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1. ECB Secure Pay Recommendations for the Security of Internet Payments. The clock is ticking

by Ignacio González-Páramo[1]

The European Central Bank (ECB) Recommendations for the Security of Internet Payments[2] (Secure Pay) were already analyzed in the November 2013 edition of this Newsletter. However, keeping in mind that the implementation deadline established by the document itself (February 2015) is less than a year from now and that last February the ECB published an assessment guide on how to implement the Recommendations[3], it might be necessary to re-open a constructive debate in order to bring to the fore points to be addressed so as to potentially improve the current state of things. The deadline is close, but increasing industry awareness might help the market to move forward.

For starters, the deadline is still a major issue. Let's not forget that the recommendations are to be implemented via the legislation transposing the revised Payments Service Directive – aka PSD2[4]– (which might be delayed until some point beyond early 2015) into the legislation of the different European Union (EU) Member States or a local oversight framework put in place by the relevant local authorities, for which no relevant input has been received by the industry so far. On top of that, the section of the proposal for a PSD2 that deals with security

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[2] ECB Recommendations for the security of internet payments. Final version after public consultation. January 2013.

[3] ECB Assessment guide for the security of internet payments, February 2014.

[4] COM (2013) 547 /3: Proposal for a Directive of the European Parliament and of the Council on Payment Services in the Internal Market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC.

requirements[5] is anything but specific and leaves most implementation details to future guidance resulting from the cooperation between the ECB and the European Banking Authority (EBA). Therefore, if we bear in mind that PSD2 might not be published until mid-2015 and that the EBA guidelines might take even longer, the February 2015 deadline is not feasible. This is the reason why authorized voices in the industry are already advocating that the deadline be extended so that the potential nonsense can be tackled, though there has been no response so far from EU policy-makers. Moreover, some local regulators (the ones responsible for implementing and enforcing the recommendations) have already stated that they will wait for PSD2 and the EBA guidelines before making a move. Therefore, it seems that neither of the two alternatives to implement and enforce the recommendations can make this happen. Is it reasonable, in such a situation, to ask the industry to move forward to an undefined scenario which is even unknown to the ones supposed to shape it?

On a different note, market fragmentation, an unintended consequence implied by most (if not all) European regulatory initiatives (something that should concern the whole payments sphere), is likely to have a relevant impact. The way that most European legal instruments are usually published, interpreted and enforced does not precisely inspire optimism in this respect. This is not only worrying in terms of the impact on consumers - who might encounter different, confusing and sometimes annoying payment experiences depending on the rules applicable in the jurisdiction where they pay. Its impact on competition is also a concern, due to the following issues that can be identified:

- ✓ First, the lack of a level playing field between the providers of the different EU territories in scope, which is obviously contrary to the most important goal of any EU legislative initiative (i.e. achieving a single market, in this case for the payments sector).
- ✓ Second, a competitive disadvantage:
    - For smaller players (if the rules are not applied proportionally, bearing in mind the risks that the specific players bring into the system).
    - And, most importantly, for European players whose businesses are based only in the EU (since their clients might opt to move their activities to regions with a more realistic and flexible legal framework). It is really dramatic to see how EU policy-makers make moves that will weaken the European Union and European Economic Area (EEA). It is astonishing, as under the rationale and principles of

[5] Operational security and authentication, Chapter 5.

the EU Treaty they are supposed to strengthen both regions. All in all, this demonstrates just some of the unintended effects of issuing regional and local rules to regulate a borderless and global environment, such as e-commerce. If we look at it from this angle, it just does not make any sense, especially if no dialogue has been established with authorities from outside the European Union in order to analyze what the state of the art is in those regions and what options there are for providing these measures with a global reach rather than a (fragmented) European one, something that would jeopardize the EU's ability to compete globally.

Furthermore, it is important not to forget that due to the way that the EU legislative process normally works (co-decision process), overregulation is also a hurdle that must often be overcome. The fact that different European Parliament Committees are involved in the drafting of different - but related - pieces of legislation results in a complex and burdensome scenario, where one provider has to comply with similar requirements covered in separate legal instruments which nonetheless have a common purpose. So requirements and mandates (with identical or similar aims) are duplicated because of ins and outs apparently linked to political motivations, rather than to a business rationale, when the latter, as something of public interest, should prevail over the former. And providers end up paying the price (especially the smaller ones who in some cases are forced to close a line of business or exit the marketplace, as their resources are far more limited than those of big players). These duplications not only occur in Level 1 legal texts (e.g. EU Directives and Regulations) but also in mandatory protocols and industrial best practices (e.g. PCI DSS), which are actually enforced via the Card Schemes.

