? Is every transaction generated by a mobile phone at a physical POS a remote payment transaction? The definition according to the PSD2 obviously needs some further explanations. In its Regulatory Technical Standards (RTS) on Strong Customer Authentication (SCA) the EBA waives further explanations, although the distinction between "remote" and "non-remote" is essential for the SCA requirement "dynamic linking" and for the exemptions based on risk analyses. We will come back to this issue in one of our next reports. What are the consequences, if contactless card payments or mobile payments at the POS are considered as "remote payments"?

Anonymous prepaid cards (e-money), which would be issued according to the 5AMLD (150 Euro threshold) could be used for payment transactions at the POS in physical shops with a transaction amount up to 150 Euro, if the card is put into the terminal (not contactless). If the same card were to be used contactless or through a wallet in a mobile device, the transaction would be limited to 50 Euros, because it is a "remote payment transaction". It is obvious that the risk regarding AML or terrorist financing is exactly the same in both cases if the card is used in a face-to-face environment.

As a consequence, only conventional cards - based on outdated technical standards - could apply the exemption of 150 Euros. The side effect of the proposed regulation will be to hinder any technical innovation in the segment of anonymous e-money.

The Commission focused on general purpose prepaid cards with international branding, obviously used by terrorists. As a consequence of the narrowed definition of limited networks in the PSD2 (Art. 3k), many anonymous prepaid card products will still be regulated as e-money without any risk for AML or terrorist financing, like gift cards. These gift cards can not only be used in a merchant's shop, but also in its web shop. The outcome would be different transaction thresholds for physical and online shopping with these gift cards.

The termination of the possibility of anonymous payments as a fundamental right to privacy is disproportional to the target of preventing terrorist attacks.

We suggest finding a more appropriate term to only exclude the online internet payments as intended by the Directive, by adding *"in case of remote payment transaction in a non-face-to-face business"*, a term which is already familiar from the 5AMLD. This would be compliant with the intention of the original proposal of the Commission and issuers will be able to make the required technical differentiation by identifying the transaction as "card not present".

On the acquiring side, the compromise comes back to the original proposal of the Commission. Acquirers (not the schemes) will be obliged to accept only payments carried out with anonymous prepaid cards issued in third countries where such cards meet the requirements equivalent to the 5AMLD requirements (thresholds of 150 Euro etc.). It granted a transition period of 6

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months after the latest transition date of the Directive in order to give the card industry time to implement technical and regulatory adjustments. Furthermore, it added an optional national solo effort: *"Member States may decide not to accept on their territory payments carried out by anonymous prepaid cards".*

It will be technically very hard to adopt this new regulatory requirement. At the time being, acquirers and their merchants have to refuse all prepaid cards issued outside the EU in order to comply. It is to be expected that the international card schemes will amend their products (e.g. prepaid cards with domestic use only) and their rules not only in Europe but globally to ensure compliance.

We already stated the inconsistency of these requirements to prepaid products on the acquiring side compared to the issuing side in our report of November 2016. The restrictions on the issuing side are applicable to all anonymous e-money products (including cards), whereas the equivalence requirement for the acquirer is linked to e-money card-only products. There is no reference to a legal definition of a "card". As a result of this shortcoming, acquirers would still be allowed to accept prepaid payment instruments, which are not generated by a plastic card (e.g. virtual token, branded by Visa or Mastercard in a wallet), and which are issued outside the EU without compliance to the 5AMLD.

Within the legislative process other players also informed the Commission about this inconsistency in the text of the Directive from a systematic legal point of view. However, the text has remained unchanged to this day. Obviously a different approach is intended.

Furthermore, the national option of a general prohibition is even much broader and could be interpreted for all anonymous prepaid cards (e-money or not). According to the proposed Directive, a Member State could make the whole gift card business illegal in its territory.

Otto von Bismarck (German Chancellor 1871-1890) once stated *"the less people know about how sausages and laws are made, the better they sleep."*

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Notes

1 It is also available in San Marino, Vatican City, Jersey and the Isle of Man. See https://support.apple.com/en-us/HT207957.
2 In fact, Apple Cash was released on December 5, 2017. See “Apple Pay Cash and person to person payments now available”. https://www.apple.com/newsroom/2017/12/apple-pay-cash-and-person-to-person-payments-now-available/
3 See https://www.pymnts.com/apple-pay-adoption/ (last accessed dec. 14, 2017)
4 See: People in Australia aren’t using mobile payments because contactless cards are too good (https://www.verdict.co.uk/people-australia-arent-using-mobile-payments-contactless-cards-good/), 1st September 2017
5 Regulation (EU) 2015/751 of the European Parliament and of the Council of 29 April 2015 on interchange fees for card-based payment transactions
6 They can still use Bluetooth. But Bluetooth is technologically inferior and not often supported by merchants.
7 http://www.mynewsdesk.com/dk/tdc-a-s/pressreleases/fun-facts-det-vidste-du-ikke-om-din-mobil-1594665
8 See ECB, Virtual currency schemes, October 2012, p. 15-16.
9 Commission staff working document, SWD (2017) 241 final, Part 2/2, p. 61.
10 See FMA paper „Alternativwährungen und Bonuspunkte als konzessionspflichtige Finanzdienstleistungen, June 2016
11 See BaFin-Merkblatt „Hinweise zum Zahlungsdiensteaufsichtsgesetz“ (29 November 2017)
12 See „5AMLD: The end of anonymous online payments“ (Issue No. 7 of November 2016).
13 See the EDPS Opinion on a Commission Proposal amending Directive (EU) 2015/849 and Directive 2009/101/EC, Access to beneficial ownership information and data protection implications of 2 February 2017 (www.edps.europa.eu).

We wish all our readers a Happy New Year!

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