Response to the European Commission's Green Paper on Payments

Towards an Integrated European Market for Card, Internet and Mobile Payments

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1. Executive Summary

The future of payments in Europe is of fundamental importance to the European economy, not only in terms of internal efficiencies but also in relation to integration with international flows of payments as retail payments become increasingly worldwide in their scope and application. This paper addresses a number of the issues raised by the EC Green Paper but we consider the following five to be of key significance.

1.1 Governance

This is critical to achieving outcomes that balance the interests and needs of all stakeholders. Consumers, public authorities, merchants, vendors and payment service providers all invest and participate in this sector of the economy. It is not appropriate to have a single interest group make policy, establish rules, set standards and set implementation deadlines which all other stakeholders must accept without having any input or authority. The EPC represents the European banking industry. Either membership of the EPC should be opened to all stakeholders or its current role should be given to a new truly representative body of which the EPC can be a member representing its banking members. This has been a major failing of SEPA and the key reason why its work has delivered bank-centric results. The SEPA Council and the CSG have been steps in the right direction but are not enough. Getting the governance issue right going forward is absolutely imperative.

1.2 Interchange

In the short to medium term there needs to be regulation of domestic and cross-border interchange fees for all card scheme products to keep these fees at reasonable levels and to monitor any attempts to avoid or circumvent the regulations. Competition hearings take too long, are fragmented, and subject to appeals and other delaying tactics. In the longer term, interchange fees should be eliminated altogether from all European payment schemes. They are not subject to the normal forces of competition and distort pricing at all levels of the payments chain. It has been established that card schemes can operate successfully and profitably without interchange fees. In countries where these fees have been reduced by regulation the cards market continues to grow and deliver benefits to all parties. No interchange fees should be permitted for any other payment types and should not be allowed or introduced for any new or emerging sectors of the payments market.

1.3 Cross Border Acquiring

Card schemes currently set their own definition of a cross-border transaction. We believe the EC should set the definition of a cross-border transaction so that it is standardised for all European card schemes. A cross-border transaction should be a transaction where any two of the acquirer, issuer and merchant are located in different countries. The cross-border interchange fees should apply to these transactions. This would result in all transactions where the merchant and the acquirer are in different countries attracting the cross-border interchange rate.

1.4 Co-badging

Co-badging should be mandatory for all scheme debit cards in Europe in a similar manner to the new debit card regulations introduced last year in the USA. This would give new debit card schemes an opportunity to grow their scale and reach and would assist in achieving the separation of card scheme governance and brand management from processing, settlement and other services, in line with SEPA requirements. Merchants should be given the choice of which brand to accept at the POI in order to reduce their cost of card acceptance. It is not appropriate for cardholders to make the choice when they may be completely unaware of the range of costs faced by the merchant, and where their choice may be influenced by incentives and rewards offered by issuers promoting the option which offers them the highest income.

1.5 Standards

The definition and implementation of technical and security standards should be based upon an international approach. A relevant international standard should be chosen as a base and then any necessary European variations can be discussed with the international standards body and incorporated into future versions to ensure that there is no divergence between the European and international standard going forward. This approach is essential to avoid having different standards around the world. Financial institutions and merchants operate their businesses internationally and wish to standardise their payments infrastructure to achieve economies of scale and drive down per-transaction costs. For example, it should be possible for a merchant to purchase a standard approved card terminal and install it at all their points of sale worldwide. This will take time to achieve in practice but the principle is critical and must be observed. This will also help Europe to integrate with the rest of the world for payments across borders, via the internet and on mobile consumer devices in the future.

2. Introduction

2.1 Background

This paper is a response to the European Commission Green Paper *Towards an integrated European market for card, internet and mobile payments* 11 January 2012. We are very pleased to see this initiative from the EC as it addresses some areas and issues that are very important for the future of the European economy.

TransAction Resources is a specialist payments and loyalty consultancy founded in 1994 and based in Australia. We have been involved in payments reform and regulation around the world since 2000 including Australia, Europe, UK, New Zealand and the USA. Our client base is primarily merchants and government departments internationally.

This report was commissioned by Shell as an expert contribution to the stakeholder consultation on the Green Paper *"Towards an integrated European market for card, internet and mobile payments"*.

2.2 Scope

We have responded to the issues raised in the Green Paper, although not necessarily directly to the specific questions asked. This response uses the same headings as the Green Paper so that our responses to specific issues raised in the Paper can easily be cross-referenced. Our comments are based upon our extensive experience across many countries and jurisdictions over many years.

Our comments apply to open loop payment schemes, such as schemes offering general purpose credit cards and debit cards, and not to closed loop systems such as store cards or closed loop gift cards and gift vouchers[1].

We would be happy to discuss any of the issues in this paper with the European Commission via a telecon.

3. Overview and Approach

Before addressing some of the issues discussed in the Green Paper we feel it is important to take a step back and look at the big picture. How has the payments market evolved, where is it going and how can we avoid repeating some of the problems that have arisen?

3.1 Card Payments

The card payments market has been dominated by banks and large financial institutions that are driven by the need to maximise profits for their shareholders. They do not operate within the payments space because they wish to provide a public service or utility. These large

[1] Open loop is a term used to describe payment cards that can be used at a wide range of merchants. These are typically scheme-branded cards such as Visa and MasterCard. Closed loop cards, by contrast, can be used only in a single store or group of stores.

institutions typically work well together and in most countries they exist in small numbers. In the USA, for example, where there are many thousands of financial institutions the large and influential card payment issuers and acquirers are relatively small in number. The top three US issuers represent more than 60% of the card issuing market[2]. These institutions have evolved their payments businesses largely within domestic borders and have established various means of protecting their market from external competitors.

The international card schemes, MasterCard and Visa evolved over time out of the need to co-ordinate card issuing, transaction processing and merchant acquiring both within domestic borders and then internationally. These organisations were run by their members, all of whom were card issuers. The policies and decision-making were inevitably issuer-centric and aimed towards maximising profits and growth opportunities for those members. In Europe, Europay was affiliated with MasterCard for international acceptance and eventually was merged with MasterCard.

In recent times, the card schemes have decided to move away from their traditional member model and become incorporated entities (except for Visa Europe which remains a member-based organisation). This has been a fundamental change and has changed the focus of the card schemes more towards growing their own revenue streams (primarily scheme fees) with perhaps slightly less emphasis on increasing interchange fees which flow to the issuers and not to the schemes themselves.

Financial institutions do not dominate the acceptance and point of sale processing of card payment transactions as this part of the payments environment is largely controlled by merchants. The merchants wish to accept as many forms of payment as possible and at the lowest possible cost. For many years the merchants accepted the status quo. However, over time, card transactions became an increasingly greater proportion of their total sales and the associated costs impacted their profitability. At the same time, many merchants began to understand some of the cost drivers, particularly interchange fees, but also scheme fees as well. As the competition between card schemes for issuers tended to push interchange fees higher over time, retailers and merchants began to negotiate with their acquiring institutions to get lower Merchant Service Charges (MSCs).

Eventually, the acquiring margin had been reduced to a fairly low level through competition but the underlying interchange fee(s) remained high. The interchange fee typically represents 80% or more of the MSC and for some large merchants it accounts for more than 95%. This led merchants to look for ways to reduce the interchange fees and the scheme fees in order to reduce their overall Merchant Service Charges. Our experience has shown that even the largest merchants are generally unable to negotiate reductions in either scheme fees or interchange fees.

The best results in reducing interchange fees to more acceptable levels have come through regulation where a sustained result can be achieved within a reasonable time frame and the regulator can monitor outcomes to ensure that the intended results are actually achieved. In some cases where interchange fees have been reduced, the card schemes have responded by increasing scheme fees or creating new fees to bypass the new regulations. This type of response must be continually monitored over time as financial institutions and card payment schemes naturally react to protect and grow their revenue base and profit margins. It is interesting that the Durbin legislation in the USA specifically prohibits any actions which are specifically designed to circumvent or evade the regulations.

The gradual migration of retail payments away from cash and cheques towards payment cards has effectively moved customer payment out of the realm of the public sector and into

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[2] Based on 2009 data from the Nilson Report 942, February 2010.

the private sector. Commonly used means of tender are now controlled by, and regulated by, organisations seeking to generate profits from those tender methods. Where bank notes, coins and cheques are exchanged “at par”, card payments are processed for a fee. Also, whereas cash and cheques are controlled by central banks, cards are controlled by for-profit organisations or by private sector membership organisations which are typically comprised of for-profit financial institutions.

The fees that are charged by the card issuer to the cardholder are largely transparent and subject to competitive forces. However, interchange fees are unseen and unknown by consumers even though they have an impact on the price of goods they purchase. As an advertising campaign by merchants in the USA and targeted at consumers stated: *"Interchange is the biggest credit card fee you’ve never heard of"*.

The fees that are charged by the card acquirer to the merchant have a component that is subject to competition (the acquirer margin) and a component which is not (interchange and scheme fees).