This overregulation is especially serious if we analyze strong customer authentication (recommendation 7), which is the measure with the most impact in the whole document. The main justification cited by policy-makers in the introduction to these recommendations is the ECB Report on Card Fraud, which states that the fraud levels for card-not-present transactions are much higher than those for card-present ones. What the report does not show, and this is key, is the level of card fraud for authenticated transactions (as opposed to non-authenticated ones), something which has not been mirrored anywhere - not because they did not hear about it - and without which we cannot ensure that these recommendations have a real business case. So, based on all the evidence available so far, authentication does not seem to be the issue. The lack of it is, in my opinion, what we have to combat. One of the reasons why I raise this is because there are already widely accepted authentication methods within the industry, which are familiar to customers and for which considerable amounts of money were invested by most market participants. Apart from the fact that liability shifts had been applied for years (with relative success) by the industry to foster the use of more secure payment methods, recommendation number 7 might be a bit untimely and even counterproductive, if we bear in mind the critical momentum that the Union is facing from a financial perspective. The investment this measure requires will entail hurdles for all participants, especially for smaller ones. As a general principle, I would advocate that the existing procedures (created by self-regulation) be boosted, instead of introducing brand-new ones that might be divorced from the business reality. Policy-makers have recently been calling for more innovation. And I cannot agree more with that goal. But in order to achieve it, policy-makers should leave some room for companies to move resources away from compliance, so that they can add value through technology and formulate long-term strategies in that direction. Designing such business plans is difficult with constant and restrictive regulatory interventions, especially if their business impact is not conveniently measured beforehand.

To end with, and despite the assessment guide[6] that was published last February by the ECB, I feel compelled to highlight that clarity and completeness are still things that the recommendations lack. Some of the requirements (e.g. the required frequency for providers' mandatory risk assessments, the need for a 2-factor authentication, the “comply or explain” principle, the conditions under which a waiver might be granted for a low-risk scenario, etc.) really need to be further clarified and explained. Transparency should not only be something that is required of providers but also, and most notably, of the policy-makers who set the conditions with which the former must comply.

2. More on the proposed interchange regulation

On 20 February 2014, the ECON Committee of the EU Parliament adopted the report on the proposed interchange regulation[7]. This report has been published on 11 March 2014. It will be discussed in the plenary on 2 April 2014 in the first / single reading. Voting is scheduled for the 3 April 2014. The EU Council will deal with the issue on 4 April 2014. Besides many

[6] ECB Assessment guide for the security of internet payments, February 2014.
[7] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2014-0167+0+DOC+PDF+V0//EN

clarifications, the most important amendments compared with the initial proposal of the EU Commission are:

Recital 18a	Prohibition of interchange fees for debit card transactions would be beneficial
Recital 19a	Acquirers should not apply higher MIFs to cross-border transactions than they apply to national transactions
Recital 22	Three-party schemes should accept transactions made using their cards from any acquirer [...]
Article 1	Commercial cards not exempted from IF regulation
Article 1 paragraph 3c	Three party systems are exempted from IF regulation only where their volume does not exceed a threshold set by the commission
Article 1 paragraph 4a	Articles 6 and 7[8] shall not apply to low-cost domestic debit card schemes
Article 3 paragraph 1	Valid date of interchange caps one year after entry into force for both, national and cross-border transactions Interchange for debit card transactions capped at the maximum of 0.2% and 7ct.
Article 6a	For cross-border transactions, the interchange fee applicable shall be that of the country of the acquirer
Article 7 paragraph 4a	EBA shall develop draft regulatory technical standards Power is delegated to the Commission to adopt the regulatory technical standards
Article 6a	For cross-border transactions, the interchange fee applicable shall be that of the country of the acquirer

Our Comment

- Debit card interchange fees (Recital 18a and Article 3 paragraph 1)

There are some good reasons why interchange fees for debit cards shall be transaction based rather than ad valorem, as costs for switching, authorization and clearing are independent of the value of the transaction. The introduction of the maximum cap of 7ct. per transactions takes this rationale into account. An argument in favor of ad valorem fees follows from the observation that a fixed amount per transactions results in “unduly” high percentage costs for small value payments. A pure ad valorem fee, however, results in fees of zero for small value payments. Therefore, many payment schemes follow a mixed approach. Interchange fees are set as a combination of a moderate transaction fee and an

[8] Art. 6: Licensing, Art. 7: Separation of payment card scheme and processing entities.

ad valorem fee or as an ad valorem fee combined with a minimum amount per transaction. In the proposed interchange regulation for debit cards, the transaction based component for small value payments is missing. Due to rounding, the proposed regulation would lead to a zero interchange fee for transactions below 2.50 EUR. At the same time, issuers' revenues from high value transactions would be limited to 7 ct. per transaction. Therefore, costs for small value transactions could not be subsidized by revenue from high value transactions. This matters because in countries with high card usage, transactions with a value of 2.50 EUR and below are fairly common.

