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Judgment of the European Court of Justice on Interchange Fee Regulation

(hg) On 7 February the European Court of Justice (CJEU) published its judgments in the two cases of American Express versus The Lords Commissioners of Her Majesty´s Treasury.[1] It is the first high-level court decision regarding the interpretation of the European Interchange Fee Regulation 2015/751 (IFR). Both cases are related to the question under which conditions a three party system (like Amex and Diners Club) should be considered as a four party payment card scheme (4PS) being subject to the IFR requirements for four party schemes (e.g. IF caps and access to the payment system). In its press release the CJEU stated:

"A three party card scheme involving a co-branding partner or an agent is subject to the same restrictions as those applicable to four party schemes with respect to interchange fees. However, the mere fact that a three party payment card scheme uses a co-branding partner does not necessarily mean that it is subject to the access obligation."

Our Comment:

Most of the American Express cards are issued in the EU by the UK-based American Express Services Europe Ltd. in a strict three party scheme structure (3PS), in which the scheme itself provides acquiring and issuing services. In some countries Amex cards are issued by local entities, joint ventures of Amex with banks or fully owned by Amex. Further we see a considerable number of co-branded portfolios (e.g. British Airways in the UK, Payback in Germany). In December 2015 the British PSR (Payment Systems Regulator) stated in a provisional draft paper, that Amex UK is considered as a 4PS at least for all its domestic transactions even if the card is issued in a pure 3P-structure (without involvement of a co-branding partner or an agent). Amex obviously did not agree with the PSR provisional decision. In May 2016 the UK High Court of Justice passed on the case (a reference for a preliminary ruling) to the CJEU with Amex as applicant and the UK Treasury, Diners Club and Mastercard as defendants.

Art. 1 (5) of the IFR says: *"When a three party payment card scheme licenses other payment service providers for the issuance of card-based payment instruments or the acquiring of card-based payment transactions, or both, or issues card-based payment instruments with a co-branding partner or through an agent, it is considered to be a four party payment card scheme."*

This definitional extension of a 4PS (Art. 1(5) and Art. 2 (18)) is (probably even after the CJEU judgement) open to different interpretations. The initial word "when" could be read as "in the situation where" with the consequence that only the portfolios issued by a licensee or in co-operation with an agent or co-branding partner are considered as cards of a 4PS (**portfolio-related interpretation**). This contrasts with the alternative interpretation that all the cards of the scheme are subject to the 4PS-related IFR regulations (**scheme-based interpretation**).

We discussed these different interpretations and their consequences in detail a few years ago in our Reports 7/8 and 9/10 (2015). From our point of view, the scheme-based interpretation of the UK regulator PSR was consistent with the IFR.

In the lawsuit, Amex provides the **co-issuing argument** as a new reading of Art. 1 (5). According to this reading of the article, the 4PS regulation will only be applicable if a co-branding partner or agent is actively involved as co-issuer of the scheme, based on a contractual relationship with the cardholder linked to the payment instrument. That's usually not the case. This strict interpretation was defended by Amex, Diners Club and the British Government (Treasury). By the way, the overall position of Amex was supported by the British authorities. There was no genuine dispute between these parties in the British High Court.

The CJEU rejected the co-issuing interpretation of Amex

The other litigation participants (EU Commission, Portuguese government, Mastercard) supported the broad interpretation with good arguments against the co-issuing interpretation. They argue, if the co-branding partner should be involved as issuer, this case is already covered by the first condition of Art. 5 (1) (licensed for issuing). Usually a card issuer should be licensed as a payment service provider. A co-branding partner is typically not a payment services provider. After analysing both the systematical and teleological interpretations, the CJEU rejected the co-issuing interpretation of Amex (Case C-304/16). According to Art. 1 (5), a 3PS with an arrangement with a co-branding partner or an agent should be considered as a 4PS, subject to all relevant regulatory requirements of the IFR, even if the partner or agent is not

involved in any issuing activities.