There are card schemes such as Interac in Canada and Dankort in Denmark that operate very successfully with no interchange fees and the European DG Competition survey of bank and interchange fees in 2006/07 found that in many EU countries the card payments market would be profitable for both acquirers and issuers without interchange. The “balancing mechanism” theory put forward years ago by Baxter has largely been discredited and most regulators now realise that interchange exists as a method of charging “rents” and keeping those rents away from the forces of competition. If acquirers charged fees to merchants that covered their costs and earned them a margin and if issuers charged fees and revolving interest to cardholders that covered their costs and earned them a margin, then interchange fees would not need to exist and full price transparency would exist on both sides of the “four party” card market (the card scheme itself is always a “fifth party” in these models).

In the short to medium term there is no reason why interchange fees, and scheme fees, should not be capped at a level that is determined by some reasonable process. The “price indifference” test applied by the EC is one example of such a process. In all the markets where interchange fees have been substantially lowered by regulation, the cards market continues to be robust, healthy and profitable. Competition cases take much too long and are potentially subject to an endless process of appeals and further litigation designed to delay the outcome. Regulation is a much more effective tool. Examples may be seen in Australia, New Zealand, Canada and most recently the USA. Ideally, interchange fees should eventually be eliminated from all payment systems to prevent price distortions and cross-subsidisation from occurring and to make all fees subject to the normal market forces of competition between PSP’s.

It is very important that the card payment model should not be repeated for emerging new payments markets and that interchange or equivalent “wholesale” fees should not be permitted to be introduced in those markets going forward. The payer’s chosen PSP can charge fees to the payer and the payee’s chosen PSP can charge fees to the payee. These fees will be transparent and subject to the forces of competition.

3.2 Governance

It is very important that a single interest group should not be permitted to dominate the policy-making or rule-making processes for the evolution of payments into the future. The Green Paper is correct in identifying governance as a key issue to be resolved in order to ensure that a fair voice is given to all stakeholders including consumers, public authorities, merchants, technology suppliers and payment service providers.

When a single interest group makes policy and rules, the outcomes naturally tend towards creating an environment that meets the needs and wishes of that particular interest group. This is normal commercial behaviour and the executives of those organisations are measured and rewarded according to their contribution toward the bottom line of their own organisation. Financial institutions do not have a monopoly on transaction processing systems, payments expertise, security expertise and payments innovation. Increasingly retailers, merchants and public authorities are investing in this sector of the economy and pursuing their own ideas and interests.

Retailers and merchants invest in card acceptance technology and secure card payment transaction processing systems. Larger merchants purchase their own infrastructure while smaller merchants often rent their technology from their acquirer. In both cases their cost of card acceptance exceeds the cost of the merchant service charge. In some cases card schemes have “mandated” the introduction of new technology and then merchants have had to replace infrastructure before its normal replacement cycle. These types of issues need to be debated and agreed by some representative governance body that has genuine power to create and enforce standards, policies and rules.

3.3 International Standards

The payments industry is a global business and corporations, merchants and consumers need to be able to make and receive payments across international borders. Consumers have traditionally made the majority of their purchases within their domestic market but this is changing rapidly due to increased shopping via the internet and also via increased travel and tourism worldwide.

Many larger retailers and merchants have operations in several countries located in different regions of the world. They should not face different standards and requirements in every market as this greatly increases the cost of card acceptance and prevents economies of scale from being achieved. A merchant should be able, for example, to purchase a type of card payment terminal and then install it at all points of sale worldwide. A merchant should also be able to invest in secure payment transaction processing systems and use them internationally as standard infrastructure.

This international scope of payments is critical and therefore Europe should adopt (and contribute to the development of) international approaches and standards wherever possible.

The internet has demonstrated the power of having an international standard in a manner that is quite dramatic. The World Wide Web has evolved at a speed and with a scope that is simply incredible. In the future, most payment transactions will take place over the internet with suitable layers of security wrapped around each transaction. Virtual private networks (VPN) exist to protect closed communities from being on the public internet. This is the type of approach that is needed to take the payments industry forward into the future.

Standards for message protocols, encryption, data security, secure hardware and user interfaces should be open, transparent and allow for input from all stakeholders. There are various bodies working on standards such as ISO 8583, ISO 20022, EMV and PCI security that aim to provide a platform or base for international use. It is very good to see the SEPA Cards Standardisation Volume embracing this direction and talking about interaction with the PCI Security Standards Council. This direction should also be followed for the emerging e-payment and m-payment sectors of the market.

3.4 Real Time Clearing

Cheques are a paper-based payment method and their use is declining steadily worldwide as lower cost and more convenient electronic forms of payment gradually replace them. However, the early need to process volumes of cheques between financial institutions led to the development of the Clearing House, a very significant piece of payments infrastructure.

Cheques are exchanged at par, with institutions charging fees to their customers for the cost of processing. Clearing houses charge a processing fee to cover their costs of providing clearing services and maintaining and developing their systems. These clearing houses traditionally do not charge interchange fees. A good example is the National Automated Clearing House Association (NACHA) in the United States. This operates in a similar manner to the Pan European Automated Clearing House (PEACH) in Europe.

Most countries also have a clearing system for bulk direct debits and direct credits and the SEPA Credit Transfer and the SEPA Direct Debit are recent examples of these types of payment systems. Financial institutions and Payment Institutions pay transaction processing fees to PEACH for each SCT and SDD put through the system.

This developed clearing system infrastructure has the potential to play a critical role in the future of payments worldwide. More and more consumers are using online banking and online bill-paying systems (such as BPAY in Australia) to make direct transfers of funds from their bank accounts to the account of a biller or a utility or even a friend. All that is required is the online banking application, access to the internet and the bank account number of the payee. These transactions occur rapidly and at comparatively low cost. Importantly, they all occur without any interchange fees, without any scheme fees and without the necessity for any payment cards.

However, most such clearing systems process their transactions in batches overnight. This means that the payee initiating a direct debit must wait until the next business day to discover whether there were sufficient funds in the payer’s account to cover the direct debit. In the modern world of high speed electronic payments and with computer systems that routinely process hundreds of transactions per second, this is an approach that is not suited to the future of payments processing. All clearing house organisations, including the PEACH, need to evolve their systems to allow on-line account balance inquiries and on-line direct credits and debits that occur in real time and deliver a Success or Fail response back to the initiator within seconds.

Payment Service Providers need access to real time direct clearing systems to allow them to process on-line payment transactions between the payer’s transaction account (wherever it is held) and the payee’s transaction account (wherever it is held). The PSP will pay a transaction fee to the Clearing House and will charge a fee to its customer. The two account-holding institutions will charge fees to their account holders if they wish to do so.

The establishment of this infrastructure will allow customers to initiate payments from a mobile device or via the internet (or both) or a card (such as a decoupled debit card) by authorising a direct credit from their preferred transaction account to the account of the retailer or merchant or any other party to which they wish to make a payment. This transaction will occur in real time and will not involve an interchange fee. Real time direct clearing will provide the competition to the international card schemes that Europe needs to develop going forward.

3.5 Access To Infrastructure

The Payment Services Directive (PSD) was passed by the European Parliament with the objective of increasing competition, increasing innovation and lowering payment processing costs across Europe. It aimed to achieve these objectives by harmonising laws across the Member States and by introducing a new class of entity, the Payments Institution, which would have lower prudential hurdles than normal financial institutions and would be able to compete on service and price across Europe from a base located in a single Member State.

Payments Institutions must be guaranteed direct access to payments infrastructure to be able to compete:

> *"It is essential for any payment service provider to be able to access the services of technical infrastructures of payment systems. However, access is subject to appropriate requirements in order to ensure system integrity and stability."* [3]

They must be able to pay the same wholesale fees that their financial institution competitors pay and they must have direct access to clearing and settlement systems so their competitors cannot act as “gateways” and price them out of the market. A Payments Institution cannot rely upon a competitor providing its key infrastructure or it will not be able to survive and its competitor will know a significant part of its cost structure and will also know its volume and turnover figures. This situation would be unacceptable and is certainly not going to help achieve the objectives of the PSD.

4. Response to Issues Raised in Green Paper

4.1 Multilateral Interchange Fees

As the European Commission has found, interchange fees directly impact the Merchant Service Charge (MSC) paid by merchants which, in turn, is passed on to consumers in the form of higher prices.

> *“A MIF effectively determines a floor under the merchant service charge and merchants are unable to negotiate a price below it. This can considerably inflate the costs of payment card usage at merchant outlets to the detriment of merchants and their customers.”* [4]

This problem is compounded because interchange fees are set by the card schemes **and merchants are unable to negotiate on the level of these fees** even though they are paying them. Many large merchants are on "interchange plus" pricing and therefore pay the interchange fee directly plus scheme fees and an acquirer margin.