In the report, legislators explicitly point out to potential benefits of a prohibition of interchange fees. Accordingly, the above mentioned effect of a zero interchange fee for small value payments may be welcome – at least for some regulators. However, we would like to emphasize that this approach is not consistent with the Merchant Indifference Test methodology, which was used as justification and guideline for the Commission's initial proposal.

- Export of national interchange fee to cross border acquiring (Recital 19a, Article 6a)

We have explained the applicable interchange model in more detail in edition 5/2013 of this newsletter. First, it should be noted that in Recital 19a reference is made to <u>multilateral</u> interchange fees (MIF) whereas Article 6a refers to interchange Fees (IF). Given that a concept such as "the interchange fee of the country of the acquirer" – the term used in the proposed article 6a – does not necessarily exist in each country, it would be helpful if the term "MIF", used in the recital, could also be used in Art. 6a. This point is important because interchange fees are set in different ways. In countries like Germany of Switzerland where a national body of issuers and acquirers sets domestic interchange fees which become mandatory for all domestic issuers and acquirers according to the Rules of MasterCard and Visa. In these cases, the term "the interchange fee of the country of the acquirer" refers to just these domestic interchange fees. In other countries, domestic fees are set by the card organizations or the intra-regional fees are applied as default to domestic transactions. In these cases, the interpretation is also clear. However, there are countries where a domestic interchange fee has been implemented through a set of bi-lateral agreements between issuers and acquirers rather than through a common multi-lateral agreement. Moreover, even when a multi-laterally set interchange fee exists, any bi-lateral agreement between an issuer and an acquirer will override the default fees, even those domestic fees which are set by local bodies. Given that an acquirer entered in an interchange agreement with one or *more issuers in his home country, which interchange should this acquirer apply to cross border transactions? Shall he apply the default fee in his national market or the fee he actually pays due to bi-lateral agreements?*

The term MIF which is used in Recital 19a may be a hint that only multilaterally set national interchange fees may be "exported" by cross border acquirers, but it appears doubtful whether this really was intended by Ms. Sari Essayah, MEP who proposed this amendment. We would like to emphasize explicitly the importance of this issue. Suppose an acquirer would be entitled to export any bilaterally agreed interchange fee which he applies in the domestic market. In this case, it would be an easy and straightforward exercise for this acquirer to agree with a couple of niche issuers on a zero-interchange and then to export the zero-interchange across Europe. We are wondering whether the European legislator actually intended this effect and urgently recommend clarifying the wording in the clause.

Another concern with this provision is that we consider it to be anti-competitive. Ultimately, issuers would be bound by contracts which acquirers have made with other issuers in their respective home countries. In such a setting, issuers do not have any means to influence the commercial terms for usage of their cards.

A third issue with proposed Article 6a is the legal entry into force. According to Article 17 of the initial proposal, the regulation enters into force two weeks after its publication in the OJ. In effect, from this point in time, cross-border acquirers could apply their domestic interchange rates to all transactions they acquire - not only to domestic transactions, in the home market of the acquirer – but due to Article 6a also to all the other transactions which are "cross-border".

Thus, once again a problem emerges that was supposed to have been fixed by amending the initial proposal with regard to the transition period for the regulation of domestic interchange rates. The ECON report explicitly points out that the interchange caps for domestic transactions and cross border transactions will be implemented at the same time, namely one year after entry into force of the regulation. To achieve this, the initially proposed transition period for domestic interchange rates has been deleted. In fact, it was acknowledged by all involved parties that a parallel regime of unregulated and regulated interchange fees would lead to market distortions. Now with different dates of entry into force of the interchange caps and of Article 6a (provided this article will pass the Parliament and the Council), there is, again a transition period where domestically regulated low interchange *rates of countries like France or Poland "compete" with unregulated interchange fees in other countries. Obviously, this will result in the suspected market distortions, namely acquirers from high-interchange countries establishing entities in low-interchange countries to safeguard the competitive position compared to foreign acquirers.*[9] *We think that it is of upmost importance that regulators synchronize the validity of Article 6a with the interchange caps – or not pass Article 6a at all.*

- Three-party schemes should accept transactions made using their cards from any acquirer on general card transaction standards and acquiring rules (Recital 22)

Initially the above cited Amendment 66 was complemented by another amendment, namely the introduction of an Article 7a (Amendment 251), which however was not adopted by the ECON Committee. Instead the more technical Amendment 252 has been accepted and moved to Art. 7 (4a).

