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All change, EU Interchange

The early Christmas present from the EU

The EU regulations on interchange, will if it is to be believed, save consumers €6bn a year and help to boost more innovation and competition in online and mobile payments. **David Parker** assesses the likely impact of the regulatory changes, getting comment from industry players and lawyers on what we should expect

As summer closes, the big question for many prepaid cards issuers, programme managers and brands must be 'And where now given the changes in interchange coming?' – see box, p9. On 20 April 2015 the Council of the European Union (EU) formally adopted the Regulation on interchange fees for card-based payment transactions.

The stated aim of the EU Council is to reduce costs for both retailers and consumers, to help create an EU-wide payments market and to help users make more informed choices about payment instruments.

The point about reducing costs for consumers is hotly contested given the fact that in Australia (which led the way in 2003 with interchange regulation), consumers saw no reduction in prices from merchants, but watched the cost of card fees in Australia increase by up to 50%. Furthermore cardholders are paying approximately £226m each year in additional fees as a result of the RBA's regulation.

The EU regulations will come into force 20 days following publication in the Official Journal, with the interchange fee caps becoming effective six months later, which is expected to be October 2015.

As a Regulation, its provisions become effective immediately: they do not need to be transposed into local law. But as usual with the EU, not everything is quite black and white. Whilst the headline numbers are easy to read, Member States are permitted, for domestic transactions, to set lower caps or allow a fixed fee of no more than €0.05, which can be combined with the 0.2% or 0.3% fee cap.

Also, during the first five years of application, Member States may apply the caps calculated as an annual weighted average of all domestic debit or credit card transactions within each payment card scheme. Further for domestic so-called "universal card" payment transactions, i.e. those that are not distinguishable as debit or credit card transactions, the debit card cap applies.

Again, there is a Member State derogation, but applying only for the first year of application of the caps. So whilst the headline provides nice clean numbers, in effect each member state can interpret them slightly differently within overall boundaries – leading to a number of variations of grey.

The majority of consumer prepaid cards have always been a volume game and this will not change, but for many programmes the reduction by around 70% of the interchange will have a dramatic effect on programme revenues, especially for those without other major sources such as FX and fee income.

EPI asked a range of issuers and programme managers and all generally commented that the schemes had done a good job in communicating the changes although as Ray Brash CEO of PPS a processor and issuer commented: "Until recently we didn't know when it would be implemented, it is good that it is now confirmed for December, slightly later than the originally forecast October date."

The key question though is of course how will this affect fees to consumers, as Ray Brash again commented; "Certainly, those that are reliant on interchange revenue will have to change their business model, whether this is by increasing fees, but jeopardising the competitive nature of the product or by diversifying and adding new services to warrant a fee increase."

Noel Moran, CEO of PFS, an issuer and programme manager added: "From the issuer perspective, and as a result of the schemes amending fees, as a direct result of interchange increases, we have had no alternative but to increase fees to all our card programmes. This will have a direct impact on end consumer pricing." As a programme manager with many brand clients Moran went on to say: "Pushback as you can imagine has been enormous. It is easy for the schemes to push increases down the line, but it is the programme owners who have to deal with the end customer."

For others though with their own product in the market the affect has been more dramatic, with products actually already being withdrawn. Rich Wagner, CEO of APS, an issuer and programme manager as well as brand owner of CashPlus Plastic stated: "As we have a number of product price points, what we have done is not changed our pricing, but in fact eliminated some of our low fee products from the market."

Paul Swinton, managing director of Payment Card Solutions, a Programme Manager agreed, stating: "I see some of the low cost GPR programmes will become even more unsustainable. Whilst launching to market in this way may attract cardholders, long term sustainability has not and will not be possible."

Could the interchange restructuring drive some programmes out of business? While all those we interviewed said it would not dramatically affect them personally, several noted that it could have effects on others.

Petur Jonsson, head of international issuing of Valitor Bank, an issuer and processor, stated: "This may well force some programmes out of business, but those programmes were not correctly structured in the first place. It has been known for a long time that interchange is coming down and issuers should have adjusted their pricing a long time ago."

John Sharman CEO of Tuxedo, an issuer and programme manager added: "Programmes that rely on interchange as a material income stream are already high risk. The fee cap will only exacerbate this. The fee cap may well force some programmes to close down and these are likely to be the ones that offer low fees today."

And the point raised by Rich Wagner about having to withdraw 'low cost' products is re-enforced by John Sharman stating: "Consumers could be worse off with fewer low cost products available."