For many years the international card schemes, Visa and MasterCard, have argued that interchange fees are necessary and that to interfere with the delicate balancing role they play via regulatory intervention will result in disaster. For example, MasterCard Worldwide states:

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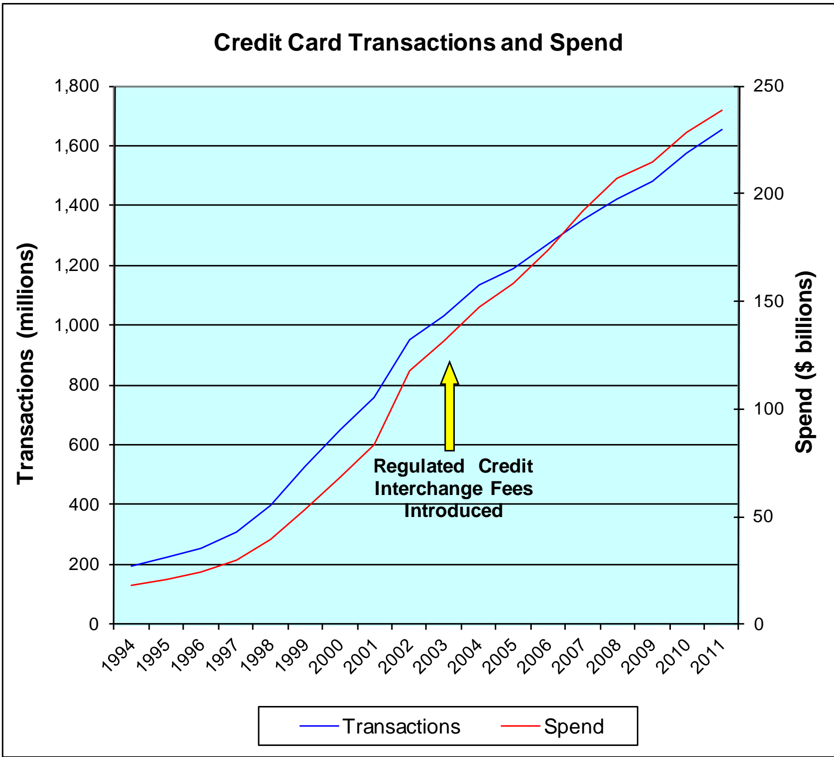
[3] Payment Services Directive, 2007/64/EC, p.10.

[4] *Antitrust: Commission prohibits MasterCard's intra-EEA Multilateral Interchange Fees*, European Commission, MEMO/07/590, 19 December 2007

> *"Setting interchange rates is a challenging proposition that involves an extremely delicate balance."*[5]

During the Reserve Bank of Australia's (RBA) review of interchange fees, both Visa and MasterCard argued that any interference in the setting of interchange fees would have disastrous effects on the card payment market. For example, MasterCard warned that any reduction in interchange fees would lead to reduced cardholder usage, which would lead in turn to fewer merchants accepting cards and would result in *"a death spiral process"*[6].

It is our belief that the experience of reduced interchange fees resulting from regulatory intervention across a wide number of countries has clearly demonstrated that this view is not valid. For example, in Australia, since interchange fees were first reduced by regulation in 2003[7], card usage (+113%), card spend (+111%) and cards on issue (+31%) have all risen strongly. Growth has continued uninterrupted by the introduction of lower interchange fees, as can be seen from the graphs below.



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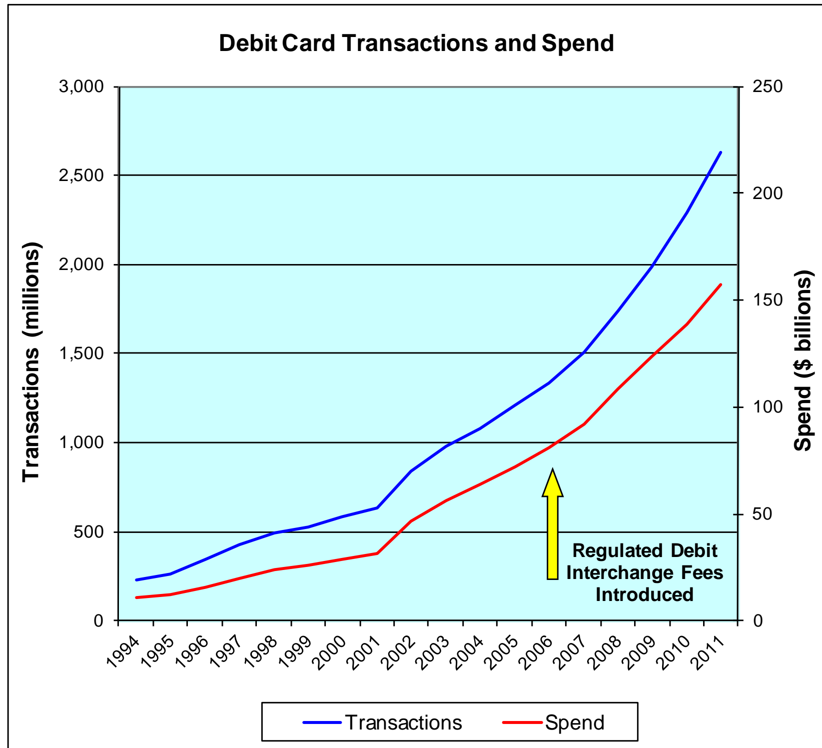
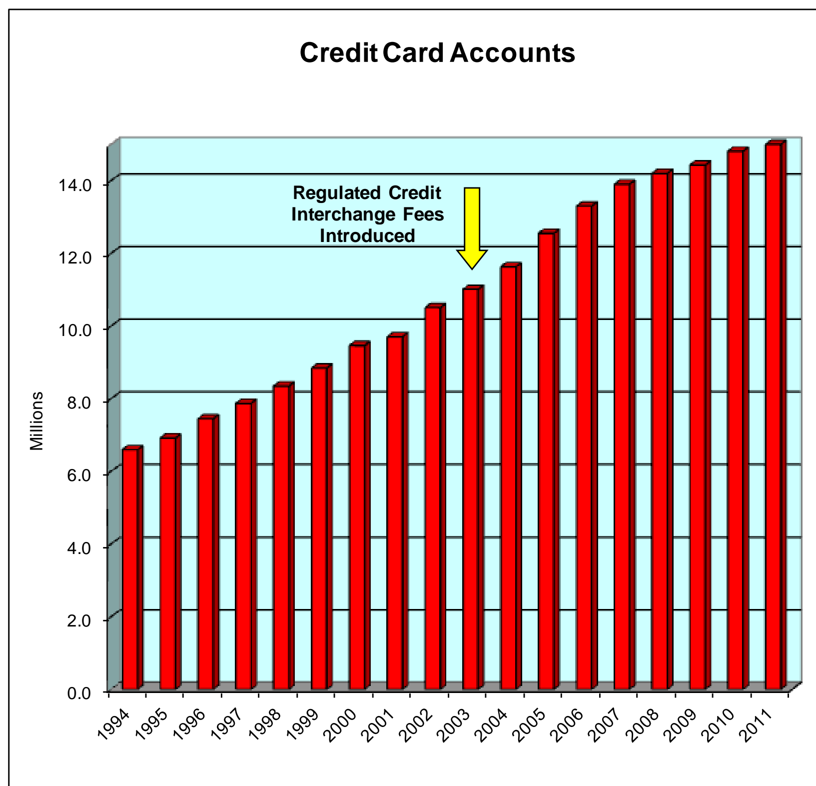
[5] *U.S. and Interregional Interchange Rates - Rates and Criteria Effective as of April 2011*, MasterCard Worldwide, p.4.

[6] *Submission to the Reserve Bank of Australia*, MasterCard International, 20 July 2001, p.10-11.

[7] Credit card interchange fee regulations were implemented in November 2003. This reduced the weighted average MIF from 0.95% to 0.55%. A further reduction in the credit card MIF to 0.50% was introduced in November 2006. Interchange fees for debit cards (both EFTPOS and Visa Debit) were also implemented in November 2006, reducing the Visa Debit MIF to a benchmark of $A0.12 per transaction while raising the EFTPOS interchange fees from an average of negative A$0.20 to a range mandated at between negative A$0.04 and negative A$0.05. A further revision to EFTPOS interchange fees was introduced in January 2010 which allowed for a MIF at the same level as Visa Debit (a benchmark of A$0.12 per transaction) in addition to bilateral interchange fees which remained at the same level. All interchange fee rates include Goods and Services Tax (GST) of 10%.





A more detailed discussion of the impact of interchange reforms in Australia can be found in our submission to the Federal Reserve Bank on the Durbin regulations[8].

8 Review of the Impact of Australian Payments Reforms, TransAction Resources, 22 February 2011. See www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67474_559255029499_1.pdf

In the jurisdictions where interchange has been reduced, we have seen no signs of negative impact on card usage.

Another traditional view held by card schemes and PSPs, particularly on the issuing side, is that interchange fees are necessary in order to provide income incentives for issuers to issue more cards. However, a study undertaken by the Directorate General Competition of the European Commission (DG COMP) into Payment cards in 2006/2007 shows that not to be the case. As part of this study, a survey was sent to a representative sample of 203 acquirers and issuers and 26 domestic and international payment card systems across the 25 EU countries. The evidence collected showed that

> *"card issuing would generate positive profits in 20 out of 25 countries even without interchange fee income."*[9]

The final outcomes of the study were released in January 2007 and concluded:

> *"Interchange fees appear to magnify the profits of card issuers. .... This exercise seems to partially invalidate explanations put forward by the industry that total system output would suffer if issuing were not subsidised through the transfer of revenues from acquirers."* [10]

There are a number of card payment systems around the world which have successfully operated for many years with no interchange fees. These networks often show impressive growth and usage and include, among others, Canada's Interac network, The Netherlands "Pinnen" system and the majority of New Zealand's EFTPOS network[11].