Initially proposed amendments to the MIF regulation proposal[10]

Article 7a *(proposed amendment 251)*
Obligation to accept transactions from any acquirer
Three party schemes and four party issuers shall accept transactions made using cards issued by them also directly from any acquirer following the general business rules and standards as well as the interchange rules laid down by this Regulation.
Three party schemes operating within the Union shall ensure that their system is technically interoperable with other systems of card processing entities within the Union through the use of standards developed by international or European standardisation bodies. Three party processing entities or systems shall not adopt or apply business rules that restrict interoperability with other processing entities within the Union
Article 7a *(proposed amendment 252)*
EBA shall, in close cooperation with the European Retail Payments Board, establish requirements to be complied with by payment systems, payment schemes and processing entities to ensure a fully open and competitive card processing market. Those requirements shall be issued by ...* [two years from the date of entry into force of this Regulation] and shall be updated on a regular basis, as appropriate.

[9] See our article "The proposed Regulation on Interchange Fees" in the August edition of this newsletter.
[10] European Parliament. Committee on Economic and Monetary Affairs: AMENDMENTS 29 – 318. Draft report. Pablo Zalba Bidegain (PE522.956v01-00) on the proposal for a regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions. 2013/0265(COD), 20.1.2014.

Primarily, we are wondering why the provision was introduced into the recitals without the corresponding Amendment 251. We think there will be no material effect from the recital without the corresponding Amendment 251 in the text of the regulation. Furthermore, it is not clear whether Recital 22 should be interpreted as a pure technical requirement or as a requirement to open three party systems for acquirers. Put as a pure technical requirement, the provision would oblige three party systems to make use of the same technical standards as four party schemes whenever they connect to issuers and acquirers. This would be in line with the accepted Amendment 252 which now appears in Art.7 (4a).

*But Recital 22 seems to be much more in line with Amendment 251, suggesting that regulators want an obligation for three party schemes to accept transactions from any acquirer. Actually this would mean that three party systems must license acquirers at their request. Indeed, the justification of proposed Amendment 251 states that "*open acquiring will increase transparency of merchant fees and MIF in this market since both three and four party schemes would use MIF caps laid down by this Regulation.*" We do not fully understand the rationale as – according to Article 2, point 15 - transactions with three party systems are already underlying the interchange caps, when issuers or acquirers are licensed. In addition, the provision of Article 1, paragraph 3 point c, entitles the European Commission – simply via setting of the appropriate threshold – to make sure that interchange caps apply to transactions within three party systems, as well. However, since no reasonable interpretation of an interchange fee in a three party transaction has been proposed, bringing three party systems under the scope of interchange regulation may have no effect. Thus, the proposed Recital 22 together with the (now deleted) Amendment 251 could be understood as a further measure to make sure that merchants will be able to accept cards issued by three party systems at the same commercial terms as cards issued in four party systems – ultimately an approach to regulate retail prices rather than interbank fees. The ECON Committee has adopted Amendment 66 (amending Recital 22). It has not adopted the complementary Amendment 251. We hope that the adoption of Amendment 66 was erroneous rather than the non-adoption of Amendment 251.*

- Domestic debit card schemes (Article 1 paragraph 4a)

Basically the ECON Committee introduces a "SEPA waiver". Countries with low-cost domestic debit schemes do not need to apply the general SEPA rules such as Art. 6 (Licensing) and Art. 7 (Separation of payment card scheme and processing entities). Thus they are free to consider a partial "opt-out" from SEPA.

Schemes that fall under this waiver may thus maintain or introduce "territorial restrictions" in their licensing rules such as country-specific licenses and special rules for x-border transactions. In addition, payment and processing may be carried out by a unified venture and the processing need not be technically interoperable with other systems of processing entities.

As justification the MEPs note that some domestic schemes are "cost-efficient" and that according to the Commission's impact assessment accompanying the Regulation on Multilateral Interchange Fees "this exemption would be relevant to only a limited number of Member States."

