

Economic Watch

Financial Systems and Regulation

Madrid, 15 April 2014
Economic Analysis

Financial Inclusion Unit

David Tuesta
david.tuesta@bbva.com

Carmen Cuesta
carmen.cuesta@bbva.com

Regulation and Public
Policies Unit

María Abascal
maria.abascal@bbva.com

Wojciech.Golecki
wojciech.golecki@bbva.com

The new European framework for Payment Services

Executive Summary

- On 24 July 2013, the European Commission presented a Payment Services Directive proposal (PSD2) which updates the current Directive (PSD1), in force since 2007. It also provides new regulation on interchange fees.
- One of the most important issues of this review is that **the relevant authorities establish the same registry, licencing and supervisory rules for new players in the electronic payments market**, the so-called Third Party Payment Service Providers (TPP).
- Payment Services Providers providing accounts (banks and other payment bodies) may not discriminate against TPPs, **but must give them access to client accounts and/or the capacity to handle transfers**, once the client concerned has given consent.
- The EBA, in close cooperation with the ECB, is in charge of providing guidelines and operating guides on issues relating to technical mechanisms to guarantee interoperability between all the stakeholders in a trustworthy ecosystem.
- The regulations set **caps on interchange fees**: 0.2% in the case of payment with a debit card and 0.3% for credit cards. The text provided by the Parliament provides for the replacement of the 0.2% cap on debit cards with 7 eurocents.

Issuing banks' revenues per transaction will fall as a result of the cap on interchange fees and they will be obliged to find ways to offset this, such as higher interest rates for credit, or higher annual commissions.

- Although the European Parliament has already approved amendments to the draft of both regulations, the Council must adopt its own position and negotiations between Commission, Parliament and Council must take place before the final approval, which is expected to be **postponed until 2015** because of European elections.
- The PSD2 reform is another step forward in the process of eliminating regulatory asymmetries between the new thriving technological players and traditional retail banking. The new players have a large market share in the provision of digital services but they have not been subject to the same restrictions as the regulated institutions. However, **PSD2 will not kick in for a few years**, allowing the competitive disadvantage to continue.

1. European Commission Targets

On 24 July 2013, the European Commission (EC) presented its proposal for the new legislative framework for payment services, consisting of i) the review of the Payment Services Directive proposal (PSD2), and ii) new regulations for interchange fees applicable to card-based payment transactions. The EC's aims in this proposal are to:

- **Ensure a level playing field** for all Payment Service Providers (including new providers) while retaining a degree of competition to allow a reduction in payment service costs
- **Reduce regulatory fragmentation** in the European payment services market and promote the introduction of common technical and operating standards
- **Guarantee a high level of protection** for consumers and payment security in the light of the increasing complexity but also popularity of electronic forms of payment

2. Payment Services Directive II (PSD2)

2.1. New players

The new Directive includes **Third Party Payment Service Providers** (TPPs) in its scope as new Payment Service Providers. These are providers who intermediate between the user and their payment account manager.

Specifically, the draft considers as a payment institution those institutions offering either of the two new types of services:

- **Payment initiation services:** Services designed to intervene actively in internet payment, debits and transfer initialisations through software platforms which are the interface between the customer and the Payment Service Provider which manages the account. The services of institutions such as *PayPal*, *iZettle*, *Trustly*, and *Ideal*.
- **Information services (Aggregators):** Services offering a user-friendly interface to access aggregated information for one or several payment accounts from one or several Payment Service Providers managing the client account. Banking aggregation services such as those provided by "Moven", "Yodlee", "Mint.com" and "Fintonic" fit into this category.

Parliament has also introduced a new player: **the payments instrument issuer**, to guarantee that they will also be regulated.

The rule is the result of the Commission's attempt to boost innovation and competitiveness, developing a trustworthy ecosystem. Thus, new activities that are thriving in the digital payments ecosystem will have to adhere to the same regulations as the traditional payment service providers in matters relating to **registration, licences and supervision by the competent authorities**.

2.2. Scope

The regulation will apply to all payment transactions in the EU when at least one of the Payment Service Providers (that of the originator, of the beneficiary or of both, if they use the same one) is **located in a European Member State**.

The scope of the transparency conditions and the information requirements defined in Title III are extended to all currencies, while rights and obligations requirements relating to payment service provision and use will be applicable to transactions carried out in euros or in any Member State currency.

When it comes to exceptions the new wording of the regulations **tightens the definition of limited networks to the definition laid down in the electronic money directive** (payment instruments which can either only be used in the issuer's establishments or within a limited network of providers, or else their use is limited to purchasing a limited range of goods and services). Parking payment instruments are also covered by this exception in the parliamentary text. PSD2 also restricts the exception of payments for downloads from the network invoiced by telecoms operators for low-value transactions.

2.3. Operating changes

Both traditional payment institutions and **the new TPPs will have to adapt to current rules on privacy and security**. They will have to comply with the conditions of access to information and robust authentication requirements and operation rectifications. PSD2 also includes new divisions of responsibility.