There are also some card payment systems that operate very successfully on "negative" or "reverse" interchange where the interchange fees flow from the issuer to the acquirer. In other words, the issuer pays the acquirer for each transaction rather than receiving income. These include, for example, ATM networks around the world (including Visa and MasterCard cards) and Australia's EFTPOS system[12]. In fact, EFTPOS accounts for more than 80% of debit card transactions in Australia despite being launched some two years after Visa Debit and despite the fact that issuers received no interchange income at all for more than 25 years.

These examples demonstrate that the absence of interchange fee income for issuers has not hindered cardholder usage nor merchant acceptance. Equally, the lack of interchange income has not stopped card issuers from issuing these cards in large numbers.

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[9] Interim Report I - Payment Cards, Competition DG, European Commission, 12 April 2006, p.11.

[10] Report on the Retail Banking Sector Inquiry - Commission Staff Working Document, European Commission, Directorate-General for Competition, 31 January 2007, p.127.

[11] In New Zealand, EFTPOS negative interchange fees are paid between ANZ and the "ETSL" banks, but for the majority of transactions there are no interchange fees. In all cases, issuers receive no income from EFTPOS interchange fees.

[12] EFTPOS interchange fees in Australia have traditionally consisted of a series of bilateral interchange fees averaging A$0.20 per transaction paid by the issuer to the acquirer. In 2006 the RBA regulated EFTPOS interchange fees to an average A$0.045 per transaction, but still paid by the issuer to the acquirer. Following further regulatory changes introduced by the RBA, EFTPOS introduced a MIF of A$0.05 for transactions above A$15 and a zero interchange fee for purchases below A$15. This has been gradually introduced from October 2011. Currently there is a mixture of bilateral interchange fees (with negative interchange fees) and multilateral interchange fees (with positive interchange fees).

It is our view from working with card payment systems all around the world for more than 20 years that interchange fees are not necessary and that payment card schemes have been successful irrespective of the presence or absence of interchange fees and irrespective of the direction in which they flow. We believe that cardholders should pay fees to PSP issuers, if appropriate, and merchants should pay fees to PSP acquirers and there should be no subsidisation of issuers' income by merchants via interchange fees.

A major problem we have experienced on many occasions is that merchants are unable to negotiate interchange fees despite the fact they effectively pay them.

We have conducted a number of pieces of work for various clients over the past decade seeking different ways to reduce the overall cost of card acceptance. This has included looking at ways to reduce direct costs brought about by the charging mechanisms currently being investigated, mainly interchange fees and scheme fees, in order to achieve this. While ways have been found to address internal efficiencies within the client, and we have been able to negotiate on the acquirer margin and consolidate acquirers where appropriate, the most significant cost savings can only come from the bigger cost elements such as interchange fees, and these have remained out of non-negotiable.

If interchange fees are to remain, a mechanism must be put in place to allow merchants to negotiate the interchange fees they pay. The Commerce Commission in New Zealand has had some success in this area, gaining acceptance from Visa and MasterCard that merchants must be able to negotiate interchange fees directly with issuers should they desire to do so. The New Zealand agreement also did away with MIFs for credit cards, with each issuer either posting a unilateral interchange fee or negotiating bilateral arrangements with other PSPs or merchants. While this solution may be suitable for New Zealand with a relatively small number of PSP issuers and acquirers, we do not believe it is suitable in the same format for a pan-European solution with its large number of issuers and acquirers. However, the principle of allowing merchants to meaningfully negotiate interchange fees with either schemes or issuers or both is valid.

To some extent, co-badging (as per the "Durbin" regulations in the USA[13]) allows multiple routing options to be available to merchants and the separation of card scheme management and rule-setting from card payment processing would help. However, these actions alone will not be sufficient to address all the issues associated with interchange fees.

It is our view that interchange fees for payment systems, including cards, should be eliminated. Interchange fees for payment systems are currently limited to cards. Cheques, direct debits and credit transfers, for example, typically do not have interchange fees. The important message in the context of the Green Paper is that the EC must ensure interchange fees have no role in e-payment and m-payment systems unless a card is used. Over time, the Commission should also progressively reduce and finally remove interchange fees from the card payment system. Interchange fees have no place in payments; they promote higher costs, incorrect price signals and inefficiencies in the overall European payment system.

However, while fees still exist for card payments, merchants must have the ability to negotiate any interchange or scheme fees they pay as well as having the ability to process any cards through alternative networks with alternative interchange fee structures operating under free market conditions.

[13] The Durbin Amendment is a term commonly used for Section 920 of the Electronic Fund Transfer Act. The legislation is part of the "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (HR 4173).

4.2 Cross Border Acquiring

Although cross-border acquiring has been allowed in Europe for more than a decade now, it has not had the impact that was expected and its progress has been constrained by a number of factors. Certainly the objective of a single market where cross-border transactions and domestic transactions occur at the same price and across the same infrastructure has not been achieved.

There are both pricing and structural impediments to more widespread adoption of cross-border acquiring. In reality, cross-border acquiring has been concentrated in the area of credit cards, due mainly to the domestic debit card programs having differing standards, protocols and message formats for their transactions in different countries. Many domestic debit cards have co-badging (i.e. they have a Visa or MasterCard brand as well as the domestic brand) which allows the card to be used in other countries where that domestic scheme does not operate. In principle, this would allow these cards to be processed under a cross-border acquiring arrangement using the international schemes' networks within the domestic market. However, the interchange fees and scheme fees for these international brands are generally higher than for domestic debit cards, thereby effectively precluding this methodology, particularly for large merchants.

As a practical example, we have a client who is one of Europe's large merchants for both credit and debit cards, with retail outlets in most countries across Europe. This company embraced cross-border acquiring, commencing in 2001, and remains committed to it. However, despite much effort by both itself and its PSP acquirer, 10 years later it has only five countries operating under this central acquiring model and only for credit cards. The case for adding other countries is simply not commercially viable at present.

There have been a number of attempts over the years to introduce a pan-European debit card scheme, such as Euro Alliance of Payment Schemes (EAPS), Monnet and Payfair, but to date none of these have made much progress. A European debit scheme with common standards across all countries would certainly help facilitate cross-border acquiring.

If Europe is to be treated as a single payments market, then there is no justification for different MIFs in different countries. DG COMP in conjunction with Visa and MasterCard has agreed cross-border MIFs for both credit and debit cards. It is hard to see why any domestic MIFs should be higher than these cross-border fees. Further, cross-border acquiring, by definition, involves processing transactions across borders, so it seems entirely appropriate that the cross-border MIFs should apply to cross-border acquiring. As the SEPA Cards Framework states:

> *“A SCF compliant card scheme is a scheme that allows unbundling of functions whilst applying the same pricing per card product to national Euro and SEPA transactions of the same type."* [14] *(emphasis added)*

At present, the card schemes are allowed to define what comprises domestic and cross-border transactions. Currently, the card schemes define a domestic transaction as one where the cardholder and the merchant are located in the same country, irrespective of where the acquirer is located and irrespective of whether the transaction is actually processed "cross-border". **We recommend the EC define a cross-border transaction within Europe as one where any two of the issuer, acquirer or merchant are located in different countries**. This would allow the same definition to be applied across all schemes across the whole of Europe, irrespective of whether they are domestic, pan-European or

[14] SEPA Cards Framework, Version 2.1, European Payments Council, 16 December 2009, p.15

International schemes and the cross-border interchange fees would apply to all transactions where the merchant and the acquirer are located in different countries.

We recommend that in the short term cross-border MIFs be used for cross-border acquiring. Further, all domestic MIFs should migrate to the same level as the cross-border MIFs in line with the SEPA vision. Ideally, interchange fees should eventually be eliminated altogether.

4.3 Co-badging

A major benefit of co-badging is that it potentially allows alternative routing options to be employed by the merchant. This has been a key focus of the "Durbin" legislation for debit cards in the USA where it has been mandated that issuers must allow every debit card they issue to be able to be processed on at least two non-affiliated networks and there must be no restrictions on merchants as to which network they choose for routing a debit card transaction, providing the network is able to process the transaction. The relevant wording of the legislation is as follows[15]:

> *"... an issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to -*
>
> *(i) 1 such network; or*
>
> *(ii) 2 or more such networks which are owned, controlled, or otherwise operated by -*
>
> *(I) affiliated persons; or*
>
> *(II) networks affiliated with such issuer."*

<u>and</u>

> *"... an issuer or payment card network shall not, directly or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, inhibit the ability of any person who accepts debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions."*

It is our view that similar regulations should be put in place in Europe. In other words, **co-badging of debit cards should not be optional, it should be mandatory**[16]. This would allow merchants to choose the network/scheme with the lowest interchange fees and/or scheme fees. It would also support the aim of SEPA and the SCF to unbundle the processing from the scheme branding and administration by allowing alternative routing options to be used by merchants.

