

Topics of this issue:

1. **Domestic Interchange Rates in SEPA: Room for Doubt**
2. **The Eurosystem's 5th SEPA Progress Report**

1. Domestic Interchange Rates in SEPA: Room for Doubt

It is still not clear whether SEPA will be characterised by a common interchange or not. In its 5th Progress Report (see next section) the Eurosystem states that domestic rates may be used during a transition period but that the long run goal is a unified SEPA rate. The EPC and the card schemes, favour a system that allows them to introduce domestic rates.

Our comment:

Provided that it will be legally possible, i.e. not ruled out by regulation, would domestic rates be feasible within SEPA? The card schemes and the EPC seem to think so. But there is room for doubt.

Under SEPA-rules, what exactly is a 'domestic transaction'? Supposedly, a transaction is „domestic“, when it is carried out with a card at a terminal both located in the same country. The country where a terminal is located is part of the terminal data (terminal country code). But what is the country where a card is located? So far, on cards the country of the issuer (issuer country code) is stored. However, in SEPA, cross-border issuing should be possible (and moreover is aimed to be the regular case), so that the origin of issuer may differ from the residency of the cardholder. Therefore, the question arises whether scenario S2 (domestic issuer/foreign cardholder) or scenario S3 (foreign issuer/domestic cardholder) should be processed as domestic transaction.

Table 1: Four Scenarios

Scenario	S1	S2	S3	S4
Country of terminal	A	A	A	A
Country of issuer	A	A	B	B
Country of cardholder	A	B	A	B
Domestic transaction in the traditional meaning	y	y	n	n
SEPA domestic	y	?	?	n

Cases 2 and 3 are cross border issuing, which can be expected to become a normal thing in SEPA. Under current scheme rules, scenario S2 would be processed as a domestic transaction, whereas scenario S3 would be processed as cross border transaction.

What are the implications? If the idea is that scenario S3 should be processed as domestic transaction (and S2 as cross border), obviously processing must be adapted.¹ Such an adaptation could be avoided if everything is left as it is. In this case, scenario S3 would be treated as x-border transaction. Given the possibility of x-border issuing, this would provide banks with an opt-out option. When domestic interchange is lower than the SEPA default rate they could issue cards from across the border.²

So, to take an example, in SEPA a large Dutch bank may issue cards to German customers in Germany out of the Netherlands – not requiring a German subsidiary and German BIN and accordingly getting intra-regional rate. Moreover, it would seem to be a clear violation of the internal market principle to rule out that a Dutch subsidiary of a German bank applies for a Dutch BIN and issues cards to German customers from the Netherlands through the subsidiary. Thus, unless restrictions to the internal market principle are accepted, issuers in a country would have an „opt-out“ option of the domestic interchange. This option would be interesting for all issuers within countries that have domestic interchange fees lower than the intra SEPA fall-back rate.

To sum up, the implementation of domestic interchange within SEPA either is complemented by an adaptation of processing systems or it allows issuers to avoid low domestic interchange rates (if they wish).

As far as regulation is concerned, there is no clear guidance on the implementation of ‘domestic’ interchange. Whereas the EC did not yet take a clear position to domestic interchange, the Eurosystem in the fifth progress report argues for domestic interchange, “during a transition period, in order to facilitate change in national markets, given the differences in the underlying cost elements and market structures across the various euro area countries.” (See also next section.) Following the second argument in Eurosystem’s reasoning, the “difference in market structures” appears to support an implementation where scenario S3 is falling under domestic rates. The first argument in Eurosystem’s reasoning, the “difference in underlying cost elements”, would imply, however, to consider scenario S2

¹ Either the country of residence or the nationality of the card holder must be stored on the card.

² Up to now, in many cases, x-border interchange has been lower than domestic rates. However, this is likely to change in those countries with a low-fee national debit scheme.

as domestic, as cost structures are determined by the issuer, not the residency of the customer.

2. The Eurosystem's 5th SEPA Progress Report

On the 20th of July 2007 the Eurosystem published its 5th progress report 'SEPA: from concept to reality'.³ The section on cards is by far the largest section in the progress report. This can be interpreted as an indicator of the many difficulties that still have to be overcome on the road to a 'SEPA for Cards'.