Statement from the European Commission (EC)

The European Commission welcomes the adoption by the European Parliament of a Regulation capping interchange fees for payments using consumer debit and credit cards and improving competition for all card payments. The Commission estimates that the rules when implemented could lead to a reduction of about €6bn annually in hidden fees for consumer cards. The "Regulation on Interchange Fees for Card-based Payment Transactions", which largely follows a Commission proposal from July 2013, will also give more freedom of choice to retailers, enhance transparency for card transactions, and pave the way for innovative payment technologies.

Furthermore, the Regulation removes major obstacles to technological innovation in payment options. Technologies that allow consumers to pay with their debit or credit cards online or using their mobile phones (with apps, fingerprints, contactless "swipes", etc.), are readily available. However, uncertainty on the rules regarding interchange fees has been one of the factors holding up the use of these technologies.

Commissioner Margrethe Vestager, in charge of competition policy, said: "For too long, uncompetitive and hidden bank interchange fees have increased costs of merchants and consumers. Today's vote has brought us another step closer to putting an end to this. This legislation will put a cap on interchange fees, make them more transparent and remove a hurdle to rolling out innovative payment technologies. It is good for consumers, good for business and good for innovation and growth in Europe. As cards are the most widely used means of online payment, this Regulation is also an important building block to complete the European Digital Single Market." ■

Opportunities and reasons for optimism

But could these changes hide some real opportunities? As Paul Swinton highlighted: "I think the changes may force high street banks to look even further at the margins of their current account books and look to charge (probably monthly fees) to prop up these long term loss leaders. This presents an opportunity for GPR to fill the bank account lite gap or to provide a card based outlet on EMI based products which are increasingly online and operate on a much more economic footing."

Rich Wagner agrees: "I'm an optimist as I suspect that banks will need to create pricing models in a similar way to GPR prepaid cards and how APS defined the UK market when we launched the first GPR card in the UK."

Tom Jennings, general manager of Wirecard Card Solutions, believes there could be a general move from GPR to Bank Lite. "Forcing GPR programmes into charging the customers will result in more 'Banking Lite' models where GPR programmes provide a real alternative to traditional high street banking but with more innovative products and services."

With the following products all positioning themselves in the market as 'Bank Lite' i.e. products with functionality such as Direct Debit, IBAN numbers etc, this could be an area where we see a benefit to the prepaid sector:

- Cardonebanking
- Clearcash Monthly
- CashPlus
- Clearcash PAYG
- Ffrees
- MoneyMona
- Secure Trust Basic Bank Account
- Talk Home
- Think Money
- Tuxedo account money
- Change Account

So what will happen to GPR and other prepaid fees? As Phil Davies, CEO of PSI-Pay- issuer and 'E' wallet operator commented: "A good prepaid programme should already be offering a compelling consumer proposition to transcend the buying on cost mentality. Relying on price is a surefire way to being just another commodity, which has a far more damaging effect than the loss of a few basis points of interchange. The proposition should be in value for money. Research has shown that consumers do not mind paying reasonable prices if they are getting something that they feel is of value.

Ray Brash supported this adding: "Prepaid cards will have to evolve in order to find alternative revenue streams. FX will play a part but retailer cashback, additional technology that simplifies the customer experience, and some novelty features such as gamification will all potentially come into play."

Tom Jennings added: "There will be an increase in ATM fees / monthly fees, but we will also see a greater number of loyalty programmes and added services such as insurance being sold as well as other added value services. Couponing will be crucial to generate revenue for programmes."

Noel Moran of PFS forecasts that though there could be another side effect of the change in that the reduction in interchange levels and the increased fees from the schemes will be the death of certain prepaid products, an example being virtual cards. "It also makes it impossible to justify low value POS purchases, which in turn has a huge knock on effect to models like Apple Pay, HCE, contactless payments and NFC in general," added Moran.

Will costs reduce for consumers?

The key question of course, given the ECB's stated aim of reducing costs for consumers, is will this happen? Time will provide the real answer but amongst the many experts quizzed by *EPI*, there was considerable scepticism on whether consumers will see any real differences:

Ray Brash, PPS

"We don't believe that moving card costs onto issuers is in the interest of consumers. Retailers manage all their costs and in the end have to provide a competitive price to the consumer. Based on that consumers can

EU Changes to Prepaid Interchange

Prepaid cards are considered debit cards and the new regulation sets interchange fee caps at 0.2% of transaction value for cross-border debit card transactions, and 0.3% for cross-border credit card transactions. For domestic transactions, Member States are permitted to set lower caps or allow a fixed fee of no more than €0.05, which can be combined with the 0.2% or 0.3% fee cap. For domestic so-called "universal card" payment transactions, i.e. those that are not distinguishable as debit or credit card transactions, the debit card cap applies. ■

shop around and the market will give them the best outcome. By moving fees onto issuers there is a danger that all issuers charge the same or even if some issuers absorb the fee the customer is naturally less likely to move banks than change their buying behaviour.