> *"The principle of the separation of scheme management functions from processing, which is one of the key requirements of the SEPA Cards Framework (SCF), is an important element in the creation of a competitive payment cards market in SEPA.."* [17]

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[15] The full legislation can be found at www.sec.gov/about/laws/wallstreetreform-cpa.pdf. The "Durbin Amendment" runs from p.693 to p.699.

[16] This recommendation applies to general purpose credit and debit cards; it is not intended that this should apply to closed loop cards such as store cards.

[17] SEPA Seventh Progress Report, Beyond Theory Into Practice, October 2010, European Central Bank, p.24..

Importantly, such a move would increase competition and would allow merchants to reduce their card processing costs, resulting in turn in lower prices to consumers. **It is important that the decision on which payment processing network is used should lie with the merchant and not the consumer**. If the decision lies with the consumer, it allows issuers to provide incentives to cardholders to use the card brand (and, consequently, often the routing network) which provides the maximum income to the issuer. Such an outcome is typically more expensive to the merchant and is likely to result in lower efficiency in the payments market.

In fact, this was one of the key drivers behind the Reserve Bank of Australia's (RBA) payment reforms. The RBA was concerned that issuer incentives were resulting in cardholders using more expensive payment instruments to the detriment of the efficiency of Australia's overall payments system.

> *"The price signals facing consumers choosing between different payment instruments do not promote efficient resource use in Australia's retail payments system."*[18]

and

> *"... the price signals facing consumers choosing between different payment instruments would continue to encourage the use of credit cards, a relatively costly instrument, over less costly alternatives that provide similar transactional benefits. ..... The consequences of these inefficient price signals for total payments system costs are substantial."* [19]

As an example of this issue, the large majority of scheme debit cards in Australia are co-badged as EFTPOS cards. We know of merchants in Australia whose MSC on a scheme debit card is an ad valorem charge[20] which can cost up to 5 times more than if the transaction is processed via the EFTPOS network which has a fixed fee per transaction. The merchant must have the choice of using the lowest cost network to process a transaction.

Mandating that merchants have the choice of multiple routing options for any given transaction would have a substantial and beneficial impact on the efficiency of Europe's payments systems while, at the same time resulting in lower prices for merchants and consumers. With the right regulations in place, compulsory co-badging is an ideal way of achieving this.

Some schemes have compulsory reporting on transactions which involve a co-badged card with their brand, even when their brand has not been used. This appears to be a clear breach of competition principles as it requires issuers to provide data on competitive transactions which could then be used against the network which originally processed the transaction and which is in direct competition. This practice should be banned.

The same principle must also apply to scheme fees. No scheme should be able to charge any fees on a transaction which has been processed via another network. EC regulations should be put in place requiring any schemes which currently have such a fee, even it is not currently enforced, to remove the fee.

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[18] Reform of Credit Card Schemes in Australia – A Consultation Document, Reserve Bank of Australia, December 2001, p.3.

[19] Ibid, p.13.

[20] While the interchange fees for card-present scheme debit card transactions in Australia are a per transaction fee, it is not uncommon for some acquirers to charge an ad valorem MSC, often having a single blended MSC for all credit and debit scheme cards.

4.4 Separating Card Schemes and Card Payment Processing

Schemes should not be able to mandate how a transaction should be processed or through which network. It is reasonable for schemes to require that the processing of a transaction meets industry security standards to ensure integrity of the payments network, but it is not reasonable that a scheme should be allowed to mandate which network is used.

We strongly support the aim of the SCF to unbundle the governance of schemes from the processing and settlement of transactions. If schemes are able to mandate that only their own payment networks can be used, it allows them to apply whatever fees they wish to that transaction, be they interchange fees, scheme fees or processing fees, without the threat of competition.

Visa and MasterCard are so ubiquitous that merchants must accept their credit cards or face the risk of losing significant numbers of customers. The same situation applies to domestic debit card schemes in many European countries. Thus, the choice of competing networks for processing payment transactions is crucial for merchants or they are held ransom on the fees that the card scheme imposes for its own network. This issue is discussed in more detail in sections 4.3 and 4.6.

As the Green Paper states, the SCF provides for separation between scheme management and processing but does not lay down specific arrangements. We believe that more detailed rules should be put in place spelling out exactly what is required of card schemes. Further, penalties should be put in place for non-compliance.

The separation of payment processing from scheme governance is not an issue only for card schemes, it also applies to e-payments and m-payments. Irrespective of the payment system, payment schemes must not be able to mandate particular networks for the processing of transactions and merchants must have a genuine choice of competing networks. Otherwise, schemes are free to charge whatever fees they choose and merchants are captive to their charges.

4.5 Access to Settlement Systems

Payment Institutions should have direct access to authorisation and clearing systems which are essential elements of processing infrastructure and form key components of the cost and timing of the payments business. Neither authorisation nor clearing represent a potential financial exposure for the other party and therefore do not require specific prudential requirements for direct participation.

Parties to a settlement system usually participate in daily net funds transfer with each counter-party and therefore must be subject to reasonable prudential oversight and capital and liquidity management requirements. These requirements should be scaled according to the volume and type of payments business being conducted by the PSP concerned.

If the PSP is unable to meet reasonable prudential requirements, then they may have to participate in settlement via a third party sponsor or gateway provider. These third parties may often be competitors and therefore should not be permitted to charge fees that do not reasonably compensate them for costs incurred and a reasonable margin. These fees should not be allowed to penalise the indirect participant and place them at a severe cost disadvantage in the market.

The third party or "interface" institution should also not be permitted to maintain historical statistical data, beyond that required for settlement purposes, in order to prevent them from gaining a detailed picture of the state of their client's business activities.

It is anticipated that the majority of Payment Institutions will meet prudential guidelines and will be responsible and accountable participants in settlement systems.

Another alternative may be to establish a "second level" settlement system for non-FIs to participate in with different rules and financial limits. This may offer a way for Payment Institutions to participate directly while quarantining them away from the high value settlement system used by financial institutions.

The idea of establishing a common card processing framework for Europe has considerable merit if it can be mandated and enforced. Too many of the SEPA documents seem to be self-regulatory and adopted only voluntarily with no penalties for non-compliance. If such a framework can be developed with strict compliance criteria, then it could be extremely valuable to open the market to more competition.

4.6 Compliance with SCF

There have been a number of problems with the SCF with most originating from the fact that it has operated under the control of the banking industry via the European Payments Council (EPC) rather than a representative body comprising all key stakeholders.

> *"The European Payments Council (EPC) is the coordination and decision-making body of the European banking industry in relation to payments. ..... The EPC consists of 74 members representing banks, banking communities and payment institutions."* [21] *(emphasis added)*

While a Cards Stakeholders Group (CSG)[22], which includes merchants, has subsequently been implemented, it is a case of too little too late. As the EPC states: *"The CSG is part of the EPC structure"*[23] and as such still reports through to the banking industry. It is also limited in its scope with a focus on the Cards Standardisation Volume and is not involved in other strategic issues such as the SCF itself, interchange fees or other pricing and structural issues.

It is worth revisiting the SEPA vision, under which the SCF was formulated:

> *"The Commission and the ECB see SEPA as an integrated market for payment services which is subject to effective competition and where there is no distinction between cross-border and national payments within the euro area. This calls for the removal of all technical, legal and commercial barriers between the current national payment markets."* [24] *(emphasis added)*

Based on the SEPA vision, the SCF has defined what is required in order for a card scheme to be SCF compliant:

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[21] See www.europeanpaymentscouncil.eu/content.cfm?page=what_is_epc

[22] The CSG comprises representatives from five sectors - Retailers, Vendors, Processors, Schemes and Banks.

[23] EPC establishes the Cards Stakeholder Group, EPC Newsletter, 30 September 2009.

[24] Joint Press Release on SEPA by the EC and the ECB, 4 May 2006.

> *"SCF-compliant schemes must operate in such a way that there are no barriers to effective competition between issuers, acquirers, and providers. They have to meet SCF compliance requirements by offering:*
>
> - *Transparent and non-discriminatory access criteria for banks and payment institutions*
> - *Robustness of card scheme contracts*
> - *Transparent card schemes pricing structures without cross-subsidisation between issuing and acquiring services*
> - *An open business model in terms of reachability and adherence*
> - *Operational quality benchmarks*
> - *Unbundling of scheme governance, processing and other functions"* [25] *(emphasis added)*

From a merchant perspective the underlined points above are of particular importance as they directly impact their cost of card acceptance and in turn the prices of their goods to consumers.

Unfortunately, some schemes have declared themselves to be SCF compliant even though they do not meet all of the above criteria. For example, Visa has stated it is fully SCF-compliant even though it has interchange fees which are clearly a "cross-subsidisation between issuing and acquiring services".

> *"As an indication of this commitment, we became fully SCF-compliant at the start of 2007 – a full year ahead of the deadline."* [26]

Given Visa's statements on interchange in the same report, it is difficult to imagine that it will ever meet all the SCF criteria:

> *"We regard interchange as absolutely fundamental to the day-to-day functioning and future development of card payments."* [27]

We queried the EPC regarding the difference between claims of SEPA compliance by schemes and the stated requirements some two years ago. While the EPC understood our concerns, we were told this was a "grey" area and that in any case there were no penalties for non-compliance by schemes so there was little it could do. This is entirely unsatisfactory. If a scheme claims to be SCF compliant then, as per the rules, it must be required to meet all the criteria. Penalties should be put in place for non-compliance and for misleading statements about compliance.