The question remains whether only the transactions with Amex cards issued in agent or co-branding partnerships or all transactions made by Amex cards in the EU are subject to the IF caps. The court does not address directly the issue of portfolio-based vs. scheme-based interpretation, but in the judgment there is a hint at the portfolio-related interpretation: *"As a consequence of those arrangements, a large number of transactions carried out by it might, depending on the answers given by the Court to the questions referred for a preliminary ruling, fall within the scope of Regulation 2015/751, pursuant to Article 1(5) of that regulation."* (No. 37 of the Judgment C-304/16).

Anyway, both interpretations will have de facto the same effect on the regulation of the interchange fees. The net remuneration of the scheme to the agent or co-branding partner (e.g. sales provision) will be considered as the compensation which is subject to the IF-caps. The transactions with these cards are IF-regulated card transactions. Even if the other portfolios of the scheme, which are strictly issued in a 3PS-construction, are subject to the IF-caps, it will have no effect. IF can only be regulated if the fees (broadly defined) exist. The reason for this broad IF definition is the creation of a level playing field for both scheme categories (4PS and 3PS) and their partners (licensed issuers and acquirers, agents and co-branding partners).

What are the consequences of this judgment for Amex and Diners Club (mainly issuing credit cards) and other potential 3PS in Europe?

- The partner provision is limited to 0.3% of the sales transaction volume within the EU generated by the credit card portfolio where the partner is involved (agent or co-branding).
- The transactions of these cards cannot be surcharged by merchants according to Art. 62 PSD2.
- Today, co-branding partners of the 3PS are able to pay higher incentives to cardholders (rewards, cashback etc.) than partners of 4PS. An example in the German market: A Visa-Payback cardholder (annual fee 29 €) gets a bonus of 0.2% of its sales volume, an Amex-Payback cardholder gets 0.5% (no annual fee). These incentives, considered as having an equivalent effect to IF, will be equalized as a consequence of the cap on the partner provision.
- The acquirer (3PS scheme) should offer unblended service charges to its merchants by specifying the IF (partner provision fee) for transactions made by cards of the relevant portfolios.
- Article 7 of the IFR, which is not applicable to pure 3PS, will become relevant: separation of payment card scheme and processing entities.
- The schemes should offer payment service providers access to their payment systems according to Art. 35 (and Recital 52) of the PSD2.

The latter point was the subject of the second judgment of the JCEU (C-643/16). Card schemes operated by a single payment service provider or *"composed exclusively of payment service providers belonging to a group"* like 3PS are exempted from the access requirement. According to Recital 52 (PSD2), the exemption doesn´t apply if the 3PS operate as de facto 4PS by relying on agents or co-branding partners.

A 3PS that makes use of an agent for the purpose of supplying payment services is subject to the access obligation.

However, the access to payment systems is in general restricted to authorized or registered payment service providers (PSP). Logically, the CJEU stated that if a co-branding partner is not a PSP, it is not subject to the access obligation. On the other hand, the agent mentioned in the context of the extended 3PS is according

Amex and Diners should become "normal" 4PS, like Mastercard and Visa.

In our opinion, this conclusion is premature.

to the CJEU an agent as defined in the PSD: *"a natural or legal person who acts on behalf of a payment institution in providing payment services"* (Art. 4(38)). The agent could be a PSP or not. The CJEU stated that the role of an agent which is not a PSP can be treated as equivalent to that of a PSP. Therefore, a 3PS that makes use of an agent for the purpose of supplying payment services is subject to the access obligation as being de facto a 4PS. Regarding the obligation to access and the requirement of separation of scheme and processing activities (which was not the topic of the judgment), the 3PS is obviously affected as a scheme (scheme-based interpretation).

What could be the consequences?

According to Art. 35 (PSD2) the scheme should offer rules on access to PSPs which are "*objective, non-discriminatory and proportionate*". After the publication of the CJEU judgments some legal observers conclude that all PSPs should have in principle the right to be licensed as issuer and/or acquirer of the 3PS, like Amex and Diners Club. These 3PS should become "normal" 4PS, like Mastercard and Visa, licensing banks and other PSPs as issuers and acquirers. In our opinion, this conclusion is premature. According to the IFR an extended 3PS (by agents or partners) shall be from a regulatory point of view considered as a 4PS. It does not say the scheme hat to become a 4PS. If the eco-system of a 3PS offers for example the option of external agents for providing payment services in card issuing, the scheme will be obliged to give regulated or registered PSP the right in a non-discriminatory way to act as scheme agent too.