"Furthermore it's not clear to us when the acquirers will pass on the savings to merchants and when they do if merchants will pass this on to consumers. We work with the leading retailers in Europe and our feeling is their biggest issue is growing the top line and in particular online. Both of these objectives are actually helped by card and electronic payments."

Tom Jennings, WDCS, on whether costs will increase for consumers

"No, because I do not believe the retailers will pass on the saving. The argument was between the retailers and the schemes about revenue streams, which do not affect the schemes in the same way they do issuers and acquirers.

Meanwhile, scheme charges to members have gone up. Only one aspect of the cost chain has been made transparent and without any requirement to pass through savings there will be no such activity. Ultimately this has the potential to be more harmful to retailers and, as a result to consumers."

Petur Jonsson, Valitor

"No I don't believe so. In my opinion the costs have been included in the pricing for some time and I don't see the prices coming down to reflect the changes. I believe this will be an additional cost to the consumer."

Rich Wagner, APS

"Not really as the consumer will pay more (through higher issuer fees) and the retailers will be able to take the savings direct to their bottom line, and not pass this benefit to consumers which was their argument to get these fees changed in the first place."

Paul Swinton, PCS

"My short to medium term view is that this will not impact the consumer at all. Particularly in the UK, fixed pricing is levied on the majority of retailers (particularly smaller ones) by acquirers and PSPs with no reference to interchange, plus type pricing seen elsewhere. So the retailer will in all likelihood continue paying the same rates and (ironically) the acquirer will make a larger margin as the interchange rates shrink.

So the retailer and consumer will feel no benefit until there are some disruptor acquirers that become mainstream to address the market disparity. The only "losers" are the scheme and issuers, although as many of the high street banks also have a large acquiring arm, this will be little felt at group level. I am confident that the scheme will find ways to introduce new "billing codes" to address their internal disparity.

Longer term however, as the business models within the acquiring market are shaken up, some retailers will re-negotiate and may pass these savings down to consumers, but in an ever increasing margin-pressed retail market, we think it unlikely this will be that significant. One area that may (again) come under pressure is the card surcharging model, although taking the airline industry as a model, this has been largely unsuccessful in being regulated as card surcharge fees are redefined as something else."

Phil Davies, PSI-Pay

"The theory is fine but in practice merchants are unlikely to drop prices since the few basis points saved are, largely, academic and a small part of the overall merchant acquiring fee.

We can look to Australia where this was introduced a few years ago and merchant pricing remained the same but issuers sought to recover lost revenue elsewhere. The likely outcome is the consumer loses out."

But do the regulations affect all debit and credit cards equally? No, there are some clear carve outs:

1. Three-party card schemes such as Diner's and American Express
2. Commercial cards used only to pay business expenses
3. Cards with restricted acceptance e.g. Luncheon Vouchers

On the face of it this would seem great news for the three party schemes but also a real boost to commercial cards. There is, however, a potential road block in that the regulations have also given merchants a qualification on the "honour all cards" rule, so that merchants are only obliged to accept cards within a scheme where they are subject to the interchange fee.

The reality could be only consumer cards as the merchant will have the right to refuse any cards that have higher interchange and thus Merchant Service Fees from their acquirer.

This could mean that, whilst major business locations are happy to take the commercial cards for business people with a mandate that all company expenditure goes on their corporate card, this has to be changed over to a Consumer BIN, due to the risk of rejection by merchants.

EPI also asked a number of leading lawyers for their take on the new regulations:

Robert Courtneidge, global head of cards and payments, Locke Lord (UK) LLP commented:

"The anti-avoidance provisions around the definition of "interchange" which catch, for example, marketing incentive payments paid by the card schemes for attaining certain transaction levels, will make it even harder for new programmes to get going or to be viewed as viable."

Paul Anning, Partner, Financial Institutions Group Osborne Clarke observed:

"Rarely does European legislation not evolve. If the EC perceives that its regulatory objective - lower costs for consumers - is not being achieved, it will follow-up.

But it's a regulatory minefield out there - step into bank-lite products and you've got to comply with the account switching requirements."

He added: "With so many different cards and rates, the obligation on acquirers to only offer blended rates upon express request from merchants looks good on paper, but will be honoured in the breach regularly."

Thus while on one hand there appears to be clarity, on the other it seems that there is a lot still to be sorted out.

This is especially the case around the truth of whether consumers benefit from lower prices and whether basic/low cost GPR cards will disappear from the market, removing consumer choice, potentially affecting the wider drive some governments have for financial inclusion. ■