Both the SEPA vision, with respect to the cards market, and the SCF requirements are still some way from being realised. As Gertrude Tumpel-Gugerell of the ECB has said, there are a number of major issues still outstanding.

> *"A number of tasks that I have highlighted on other occasions before [in relation to the business rules for SEPA for cards] are still outstanding:*

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[25] Shortcut to the Cards Framework (EPC345-08 version) 1.0, European Payments Council, 2010.

[26] Visa Europe Annual Report, 2007, p.10.

[27] Visa Europe Annual Report, 2007, p.11.

- *the effective separation of scheme management from processing entities in order to overcome barriers to entry and to contribute to fairer and greater competition between card schemes, as well as between processors;*
- *the charges or reporting requirements that some schemes impose on issuers and acquirers for transactions carried out with cards bearing their brand, even if it was not used in the transactions;*
- *the setting of the brand that will be used at terminals, without giving the retailer and/or cardholder any choice; and*
- *the rule that in cross-border transactions, it is always the interchange fee of the country of the merchant that applies."* [28]

It is our view that the SCF has had nowhere near the impact that was hoped for in terms of reducing costs for merchants and consumers, of providing consistent pricing on card transactions be they domestic or cross-border or in providing any real-world separation of scheme management from processing entities.

It is vital that these deficiencies are rectified for the cards market, and that these mistakes are not replicated in the fields of e-payments or m-payments. For all payment systems, any bodies responsible for the development and/or implementation of guidelines, strategies or standards must be representative of <u>all</u> stakeholders and not just the banking community. A number of our merchant clients process significantly more card payment transactions than many EPC members and have invested significantly more in transaction processing infrastructure, and yet they are not permitted to be members of the EPC which is responsible for development and oversight of the SCF.

Either the EPC should be reconstituted to be representative of all stakeholders or a new representative body should be created with responsibility for the SCF and other payments frameworks. If the EPC remains a European banking industry body, it would be one member of that new body.

4.7 Information on the Availability of Funds

If Payment Institutions do not have a direct and timely method of checking the current balance of a consumer's nominated transaction account, then they are at a significant disadvantage compared to other financial institutions which are able to do this. There needs to be an online end-to-end transaction process which allows balance inquiries, direct debits and direct credits to be completed within a few seconds. It is not reasonable to have to wait until the next business day to determine an account balance or to have a payment transaction complete.

It is also important for the consumer to be able to check their account balance at any time and be confident that there are not a number of debit or credit transactions that have been initiated but not yet processed. If this was the case, then the account balance would not be correct because it would not be up-to-date. In an era where high availability computer systems are capable of reliably processing hundreds of transactions per second there is no reason why this cannot be achieved.

[28] Speech by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB, at the Monnet Symposium organised by The Monnet Project, Madrid, 5 May 2010.

It may be that the current SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD) schemes can be enhanced to include real-time transaction processing in order to make this type of transaction a reality in a reasonable timeframe. Financial institutions already have computer systems that do real-time account balance checks for debit card payment transactions and therefore the necessary internal infrastructure is available.

A real-time direct clearing infrastructure would open the opportunity for consumers to make payments directly from their preferred transaction account as an alternative option to using a traditional payment card. It would also give Payment Institutions the opportunity to offer bill payment services and other payment services to consumers where the consumer pre-registers their transaction account details with their PSP. The consumer then does not have to give any account details at the time of making the payment; they just select the account they wish to use, verify the amount and authorise the transaction. The success or failure of the transaction can be communicated back to the consumer immediately and this would be reflected in the new account balance.

The ability for PSPs to be innovative and to offer retail payment alternatives to the current card payment approach will be very important in the future to bring more options to consumers and to create some competitive pressure on transaction pricing to both merchants and consumers.

4.8 Dependence on Payment Card Transactions

The retail industry is heavily dependent on cards with card payments making up more than half of all purchase value for most retailers. In some industries this figure is even higher. For example, department stores frequently have between 70% and 80% of their purchases paid by card. Typically more than 70% of service station sales are now paid by card, although this will vary from country to country and can be higher than 90% in Scandinavian countries.

A retailer that does not accept American Express, MasterCard or Visa cards would be at a severe competitive disadvantage and, in many cases, would simply not have a viable business. The card schemes are well aware of their market power and rely upon it to support many of their pricing and rule-making decisions.

Given the high level of reliance on card payments across the retail sector, it is reasonable that some form of oversight and control of restrictive rules are put in place. The Honour All Cards Rule is one example of this, particularly the Honour All Products element of this rule. This is discussed in more detail in Section 4.10

4.9 Consumer - Merchant Relationship

This subject in the Green Paper principally concerns issues around rebates, surcharging and other steering practices. These issues are controlled by scheme rules which in turn are mandated on merchants via the contracts they have with acquirers. These issues have been discussed in detail under the Merchant-PSP relationship (Section 4.10). The issue of transparency and price signals to consumers is also discussed in Section 4.3 (Co-badging).

Merchants should be free to inform consumers about the various fees they pay, be they MSCs, interchange fees or scheme fees and any scheme rules or merchant contracts prohibiting this practice should be banned. However, there should be no obligation on merchants to display this information. It could be administratively difficult, could be confusing for consumers (particularly with merchants on interchange plus arrangements where they

would have to display a wide range of fees) and costly for merchants to implement. The main things which will influence consumers are any additional costs (via surcharging) or rebates they receive from merchants or incentives that they are offered by issuers. However, if a merchant decides to surcharge this must be notified to the consumer before they pay.

4.10 Merchant - PSP Relationship

Much of this section is actually not about the relationship between merchants and PSPs, but about scheme rules and practices, with the PSP merely being an intermediary. At present, in Europe, merchants only have a relationship with acquiring PSPs and not with issuing PSPs.

Our focus in this response is on the scheme rules that are discussed in this section of the Green Paper.

4.10.1 No Discrimination Rule (NDR)

The NDR prohibits merchants from directing their customers towards a particular payment instrument through surcharging, offering rebates or other forms of steering. Such a rule should be prohibited for all payment schemes. Merchants must have the ability to steer customers towards the lowest cost and most efficient form of payment for them.

The purpose of the PSD was to implement harmonised laws regarding certain payments elements across Europe. The PSD specifically allows merchants to surcharge on card transactions, but provides for Member States to forbid or limit surcharging *"taking into account the need to encourage competition and promote the use of efficient payment instruments"*[29]. Not all countries allow surcharging, which effectively defeats the harmonisation across Europe. Further, it appears there is no independent authority to evaluate whether the non-implementation of surcharging in those countries actually meets the criteria in the PSD. The ability to surcharge should be the right of all merchants in Europe, not just those in selected countries.

The Consumer Rights Directive states that surcharging is to be limited to the real cost of using a payment instrument. It is important in this context to remember that the cost of accepting a card payment is not confined to the MSC. Large merchants in particular often incur many other costs, which can include card terminal/PIN pad purchase and maintenance (or rental), consumables, terminal software and hardware upgrades, POS EFT software licences and management, transaction switching system purchase and operating costs, telecommunications costs, staff and help desk costs, and so on.

In countries where surcharging is allowed, some merchants have used their ability to surcharge as a lever to negotiate lower MSCs without actually surcharging customers. This is important as it is not reflected in surveys of how many merchants surcharge and how much they surcharge. The ability to surcharge can have a significant impact upon merchant price negotiations, as has been found by a number of our clients in Australia.

Surcharging is a complex issue and it is not intended to provide a detailed review in this paper. Further information can be obtained from a submission on this issue to the Payments

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[29] Payment Services Directive, 2007/64/EC.

Policy Board of the Reserve Bank of Australia which we prepared on behalf of Australian merchants in July 2011. [30]

In summary, merchants should have the ability to surcharge across Europe and it should be their decision whether or not they surcharge and on which payment types they surcharge.

4.10.2 Honour All Cards Rule (HACR)

We agree with the Green Paper's view that the HACR is in fact two rules - an Honour All Issuers Rule and an Honour all Products Rule. We do not have a problem with the Honour All Issuers Rule, providing the cost to the merchant is the same for all issuers. However, we have considerable concerns about the Honour All Products Rule.

Firstly, merchants should not be forced to accept high cost cards such as premium cards or corporate cards which have higher interchange fees than "standard" consumer cards. This would require card schemes to allow these different card types to be identified electronically, probably via separate BINs, and for merchants to have access to these BIN ranges. In Australia, when the Reserve Bank mandated changes to the HACR such that schemes could no longer force merchants who accepted their credit cards to also accept their debit cards (and vice versa), this was accompanied by a regulation that all scheme cards must be able to be visually and electronically identifiable as credit or debit cards and that these details must be provided to merchants on request. It would not be hard to extend this same philosophy to other card types with different interchange fees, such as premium cards or corporate cards.