This Directive emphasises that payment services which manage their customers' accounts (banks and other payment institutions) should allow a third party to access the customer's accounts and/or submit payment orders using payment instruments without discriminating against authorised payment service providers.

On this issue, the European Banking Federation has warned that as currently worded, **the regulation encourages users to share their financial information access credentials with third parties** in order to receive a value-added service. That represents a setback, bearing in mind the efforts that have been made in the last few years to create awareness about the importance of not sharing credentials, in the fight against phishing and fraud.

The ECB has also made a statement on this issue and finally, the Parliament has included security rules to be followed by TPPs when dealing with their client's authentication, principally:

- Access user accounts, after prior authorization, using **different security components from the user's personal ones**. The aim is to restrict the need for users to give their credentials to third parties.
- **Guarantee strong client authentication** when initiating payments or access to account information, by:
 - Redirecting the user safely to the Payment Service Providers (for instance, to their online banking account)
 - Issuing their own robust authentication features: those in which at least two of the three ways of authentication: knowing something, possessing something and/or using biometrics take place independently.

The text approved by Parliament **commits the EBA to greater active involvement** in order to provide guidelines and set up technical standards related to:

- Security Protocols that should be follow the recommendations of the European Forum on Security of Retail Payments and will include:
 - **Mechanisms for obtaining consent** from the payer when third parties access their payment account
 - **The authentication protocol** between the different parties involved (TPPs, and Payment Service Providers providing accounts). The need to generate contracts or bilateral agreements between them to define their relationship has been ruled out.
- Impact evaluation of the European passport on Member States' banking industries in order to establish the capacity of the latter to impede an activity in their territory offered by an institution based in another Member State. The regulations require the EBA, in close cooperation with the ECB, to provide guidelines in directives and operating guides on issues relating to security mechanisms, formalizing access to authorized institutions' registers and norms relating to the "passporting" of institutions operating in several Member States.
- Research whether it is a good idea for the IBAN associated with a debit or credit card to be accessible electronically.

3. Regulations on interchange fees

3.1. New areas covered in the regulation

The proposed regulation sets a cap on interchange fees of **0.2% for debit card payments and 0.3% for credit card payments**. Parliament has added the possibility of setting a fixed fee of 7 eurocents instead of 0.2% for debit cards.

These rates are on the whole lower than those being applied at present and in fact it is the brands themselves which have proposed them, with the aim of making transactions on their networks less expensive, because cardless electronic payment models are springing up, such as **peer to peer, payments transfer**, etc. which are much more attractive for merchants, since they do not have to pay commission on transactions.

In a competitive acquirer market, the fee the acquirer charges the merchant should converge to the interchange fee plus the marginal cost of the transaction (which will include the commission paid by the acquirer to the brands).

By reducing interchange fees, the Commission wants eventually to reduce the fees paid by merchants on each transaction, which would encourage the entry of new online businesses which currently view the high fees they have to pay on each sale as a barrier, particularly when the transactions are for small sums.

Although there is an argument that these fees should disappear entirely, the brands understand that at very low rates, the merchant would be indifferent to being paid in cash or by card, while on the other hand there remains some incentive for the card issuers to continue their activity, although their revenue per transaction would go down and they would have to set higher interest rates for borrowing or higher annual commissions.

In terms of the date on which the rules will kick in, the Commission has set two months after the directive is approved in the case of cross-border transactions with credit or debit cards, and two years later for the remaining transactions. Parliament has proposed that **both of them should come into effect at the same time, one year after the rules' formal approval** to avoid the operating problems that the co-existence of two systems could involve.

The Regulation requires the transaction processors and the owners of the systems to be split into two entities in order to encourage competition.

Finally, we should point out that the regulation applies to the four-party scheme only, since in the three-party scheme there is no interchange fee.

3.2. Nature of the payment card market

At the moment the credit card and debit card market has two defining characteristics:

- **It is a dual market** insofar as there are two types of customer: the one who possesses the card (payer) and the merchant who enables their customer to pay with a card. So at least two markets interact: the customer-issuer market and the merchant-acquirer.
- **The co-existence of two business models** in the environment of card-based payment service provision, depending on the number of players involved: three-party and four-party schemes.