In the new progress report the Eurosystem touches a large number of issues relating to cards:

- European debit scheme

It reiterates its support for a European debit scheme – pointing once again to the efficiency and low costs of many of the current national schemes. What is new is that the Eurosystem 'encourages' (a phrase very often used in the report) the EPC to review the option of setting up a SEPA debit card scheme alongside the SEPA credit transfer and the SEPA direct debit. New is also the explicit acknowledgement that the creation of a European debit card scheme has a political dimension: *'largely a political objective, which the Eurosystem invites the banks to share.'* (page 12) Given this political will, the Eurosystem is even prepared to accept that the establishment of a new European system may not be completed by 2010.

- Co-branding

The Eurosystem states that co-branding can also be a long run solution. However, it warns that co-branding may not be the only solution offered. Co-branding may not, however, take the form known from pre-SEPA times, where co-branding contracts basically were agreements not to compete.

- Domestic interchange

The Eurosystem modifies its position on domestic interchange rates. Provided interchange rates are permissible (a decision that the EU Commission has to take) the Eurosystem is prepared to accept differing domestic interchange rates for a period of transition. In the long run, however, interchange rates should be equal within SEPA.

- Standards

The Eurosystem makes reference to current standardisation efforts and urges participants to finish definitions by the end of 2008. It is acknowledged that implementation may be time

³ <http://www.ecb.int/pub/pdf/other/singleeuropaymentsarea200707en.pdf>

consuming and no explicit deadline is mentioned. The Eurosystem thinks it is best to make implementation mandatory.

- 3-Party schemes

The Eurosystem stresses that, in principle, 3-party schemes have to comply with the SEPA cards framework. However, it points out that the matter has to be explored in more detail. In particular, for 'pure' 3-party systems, separation of scheme and processing may not be relevant. For, 3.-party systems with licensing this may be a different matter, though.

- Card fees and prices

The Eurosystem addresses the hypothesis that fees will have to rise in some countries. Once more, it makes clear that it opposes such a move. *'SEPA cannot in any circumstances be used as an excuse to increase the general price level. In line with the messages it has already conveyed, the Eurosystem confirms its policy stance on the need to preserve the high efficiency and low fee levels currently offered by card payment schemes and processors in several countries in this report.'* (page 16)

- Monitoring framework for card fees

The Eurosystem supports the idea to set up a monitoring framework for card fees.

Our comment:

Not surprisingly, much of what is said in the 5th progress report has been known before. However, there are some new aspects. First and foremost, the Eurosystem is prepared to accept domestic interchange rates for a transitory period. Thus, it sanctions movements of the card schemes that have been made already or are under way. As a consequence, for the coming years we will definitely see fee differentiation along national lines. Whether and to what extent that will work is a different matter (see section 1).

Not accepted, however, will be restrictions on x-border competition within SEPA between schemes, issuers, acquirers, processors or other service providers. This is in line with the PaySys interpretation that formed the basis of our argument on co-branding in SEPA.⁴ The old co-branding agreements that basically split the market between two schemes will not be allowed under the SEPA. 'The use of national brands should therefore not be favoured by a pre-assignment priority at the POS (point-of-sale) terminal, but the choice of brand in a payment transaction should be left to the merchant and/or the cardholder.' (page 13)

⁴ See 'Co-badging issues', EPSM Market Research Newsletter, May 2007.

The above quote is interesting from another point-of-view, as well. The Eurosystem states that choice of brand should be left to merchant and/or cardholder. That leaves the door open for different scenarios:

- *cardholder decides on a case by case basis*
- *cardholder can set preference on the card (supposedly 'assisted' by the issuer)*
- *merchant decides*

As has been pointed out by PaySys, it has huge importance which particular rule applies and as has also been pointed out, the last option is not compliant with the SCF.

Finally, when reading the 5th progress report it occurred to us that the Eurosystem usually refers to "banks" rather than "payment institutions" – although the latter, as well, are entitled to offer a large range of payment services, particularly in the field of card payments. Non banks (with a licence as payment institution) could even set up a whole (new) payment scheme in Europe, like PayPal did already globally. From this perspective, the recommendation of the Eurosystem that European 'banks' should ensure the governance of a European debit card scheme seems to be a traditional view becoming obsolete after implementation of the PSD.

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