As an example of the impact of higher interchange cards, we conducted a study of petroleum retailers in the UK in 2004 and found that the MSC for a typical credit card purchase at that time represented more than 60% of the gross oil company margin on a litre of petrol (ie before the service station’s operating costs are deducted).

For corporate cards, the situation was even worse. Retail service stations are key acceptors of corporate credit cards and the cost of accepting these cards was taking more than 80% of the gross margin. However, service stations were, and are, unable to reject these corporate cards if they wish to accept general consumer cards with the same brand. In these cases, the issuing PSP is receiving a significantly higher proportion of the margin than the service station itself.

Another issue is that the HACR forces retailers to accept a card which may be in direct competition with their own card. For example, many retailers now issue closed loop gift cards which can only be used in their own stores. Open loop gift cards issued by PSPs with card scheme branding not only compete against these cards but are typically considerably more expensive for the retailer. Retailers should be free to refuse to accept these scheme-branded gift cards if they wish.

A similar situation occurs with fuel cards. In many parts of the world, the international card schemes have fuel card products which attract corporate card interchange fees. These cards compete directly with the oil companies' own cards, yet the oil companies have no option but to accept them if they wish to accept other cards issued by those schemes. Again, these cards are substantially more expensive to accept than their own cards and with far fewer benefits for the oil company.

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[30] Response to Review of Card Surcharging, Australian Merchant Payments Forum, July 2011. http://www.rba.gov.au/payments-system/reforms/submissions-card-surcharging/australian-merchant-payments-forum.pdf.

A further concern is the requirement of card schemes that merchants accept not only all cards which currently carry that scheme's brand, but also any new card products that may be introduced in the future. This is regardless of the interchange fees or MSCs that may apply to that new card.

This issue has been addressed in Canada by the Department of Finance which issued a Code of Conduct for credit and debit card schemes (or networks as they are called in North America), issuers and acquirers in May 2010[31]. This Code of Conduct states that if schemes introduce new products or services, merchants cannot be obligated to accept those new products or services. The Code of Conduct also states that merchants cannot be required to accept both credit and debit payments from any payment card network - merchants can choose to accept either credit or debit payments from a network without having to accept both.

4.10.3 Blended MSCs

Many large merchants are now on "interchange plus" merchant agreements. This means that the merchant pays the interchange fee relevant to each transaction plus any scheme fees plus an acquirer margin. The scheme fees may be charged separately or may be incorporated into the acquirer margin, depending on the particular agreement. This is a good arrangement for large merchants as it provides greater transparency as to which cards are being used and it charges only according to those cards. It also provides protection for acquirers as it shields them from movements at that merchant to higher interchange cards over the life of the contract.

The schemes are making some of these interchange plus arrangements more difficult to implement with transparency as they are now saying that scheme fees are confidential and that acquirers must not share them with merchants. This requires the acquirer to include the scheme fees within their acquirer margin. We have seen increased transparency with interchange fees (although more is needed), and scheme fees should also be more transparent. As merchants must effectively pay these fees, they should be freely available. We believe all interchange fees for all countries (and their hierarchies) and all scheme fees should be published on the schemes' websites. These fees are freely available to issuers and acquirers, and the same level of transparency should be extended to merchants.

However, interchange plus arrangements can be too complex for small to medium merchants. Instead of having to reconcile against one or two "blended" MSCs, the merchant now has multiple prices for each card scheme. In the USA, for example, Visa and MasterCard have more than 100 interchange fee categories between them. Similarly in Australia, there are more than 50 categories between Visa and MasterCard. The trend around the world is for increasing numbers of interchange categories.

While blended MSCs are not ideal and do not provide transparency on the cost of individual card types, it would not be sensible to prohibit them as they make sense for many merchants. However, it does make sense for even small merchants to have differentiated MSCs between credit and debit products and acquirers should not be permitted to charge a single blended MSC for both credit and debit payment cards.

The elimination of interchange fees would remove this issue.

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31 www.fin.gc.ca/n10/data/10-049_1-eng.asp

4.10.4 Merchant - Scheme relationship

Merchants, particularly large merchants and merchant associations, should have the ability to negotiate directly with schemes on interchange fees, scheme fees and regarding restrictive rules which directly affect their business.

In Australia, some merchants have managed to negotiate lower interchange fees and both Visa and MasterCard now have lower interchange fees for "strategic merchants".

Merchants pay these fees which are set by the schemes and must have the ability to enter meaningful negotiations with a realistic outcome of reduced fees where appropriate.

Similarly merchant associations or industry associations should have the right to enter negotiations on interchange fees and scheme fees on behalf of their members.

4.11 Standardisation

4.11.1 Card Payments

Cards Standardisation Volume 6.0

The *Cards Standardisation Volume states:*

> *"It will be up to each market participant to decide whether to make use of these standards ..."* [32]

This quote represents a massive issue. Many market participants can read this statement and realise they can ignore the content of this document if they choose and therefore they don't have to be too concerned if it goes in a direction they do not support. At some point in time these standards have to become mandatory for all European open loop card payments. There needs to be a timeline to allow everyone to update or replace their systems, but also a date after which all new payments infrastructure must be compliant. Otherwise these standards will not be implemented within reasonable timeframes.

Many of the stakeholders will face significant investment costs in the future to implement these standards and the sooner they start to plan for this expenditure the better.

> *"In line with the SEPA Cards Framework, these SEPA Cards Standards represent a commitment from the banking payment industry for adoption and implementation."* [33]

This statement continues to demonstrate a bank-centric view of the world and is a direct product of the fact that the EPC is a banking organisation. It is also in conflict with the statement above from page 8 which specifically states that adoption of these standards is only voluntary and therefore is not a "commitment" to do anything.

However, this document is a very impressive improvement since the Cards Stakeholders Group was formed and became involved. This demonstrates the value of having many different perspectives considered and included in work of this type. This is now a document that can really be used to begin the necessary implementation work. There is still more

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[32] Cards Standardisation Volume 6.0, 14 December 2011, EPC & CSG, p.8.

[33] Cards Standardisation Volume 6.0, 14 December 2011, EPC & CSG, p.10.

detail work to be included, particularly in the Certification section, but the direction and intent are now clear and workable.

It is particularly pleasing to see international standards such as ISO 8583, ISO 20022, EMV, PCI DSS and PCI PTS being referenced and used as a baseline. This is very important as the payments environment is truly international and the focus should not just be placed on pan-European solutions, but solutions that will be accepted and inter-operable worldwide. These standards will continue to evolve over time as new technologies and new threats emerge and it will be critical for CSG and its members to have ongoing input into that evolutionary process.

Section 4.4.3.3.2 Application Selection

This section includes some clarification rules in relation to application selection including “Automatic Selection” which is to take place in contactless transactions, non-PIN transactions and environments where transaction speed is a priority. The “highest priority” of mutually supported applications (by both the card and the terminal) will be chosen on the cardholder’s behalf and without action by the cardholder. The volume of contactless transactions, particularly from mobile devices, is expected to increase significantly in the next few years so this “Automatic Selection” process could potentially impact upon a large and growing proportion of payment transactions.

This potentially gives Issuers and/or schemes the opportunity to set a “highest priority” default application on a chip card to be the application which will generate the highest income for that issuer (e.g. Platinum card application with higher interchange fee levels).

The cardholder should be provided with a process where they have the opportunity to select their “preferred default application” at the time the card is issued and should also have the option to amend this preference over time, particularly any time a new application is added to the card after it has been issued.

When the card schemes unbundle their network processing activities from their scheme governance and brand management activities, and therefore merchants are presented with the ability to route payment transactions across the network of their choice (usually the lowest cost option), it will also be essential to ensure that “Automatic Selection” of the application at the POI does not remove the network routing choice from the merchant.

4.11.2 E- and M- Payments

The critical issue for the future of emerging payments markets is governance. Standards for internet and mobile payments should be in the hands of a body which represents all stakeholders in payments. The internet itself provides a standard communications environment which includes secure protocols to allow encryption to protect sensitive data. An international standard such as ISO 20022 could be the base for processing financial payment messages globally across the internet in the future. SWIFT is the registration authority for ISO 20022 and could be one of the organisations included in a new representative payment standards management body for Europe.

4.12 Interoperability Between Service Providers

The two key issues here are having recognised standards and stakeholder representation in the decision making process. These issues are addressed in Sections 4.11 and 4.14 respectively.

4.13 Payments Security

All parties agree that security is extremely important and is a matter that must be addressed very seriously. Security requirements also evolve continually as new technologies become available (e.g. stronger encryption algorithms) and as new threats emerge that must be met and dealt with.

It is important, however, that an international perspective is taken (as with all standards). For example, the Cards Standardisation Volume takes PCI security standards set by the PCI Security Standards Council as a baseline and then goes on to add “EPC Plus” security requirements which represent the EPC members’ view of gaps or deficiencies in the PCI standard. We believe a better approach would be for the CSG to discuss these perceived shortcomings with PCI and to have them addressed in future PCI versions so there is no ongoing difference between PCI security in Europe and PCI security elsewhere in the world.

This principle is critical to avoid ending up with different standards in different parts of the world which is precisely the problem that the Cards Standardisation Volume is trying to solve.

