How the European Parliament can enhance the Commission’s proposal for a Regulation on interchange fees for card-based payment transactions

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1- Executive summary

There seems to be no point in debating the proposed Regulation from either an academic, economic or competition law perspective, at this stage. Rather, the proposed Regulation must be viewed as a political statement that first translates the regulator’s will to rein in the innovation capacity of 4-party card schemes presented as dominant, and second expresses a compromise between a dogmatic ban of interchange and a realistic approach of market requirements. This Position Paper hence responds to this political statement, making – after a few preliminary observations – a limited number of recommendations for enhancement, with the view of giving this Regulation a chance to produce acceptable market effects.

The proposed Regulation is about capping the per transaction interchange fee applicable to either a debit card or a credit card transaction in the EU, where both the payer’s and the payee’s payment service providers are established in the EU (in addition the Regulation proposal lays down a number of business rules applicable to these card transactions). The core of this proposal is thus about the level and scope of applicability of an interchange fee cap, and not about whether interchange is permissible, quite understandably as no Court in the EU or elsewhere ever found that card interchange fees restrict competition by object. Merely, the effect(s) of such fees can be discussed.

ESBG values confirmation that interchanges for card-based transactions are permissible. One shortcoming is however that the proposal caps interchange uniformly across transaction values, thus penalizing providers who’d wish to displace cash for smaller transactions (e.g. less than 30 EUR). To both keep that market open for new entrants and prevent a cross-subsidization of such transactions by higher value transactions a nominal fee (or a higher ad valorem fee) rather than an ad valorem fee should be allowed for transactions up to 30 EUR (the “low value transactions” as per the Payment Services Directive). A specific interchange fee applicable to low value transactions will ensure that not only the traditional incumbents offer innovative services in this critical market segment.

The business rules section of the Regulation proposal borrows substantially from the banking payment industry’s 2006 SEPA Cards Framework (“SCF”). As significant time elapsed since the latter was formulated, and as the then contemplated self-regulation is substituted by regulation,

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1 Theory and data have been used either way in support of the regulator’s, the demand side’s, or the supply side’s cause.
several of the dispositions taken over from the 2006 Framework require rebalancing to prevent unintended consequences.

This Position Paper\textsuperscript{2} formulates several considerations on the Regulation proposal, prior to explaining ESBG’s position on the interchange fee caps and the business rules chapters (and where relevant the related recitals).

\section*{2- Preliminary considerations\textsuperscript{3}}

2.1- Is the market for payments comparable with a market for goods or other services? The market for payments is finite, as payers will not – ceteris paribus - make more payments than they have individual debts (of whatever kind) to settle. A further use of any payment instrument will be by substitution of another payment instrument, the total payment instrument market remaining unchanged. Because of the still prevailing Member State nature of the payments market any such substitution will primarily impact the structure of payment instrument usage within a Member State. For the same reason, the ways in which a decrease in revenues and/or costs of a given payment instrument will – in addition to the observation above - impact a Member State’s payments market is a function of the structure of the supply (number and markets share of payment service providers, roles as issuers and/or acquirers of which payment instruments) and demand sides (number and market shares of retailers) of that payments market. In the absence of a market model integrating these variables (which cannot be found in the Impact Assessment) no single, EU-wide generic conclusion can be drawn on the impact of the Regulation proposal.

2.2- Is the “Tourist Test” the appropriate model to uniformly cap debit and credit card interchange fees across Member States and across transaction values? A benchmark is certainly required, but the applicability of the Tourist Test model across markets has never been established. This applicability\textsuperscript{4} is a function of notably the costs of payment instruments and current fee levels in each Member State – costs and fees which still vary considerably across the EU. In addition, applying a Tourist Test conclusion to online transactions, beyond physical point-of-sale transactions for which the reference is cash, is an experiment that may foster unintended consequences.

2.3- Can one safely assume that card interchange fees are on their own incentives or disincentives for merchants and retailers to accept a given payment instrument? The September 2012 European Central Bank Occasional Paper on “The social and private costs of retail payment instruments” finds that 75\% of retailers’ private costs for payments are generated in their back office – a situation

\textsuperscript{2}ESBG’s amendment proposals will be the object of a separate Position Paper

\textsuperscript{3}Please see ESBG’s January 2013 Position Paper: « 10 reasons why interchange must be allowed » - \url{http://www.esbg.eu/uploadedFiles/Position_papers/Ten\%20reasons\%20why\%20interchange\%20must\%20be\%20allowed.pdf}

\textsuperscript{4}Please see “Tourist Test interchange fees for card payments: down or out?”, Nicole Jonker and Mirjam Plooij, Dutch Central Bank, in Journal of Financial Market Infrastructure 1(4), May 2013
that no variation of a few basis points in merchant service charges will improve. The sheer size of these back-office expenses also means that retailers will have no incentive to pass on to consumers any savings from a reduction in merchant service charges (due to e.g. a reduction in interchange fees), but on the contrary every incentive to retain such savings and cross-subsidize their back-office expenses.