Partnerships for co-branding and the utilization of agents in card issuing are not an exception in the Amex scheme. In order to establish a level-playing field, the scheme-based interpretation (vs. portfolio-based interpretation) is not only obvious in terms of the literal text, but also justified from a market perspective.

However, let us imagine an European wide 3PS with millions of cards issued in a strict 3-party construct and only one very small card co-branded portfolio issued on the edge of the imperium. The small portfolio will infect the whole scheme to be subject to the 4PS-requirements. What could be the rationale of the regulator behind this intention? The CJEU judges are silent.

Finally, to make us smile an excerpt from the Advocate General's Opinion:
"*Albeit at the risk of repeating what I have said earlier, I shall point out that the aim of the Regulation was to limit the passing on to consumers of costs generated by card payments, the main such cost being interchange fees.*"[2]
There is no doubt: the consequence of the rebalancing of the total costs of a card system by the IFR from the acquiring to the issuing side is passing more costs to the cardholder-consumer.

SCA & remote payment transactions: still without clarity

(hg) After a long and winding process, the RTS (Regulatory Technical Standards) for implementation of Strong Customer Authentication (SCA) requirement of the PSD2 seems to be finally agreed as a compromise between EBA, Commission and European payment industry. It is common with compromises that nobody is really happy. Besides some exemptions proposed by the EBA, the requirement for SCA is in general applicable to all electronic payments transactions initiated by the payer at the physical POS or in Ecommerce (Art. 97 PSD2). However, electronic "remote" payment transactions should include "elements which dynamically link the transaction to a specific amount and a specific payee" (Art. 97 (2) of the PSD2). Dynamic linking could be realized e.g. by a one-time PIN. Therefore the definitional delimitation "remote" versus "non-remote" is essential for SCA implementation and for claiming the exemptions based on risk analyses. However, the legal PSD2-definition of a remote payment transaction is open to different interpretations. It should be the task of the EBA to paraphrase the equivocal definition. In the EBA documents (discussion and consultation papers and the final draft of the RTS on SCA[1]) a clear definition is still lacking. In our last Report (10/2017) we discussed some consequences of this shortcoming.

Our Comment:

According to Art. 4 (6) of the PSD2 a 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 contactlessly (e.g. NFC) a device that can be used for a distance communication? Is every transaction generated by a mobile phone a remote payment transaction?

Answers can be found only in a deductive approach, combining several statements of the EBA. In its Final Report on Draft RTS on SCA and CSC (Feb. 2017, p. 38), the EBA gave us some examples of remote transactions: "*an online payment or payment via a mobile device*". Here, online payments are probably transactions initiated via internet. For card-based payments the EBA mentioned card-not-present transactions (CNP) as remote payments. Some further guidance is given through the introduction of the SCA exemptions for remote payments in EBA´s final draft of November 2017 (p. 2-3): one covering transaction-risk analysis (Art. 18) and the other on low-value payments (below 30 Euro) in Art. 16. That means in reverse, that the other listed exemptions (related to "proximity" payments) could be considered as being non-remote.

Therefore contactless payments at point of sale (Art. 11) and at unattended terminals for transport fares and parking fees (Art. 12) are non-remote. In the EBA guidelines on fraud reporting under PSD2 (EBA-CP-2017-13), the required data for these two segments are logically classified in the category "non-remote payment channel". Here, the EBA implemented the request of Recital 96 of the PSD2 to exempt low value contactless payments at the point of sale, "*whether or not they are based on mobile phone*".

What is a point of sale? Usually we are thinking about physical terminals in a shop of a merchant. However, EBA doesn´t say "physical POS" or "terminal" like it does in Art. 12 (unattended terminals). According the definition of the Interchange Fee Regulation (2015), a

POS could be the physical premises of the merchant or its address in the case of distance sales. Are contactless payments outside a physical POS environment included? What about contactless payments using two mobiles or other devices in a P2P constellation without sales?