Financial institutions and merchants that operate internationally need to have a payments environment that is as standardised as possible in order to achieve economies of scale and to have an efficient payments infrastructure that processes large volumes of transactions reliably, securely and at the minimum cost.

4.14 Governance

4.14.1 Governance of SEPA

We believe the major weakness in the governance of SEPA is that it has been controlled by the banks and financial institutions via the EPC. As discussed earlier in Section 4.6, the EPC is comprised only of banks and financial institutions and its mandate is to be "*the coordination and decision-making body of the European banking industry in relation to payments.*"[34] It is not surprising that its members have a bank-centric perspective on issues they are considering.

The EPC is responsible for delivery of SEPA payment schemes and frameworks[35]. The following extract from "Who is Who in SEPA" outlines more fully the role of the EPC in SEPA:

> *"The EPC develops the payment schemes and frameworks necessary to realise SEPA. In particular, the EPC defines common positions for the cooperative space of payment services, provides strategic guidance for standardisation, formulates rules, best practices and standards and supports and monitors implementation of decisions taken. The EPC consists of 74 members representing banks, banking*

[34] See www.europeanpaymentscouncil.eu/content.cfm?page=what_is_epc

[35] See www.europeanpaymentscouncil.eu/content.cfm?page=what_is_epc

communities and payment institutions. More than 300 professionals from 32 countries are directly engaged in the work programme of the EPC, representing all sizes and sectors of the banking industry within Europe." [36] *(emphasis added)*

Out of interest, this 8 page document on Who is Who in SEPA which is prepared by the EPC has a full page devoted to the EPC and its banking remit, but merchants and retailers are not mentioned once in the whole document. This is an insightful example of the EPC's bank-centric perspective on SEPA.

There have been efforts over recent years to be more inclusive of other stakeholders, including the formation of the SEPA Council and the Cards Stakeholders Group (CSG), although we believe these have not resulted in actually empowering other stakeholders to make decisions to anywhere near the same extent as the banking industry.

The SEPA Council is an advisory body only and its powers and the limits on what it can do are clearly spelled out in the Who is Who document:

> *"The SEPA Council may provide guidance and / or statements, where possible on a consensual basis. ... The SEPA Council has no powers to impose binding measures."* [37]

Unlike the EPC, the SEPA Council has no ability, for example, to mandate standards, develop payment schemes or frameworks, formulate rules or define common positions. These functions are all left clearly under the control of the banking industry.

The Cards Stakeholders Group, while including representatives from the merchant, processor and vendor communities, is limited in its scope to developing standards and does not become involved in important issues such as the SCF, interchange fees, scheme rules or other vital matters which directly impact merchant and cardholder costs. As the ECB web-site states, even in the area of standards the CSG plays only a support role to the EPC.

> *"The EPC created the Cards Stakeholders Group (CSG) which brings together representatives of all relevant sectors including schemes, processors, vendors and retailers as well as banks. The aim is to achieve consensus on the standards needed to realise the vision of a SEPA for cards and to agree on timelines for their application. The CSG supports the EPC in the maintenance and enhancement of the SEPA Cards Standardisation Volume – Book of Requirements."* [38] *(emphasis added)*

All stakeholders need to be actively involved in the decision-making and governance of SEPA, particularly in the area of payments.

It is our view that regulators should play a more active role in the SEPA process. A self-regulatory approach cannot work when the self-regulation is largely controlled by only one participant, in this case the banking industry via the EPC. It is our view that the EPC should be restructured to genuinely become the European Payments Council rather than simply a banking organisation. All stakeholders should have equal representation and access to membership of the EPC. Alternatively a new genuinely representative body should take over the role and authority of the EPC and the EPC can be a member of the new body.

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[36] Shortcut to Who is Who in SEPA, European Payments Council, September 2010, p.4.

[37] Shortcut to Who is Who in SEPA, European Payments Council, September 2010, p.8.

[38] See www.ecb.int/paym/sepa/stakeholders/html/index.en.html

To give the EPC responsibility for making decisions on, for example, fee structures for the financial sector, including banks and card schemes, seems highly irresponsible given these organisations have a vested interest in keeping these fees high. Further, as discussed earlier, these fees are effectively paid by merchants and cardholders who not only don't have a say in setting them but also have no ability at all to negotiate them. Regulators, such as DG COMP, should be involved in the setting and/or capping of these fees to ensure they are fair and reasonable to all stakeholders.

4.14.2 Governance in the Field of Cards, m-Payments and e-Payments

It is vital that the mistakes that have been made with card payment systems and with the governance of SEPA and the SCF are not repeated with m-Payments and e-Payments.

There are a number of lessons to be learned from the cards regulatory activities in Europe and around the world. Interchange fees in particular have dominated these regulatory activities. We believe there is no need for interchange fees and that card systems have prospered irrespective of the presence or absence of interchange fees and irrespective of the direction of flow.

Interchange fees should be prohibited for any new or emerging payment systems and those parties who incur costs should recover them from the parties to whom they provide services, with no cross-subsidisation between "issuers" and "acquirers", whatever form they may take. This is line with the SCF guidelines which require transparent pricing structures without cross-subsidisation between issuing and acquiring services, as discussed earlier in Section 4.6. It is also in line with other payment systems such as cheques where there are no interchange fees.

With regard to governance, the same issue as has occurred with SEPA for cards is equally relevant for m-payments and e-payments: **do not allow a single interest group to control the governance or development of these emerging payment methods**.

There are two statements in the Green Paper which are cause for concern in relation to governance of e- and m-payments.

The first is:

> *"One of the main barriers to widespread take-up of m-payments seems to be a stalemate between Mobile Network Operators (MNOs), traditional PSPs (banks) and other players, such as manufacturers or application developers. MNOs seem to be seeking to retain control of the business, at least in their role of security manager for the service. At the same time, e-payment players are seeking to extend their reach to the mobile environment (for both remote and proximity payments)."*

The second is:

> *"Efforts for m-payment integration at European level currently take place on a self-regulatory basis. In this context, the EPC is cooperating with the global association of mobile operators (GSMA) and published a White Paper on mobile payments in July 201010. The White Paper focuses on mobile payments through payment cards."*

MNOs, PSPs and the international card schemes are all seeking to gain and retain control of these emerging payment networks. These parties are all wishing to generate new income streams which will eventually be paid for by merchants and consumers. It is vital that these

parties do not control governance of these payment systems. All stakeholders should have appropriate representation on any governance body. It is of considerable concern to us that the EPC and the GSMA have developed a White Paper on the future of mobile payments in Europe and that merchants were not involved in this process. Both the EPC and the GSMA have a vested interest in providing income streams for their members.

In Q31, the Green Paper specifically asks whether a memorandum of understanding between the European public authorities and the EPC could consider various issues. As stated earlier, the EPC is not the appropriate body for this role as it is not representative of the European payments industry, but instead represents only a single group of stakeholders.

5. Payments Innovation

Innovation is extremely important to create new competitive forces, increase efficiency and drive down prices over time. It is our view that the best way to stimulate innovation is to encourage new players to enter the payments market and to provide them with an environment in which they have a fair chance to invest, grow and become profitable.

If barriers to entry are removed and anti-competitive pricing, regulations or rules are removed and access is given to the necessary infrastructure on equal terms, then new entrants such as Payment Institutions will appear and will innovate to gain market share.

One example of such a new entrant is Voice Commerce which aims to employ voice recognition technology for two-factor authentication in mobile phone payment transactions.

Innovation is essential to a healthy European and global payments system and must be encouraged by European authorities. For a more detailed discussion of payments innovation you may refer to the 2011 submission to the Payments Policy Board of the Reserve Bank of Australia which we prepared on behalf of Australian Merchant Payments Forum[39] (footnote).

5.1 Decoupled Debit

For many years credit card issuers have offered payment cards to consumers that have no previous banking relationship with their organisation. This is now accepted market practice and generates good competition between card issuers who cannot "lock in" their transaction account holders to only using credit cards issued by them.

The concept of decoupled debit aims to bring the same competitive forces into the debit card issuing market where traditionally a deposit account holder is offered a debit payment card by their account-holding institution but is not offered a debit card from any other organisation.

Decoupled debit cards separate the issuing of the card from the account-holding function so that a card can be issued by an organisation which is completely separate to the institution which holds the account. Any organisation, including merchants, can issue these cards. The card is linked to the customer's existing bank account and the customer does not need to open a new bank account as is the case for traditional debit cards. This scenario requires a

[39] Submission to the Reserve Bank of Australia - Strategic Review of Payments Innovation, Australian Merchant Payments Forum, 5 May 2011. www.rba.gov.au/payments-system/reforms/strategic-review-innovation/submissions/201106-strategic-review-innovation/payments-forum.pdf

real-time direct clearing system so that these card-based direct debit transactions can occur in real time and the cardholder's account balance can be updated in real time and the availability of funds can be reliably determined at the time of the transaction.

We believe that decoupled debit has a role to play in the future of payments and Europe has the opportunity to put the required enabling infrastructure into place if it chooses to do so. This has the potential to provide genuine competition to the international card schemes and to allow the establishment of a competitive European payment scheme.