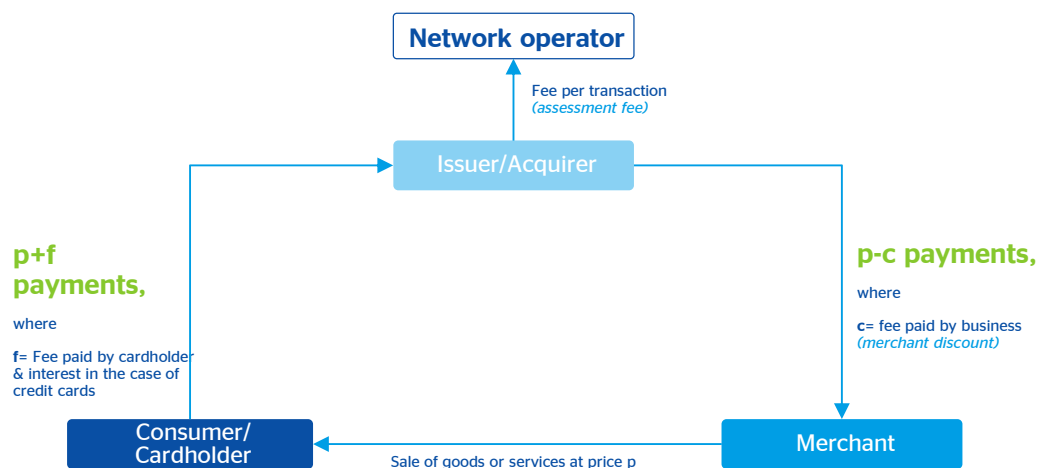
A **three-party scheme** is made up of **a single, for-profit institution** which becomes the issuer and acquirer in a transaction in such a way that both the consumer and the merchant are their customers. These are the models followed by *Diner's Club* and *American Express*.

In a **four-party scheme**, an issuer intervenes, whose customer is the cardholder and an acquiring institution, whose customer is the merchant. The payment scheme revolves around the companies owning the brands (*Visa* and *MasterCard* basically) which issue licences, both to

issuers and to acquirers. With a card-based transaction both the issuer and the acquirer have to pay fees to the brands for using their network.

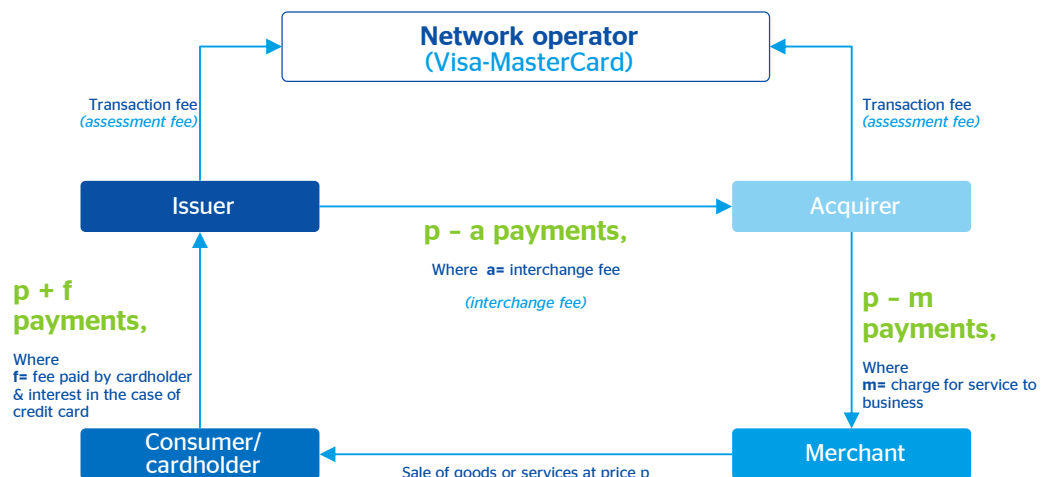
In this latter scheme, **the acquirer**, the entity which is responsible for the relationship with the business, charges the merchant a fee for each transaction and in turn pays the issuer the above-mentioned interchange fee. The issuer, on the other hand, the entity responsible for identifying and authenticating customers, as well as defining their credit risk, receives remuneration from the card user for maintenance of the same.

Figure 1
Three-party scheme



Source: BBVA Research

Figure 2
Four-party scheme



Source: BBVA Research

4. Legislative status

For legislative purposes, the proposed Regulation and the proposed review of the Directive, both presented on 24 July 2013 by the Commission, are considered as a single legislative

package, which means that no progress can be made in the legislative process on one without the other. Both have to go through the ordinary legislative process, that is:

- In the first place, both co-legislators (**the Council of the EU and the European Parliament**) will each have to decide their own position on the Commission's proposal.
- Once the individual positions have been determined for both drafts, together with the Commission, both co-legislators will sit down for three-way negotiations (**trilogues**), in order to converge on a shared position which in turn must be approved separately by each of the co-legislators.
- The version of both documents agreed in the trilogues and approved by the co-legislators then goes to the vote for the last time by the Council and the European Parliament, but this time it will be voted on **in Plenary**.

Voting in Plenary will not take place until the next legislature. The proposals discussed in this note **are still at the first of the above stages.** The Parliament approved its position on the Directive and the Regulation on 20 February but there is no date fixed for the second co-legislator's positioning, the Council.

The new Parliament will meet for the first time in July but is not expected to begin working fully until September. This means a delay of around six months before it is approved.

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.