That is really a wonderful argument, in particular when considering that SEPA is about having a unified Euro payment landscape and when considering that regulators have told us time and again that the new SEPA schemes will be at least as efficient as the legacy schemes. Time and again, we have been told that card schemes need to be "SEPA compliant". Indeed, some domestic (and low-cost!) schemes such as the Dutch PIN and the Finnish Luottokunta have already vanished. Now the ECON Committee basically tells them that they might as well have carried on!

If the proposal should survive the vote in Parliament and the subsequent negotiations with the Council and the Commission, then SEPA for cards will be dead. The European Card Payments Scheme will remain "forever a phantom".[11]

3. The mystery of non-regulated "massive payment volumes" in Europe

In its final report on the PSD II (11 March 2014[12]) the ECON Committee accepted the Recital 12 with the statement of the Commission of the existence of "massive payment volumes and values" offering "hundreds or thousands of different products and services" which are wrongfully operating under the exception of the limited networks of the Payment Services Directive (2007/64/EC). In order to improve consumer protection, these huge payment schemes should no longer be waivered. Therefore, the Commission proposed a narrowed

[11] See also Ewald Judt and Malte Krueger: European Card Payments Scheme forever a phantom?, Journal of Payment Strategy & Systems, Vol.7, No. 4, 2013, 344-358.

[12] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bREPORT%2bA7-2014-0169%2b0%2bDOC%2bPDF%2bV0%2f%2fEN

definition of “limited network/limited range” (Article 3 k) and a very restrictive implementation. This extended regulation will not only affect payment services but also e-money (prepaid) products in the European market.

The amendments of the ECON-Committee to this important article and the accompanying Recital are only of marginal importance. As example for exempted products it added “parking ticketing” to the list of payment instruments in Recital 12 (instruments restricted to a narrow range of goods or services). The waivered payment instruments based on specific social or tax regulation (like social benefits cards, vouchers for lunch or household support) are now also listed explicitly in the extension of Article 3 k. Apparently it was assumed to be “safer” to have the exemptions in an Article and not just in the Recitals. But in general, the ECON Committee followed the proposal of the Commission by taking over uncritically its assumption of the existence of non-regulated “massive payment volumes” in the market.

Our Comment

In our Newsletter of January 2014 we doubted the existence of extended payment schemes with massive volumes in the EU Member States, operating under the exemption of the PSD I for limited networks. In its impact analysis the Commission was not able to deliver hard facts or concrete examples for its questionable hypothesis. The huge external study (about 650 pages) on the economic impact of the PSD I is completely silent on this issue. During the consultation and consent period, we have asked all of the MEPs who made amendments to Art. 3 about this topic. They were not able or willing to share their views about the existence of these massive payment volumes. They obviously trust the Commission. Are we hunting a phantom?

But there is another strange phenomenon. The formulation of amendments in the ECON reports to PSD II and Interchange-Regulation has been accompanied by massive activities of the lobbyists of the market stakeholders during the last months. Related to the limited network exemption of Article 3 k we do not see any activity of lobbying of representatives of the threatened huge payment schemes with massive volumes. What could be the reasons?

1. *These huge payment schemes are not existing, therefore their lobbyists are not existing (our speculation of the January issue of this newsletter) and small schemes do not have a powerful lobbying vehicle,*
2. *These payment schemes are happy to become regulated (benefitting from increasing consumer trust, European “passporting” of their services etc.),*

3. No awareness of the threat due to the assumption of being out of scope.

In our January issue of this newsletter we opted for the first explanation. The second explanation is an optimistic regulator´s view, which is not in line with the views of the entities which are already or will become regulated. Let us consider the third explanation. The Recital 12 is not mentioning examples of the exempted products (store cards, petrol cards, public transport cards etc.). It is referring to these payment instruments as being only exempted if they do not develop from a specific-purpose instrument into a general purpose instrument. The consequence of the new article 3 k is a much more restricting reading of "specific purpose" which may include only a very narrow range of goods and services. The only payment schemes listed in Recital 12 with really massive volumes in Member States are the petrol cards. The payment volume of these cards in Germany is about 14 b € (5% of the total card payment volume). The usage options of these cards – besides filling your tank – are varied: car wash, car repair, coffee-to-go and other shop merchandises, toll etc. Still narrow enough after the implementation of the new PSD? Local supervisory authorities in several Member States are paying more attention to these card-based products. The regulation of the petrol cards could be on the hidden agenda of the Commission by amending the limited network exemption.

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