2.4- Surprisingly the Regulation proposal, in its Articles as well as in its Recitals, remains mute about fraud, the necessity for the supply and demand sides to cooperate in fighting it, and the role that supply-side constant research, development and operations play in combating it.

3- Regulating interchange fees (Chapter II)

The transparency-enhancing aim of the proposal to cap card interchange on a per transaction basis is well understood. To produce the intended effects this provision should be complemented by 3 dispositions:

4.1- With a single interchange cap (for either debit or credit card transactions) lower value transactions (in particular debit card transactions) will be subsidized by larger value transactions. This will prevent the development in particular by new entrants of innovative products to substitute cash for low value transactions (e.g. in the 1 cent to 30 EUR segment). This would be a much undesirable consequence as replacing cash in this segment is one of the outstanding payment efficiency challenges. To mitigate this, individual debit and credit card transactions of a value up to 30 EUR (i.e. the low value payment threshold defined in the Payment Services Directive/PSD2 proposal) should be subject to a maximum flat (instead of an ad valorem) interchange fee of 6 eurocents per transaction – the actual amount being set by the issuer. Of course each merchant/retailer will be informed about the fee(s) applying.

4.2- The proposed timeframe under Art. 4 for national debit and credit card transactions to comply with the Regulation (2 years) is too short to enable payment service providers to depreciate investments in infrastructure which have just been made, or which will have to be made to comply with the Regulation. A 4 year timeframe would allow for such depreciation.

4.3- The proposal in Art. 11 Steering rules is supported. However, in order for both the cap on interchange as well as the steering rules to produce the intended effects, a supplementary disposition should require merchants/retailers, where they choose to inform customers

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5 Evidence of such behavior:

- Member States that introduced VAT reductions generally cannot see such reductions being passed through by merchants to consumers.
- Partial evidence in 2011 and 2012 in the petrol retailer sector further to the implementation of the Durbin amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act suggests that petrol retailers alone are saving a billion USD a year on MIFs (funding no longer available to payment service providers for security enhancements and innovation), yet not passing any of these on to consumers.
about the interchange fees they pay, to also inform customers about the cost of the cash transactions they accept, and about the savings that interchange cap represent.

In addition “cash-back” transactions (or the cash-back portion of a debit or credit card transaction) should be exempt from the proposal’s dispositions on interchange. Any decrease in cash-back volumes will increase retailers and payment service providers’ costs of recirculating cash.

4- Regulating business rules

The Chapter on business rules borrows heavily from the Framework published by the banking industry in March 2006 – which could not be transposed due to competition legislation. That there are similarities between the SCF business rules and the Regulation proposal business rules does not imply that the latter can now be endorsed without debate. The market environment has changed significantly since 2006, and continues to do so. The SCF was developed in a self-regulatory environment, under the (with hindsight misguided) premise that it could be implemented by self-regulation. The effects of a Regulation proposal have to be pondered, in particular with respect to the development and evolution of standards.

Therefore the Regulation proposal calls for the following remarks:

- Art. 7.10 Separation of card scheme and processing entities: the Regulation proposal disposes that schemes and processing entities be independent in terms of legal form, organization and decision making, and that they shall not discriminate in any way between their subsidiaries or shareholders and users of these schemes and other contractual partners. Whilst there is no objection to this principle, there is concern that non-European schemes will not be compelled by these rules, thus enjoying a competitive advantage. How these rules would be enforced vis-à-vis de facto schemes and non-financial market participants is another open question.

- Art. 7.11: The Regulation proposal requires payment card schemes to allow for authorization and clearing messages of single card transactions to be separated and processed by different processing entities. Whilst scheme rules should not mandate that any particular provider of processing services must be used, for efficiency’s sake a same processing entity should not be prevented to authorize and clear any given card transaction.