Contactless payments are not defined - neither in the PSD2 nor in the EBA documents. A reference by the EBA to the sound and clear definitions of "mobile and card-based contactless proximity payments" of the ERPB (Euro Retail Payments Board[2]) would be helpful. Here contactless is per definition a proximity payment based on communication between two devices operating at "very short ranges". This proximity technology could be NFC, QR codes, BLE, etc. Payer and payer (and/or their devices) should be in the same physical location. By using the wider term POI (Point of Interaction), including vending machines, ATM etc., the ERPB doesn´t limit contactless payments to POS, which makes sense.

One can draw the conclusion that payments based on proximity technology are non-remote.

Contactless proximity payments could be generated by cards, mobiles or other devices (e.g. wearables). Consequently, one can draw the conclusion that payments based on proximity technology are non-remote. However, the POI ("terminal") of the merchant (payee) should be somehow technically involved in the authorization process and in the initiation of the back-office payment processing.

The involvement of the terminal seems to be the requirement for non-remote transactions in the opinion of the German competent authority BaFin. Does it agree with the opinion of the EBA? We don´t know. Therefore, we asked EBA.

In its answer, the EBA referred to the examples of remote payment transactions as mentioned in its Final Report on the draft RTS on SCA and CSC of February 2017, which is not helpful (see above). Regarding the interpretation of the PSD2 definition of a remote payment transaction, EBA says it is not in a position to respond to such queries. We should ask the Commission. We asked the Commission, but have still received no answer.

In our understanding, it is EBA´s role to translate such definitions made at the political level into regulatory practice in order to create a harmonized market place. Have we misunderstood something or is it rather a consequence of the recently troubled atmosphere between EBA and Commission regarding competency issues with regard to the SCA regulation? Finally the EBA comforted us with the announcement of the extension of the existing public Q&A tool to the PSD2, whose implementation is still lacking resources. We will probably have to wait a bit longer.

Maybe a recital of the PSD2 could give us some further guidance. Recital 96 stated:

"Payment services offered via internet or via other at-distance channels, the functioning of which does not depend on where the device used to initiate the payment transaction or the payment instrument used are physically located, should therefore include the authentication of transactions through dynamic codes..".

For a non-remote payment transaction, which doesn´t require a dynamic linking, the requirement of the physical presence of the device or payment instrument of the payer (card or mobile) at the POI (?) seems to be essential. However, it deviates from our conclusion above that the involvement of the payee´s terminal is the crucial element to distinguish being remote or non-remote.. Just a quibble?

Today, contactless proximity payments are generated by an interaction of two payment devices, hardware and software physically present at the same location.

Let us think about the near future of cashierless stores based on "just walk out" technology. In January 2018 Amazon opened a futuristic supermarket without checkouts in Seattle ("Amazon Go"). After identifica-

tion by mobile (scanning the Amazon app) shoppers can take the products from the shelves. The content of the cart is checked by cameras and built-in electronic weighing scales. By leaving the store (without check-out lane or till) the amount due is paid in a traditional way through the Amazon account of the consumer. The German electronics retail chain Saturn is starting a checkout-free pilot in Innsbruck (Austria) in March 2018. Here shoppers have to scan the barcode of each product they want to buy with their mobile. The total amount has to be paid with a wallet app ("MishiPay") but without involvement of a Saturn terminal.

The physical presence of the mobile in the store is in both cases necessary to initiate the payment. After reading the Recital 96, the transaction could be classified as a non-remote payment. However, the BaFin would conclude: remote.

EBA, it is your turn!

Notes

1 See links in the Press Release No. 12/18 of the Court of Justice of the European Union, Luxembourg, 7 February 2018 (www.curia.europa.eu)
2 Opinion of advocate general Campos Sánchez-Bordona delivered on 6 July 2017 (Section No. 130)
3 See Regulatory Technical Standards on strong customer authentication and secure communication under PSD2; https://www.eba.europa.eu/regulation-and-policy/payment-services-and-electronic-money/regulatory-technical-standards-on-strong-customer-authentication-and-secure-communication-under-psd2/-/regulatory-activity/consultation-paper
4 The ERPB was initiated by the ECB in 2013 as replace of the SEPA council.

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