- Art. 7.13: The Regulation proposal requires processing entities to ensure that their system is technically interoperable with other systems of processing entities through the use of standards developed by international or European standardization bodies. The reference to both international and European standardization bodies is welcome. The Regulation proposal should however acknowledge that much work has already been undertaken by the Cards Stakeholder Group, a multi-stakeholder group of private market participants, to align such standards and formulate implementation guidelines. Both the European Commission and the European Central Bank have been kept well appraised of the work of this Group, and are aware of the

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6 The very prototype of the « multi-stakeholder group » which is considered under te new SEPA governance. Members of the Cards Stakeholder Group (CSG) are representatives of payment service providers, merchants/retailers/wholesellers, schemes, vendors, processors
challenges of convergence, even for existing standards. An ample deadline should be provided for compliance with this disposition of the Regulation proposal.

- Art. 8.18: It is proposed that the choice of application always be the cardholder’s decision at point of sale. This is both unpractical (with the potential of generating check-out queues as customers fumbled to select one application) and fails to acknowledge technology developments (e.g. contactless cards, unattended terminals…).

- The wording of Art. 10 (24) with respect to the information to be displayed on “the website or other applicable electronic or mobile medium” should be reflected in the obligations in Art. 10.25 for issuing payment service providers as to their payment instruments.

- The Regulation proposal is mute regarding certification (including the SCF requirement that it is not to be provided by any scheme proprietary body) – unless one assumes that this is implicitly covered by the definition of payment card scheme (see Art. 2 (13): …and which is separated from any infrastructure or payment system that supports its operation.” The Regulation proposal furthermore remains mute with respect to notions such as mutual recognition or type approval. The Regulation proposal should acknowledge the industry efforts to establish (in constant liaison with the European Commission and the European Central Bank) a European card and terminal certification management board. Going forward certification should be separate from scheme management yet type approval may remain scheme-specific, provided this creates no hurdle to implement the principle of neutral processing.

- Art. 16 Review clause: the Commission’s report to be presented 4 years after entry into force of the Regulation should specifically conclude, through the consolidation of the results of regular market panels, whether the merchant/retail sector passed on to cardholders the savings from the proposed caps in interchange fees.

5- Remarks on several Recitals

Several Recitals are worthy of remarks (in the order of Recitals):

- Recital (27): If any restriction imposed by either card schemes or payment service providers on payees’ ability to steer payers towards the use of a specific payment instrument is to be lifted, then any restriction (whether legislative or regulatory) imposed on payees with the effect of not being able to refuse payment in cash must be removed too.

- Recital (12): There is no analysis as to the reason(s) for which existing legislation (including the stringent provisions of the Treaty) were unsuccessful to “redress this situation” i.e. the alleged persistence of high interchange fees and rules preventing e.g. banks from offering cross-border services or retailers from reducing payment costs. There is no explanation either as to why new legislation would succeed where the existing one failed.

- Recital (14): The Regulation proposal states that “the application of this Regulation is without prejudice to the application of Union and national competition rules” and that “it should not prevent Member States from maintaining or introducing lower caps or measures of equivalent object or effect through national legislation.” This challenges the rationale and objectives put
forth for this Regulation, namely on one side the necessity to establish legal certainty, on the other the further construction of the internal market. This contradiction must be addressed.

- Recital (21): The Regulation proposal’s statement that “in accordance with the principle of technological neutrality set out in the Digital Agenda for Europe, this Regulation should apply to card-based payment transactions regardless of the environment in which this transaction takes place, including through retail payment instruments and services which can be both off-line, on-line or mobile” must leave the reader in doubt whether the technological environment has been well understood: there would seem to be confusion between the authorization process to which a card transaction can be subject (either on-line or off-line), and the channels for such authorization, which may include mobile. Such confusion must be removed, as it would impact the interpretation of the scope of the Regulation proposal.

- Recital (24): the Regulation proposal that “restrictions on interchange fees only apply to payment cards that have become mass products” must be clarified in order to prevent interpretation. Regulation EC 260/2012 provides useful guidance with respect to the definition of non-mass products, which could be leveraged.
About ESBG (European Savings Banks Group)

ESBG: The European Voice of Savings and Retail Banking
ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,500 billion and non-bank loans of almost €4,000 billion (31 December 2012). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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Rue Marie-Thérèse, 11  ■  B-1000 Brussels  ■  Tel: +32 2 211 11 11  ■  Fax: +32 2 211 11 99
info@savings-banks.eu  ■  www.savings-banks.eu

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