

EPFSF Briefing: Payments

Background

The banking sector, including the payments industry has experienced in recent years the same attention to market liberalization and strengthening competition as policy makers have given to other sectors, such as telecommunications, energy and transportation. At the European level, such attention has often come in the form of a “one-two punch” of legislation intended to bring together fragmented national markets, with selected competition enforcement action. These regulatory instruments have indeed been applied to the payment industry, with action and implementation at both the national and European level.

Given the intensity and scope of recent regulatory initiatives and public policy efforts toward examining payment cards, it could be useful to review the main results and implications of these activities. Below is a summary of recent European-level regulatory and policy developments concerning payment services in Europe.

Single Euro Payments Area (SEPA)

SEPA is a self-regulatory initiative by the EPC (European Payments Council) which brings together the European Payments industry to establish a single market for payments in euro in the EU. In terms of payment card systems, by 1 January 2008, there should be no technical, structural or behavioural barriers for payment card acceptance at the point of sale in the EU.

At the same time the Commission is working on making the Internal Market for Payments a reality which will create one domestic market for all payments within the EU. The aim of the Internal Market for Payments is also to promote more efficient means of payment over less efficient means of payments such as cash and cheques to the benefit of the wider economy.

SEPA will provide three important benefits to consumers: more competition in payment markets, among banks for merchants to accept cards and opening of every stage of the payments value chain to new entrants; increased ability for consumers to use payment cards, as more and more merchants both national and cross-border accept them; and provide efficiency gains including reducing transaction costs of payment processing for banks. The result is a true internal market for euro payments in the EU that will positively influence citizens' intra-European mobility, encourage cross-border retailing and lead to further economic growth.

The goal of SEPA in respect of card payments is to allow European consumers to use their payment cards anywhere in Europe as they would in their home country, however, it is important to stress that the main impacts of SEPA are likely to be on the domestic markets. Already, international payment card systems operate pan-European and global payment infrastructures, thereby representing forces of market integration and cross border competition in payments. Banks are well on their way to making the necessary investments to their systems to become SEPA compliant for card payments. Remaining issues of uncertainty revolve mainly around the future of interchange fees in payment card systems, as interchange fees are the subject of competition enforcement action.

European Commission Sector Inquiry on retail banking

The European Commission's Competition Directorate (DG COMP) opened in June 2005 an investigation (sector inquiry) into retail banking. The purpose of a sector inquiry generally is to identify potential market failures which may be addressed in future by competition (antitrust) actions at the European or national level, and are therefore exploratory in nature.

Key findings from the final report, released in January 2007, from the part of the sector inquiry addressing payment cards involved the identification of several potential competition issues, including national fragmentation of markets, high concentration levels in certain countries among banks competing for merchant business, and variation across Member States in interchange fee levels. It should be noted that observing national variation in market structure does not in itself suggest that there is an abuse of market power, as historical conditions and regulatory barriers to entry may have precluded full competition at the national level. The Commission encouraged the industry to take the necessary steps through self-regulation like under the SEPA project or through further enforcement

actions by the Commission or national authorities, who would be better positioned to address specific local concerns.

Payment Services Directive (PSD)

The Payment Services Directive (PSD) is intended to complement SEPA by establishing a modernized and complete legal framework necessary for the creation of an integrated payments market across the EU. National rules governing market entry in payments in the 27 Member States vary considerably, creating regulatory barriers to entry; the PSD is intended to address this. In addition the PSD will also provide harmonised set of rules and rights and obligations for both payment services users and providers. These refers to, inter alia, information requirements for consumers, liability for payment providers and standardized execution times for payments. The PSD will also foster competition by creating a new category of actors to open the payments market to non-bank payment operators: the so-called Payments Institutions.

With regard to card payments, there is limited impact of the PSD itself, as opposed to the effect of maintaining momentum for SEPA. Whilst non-bank payment providers already exist in today's payment market, the PSD will provide a regulatory framework for them in order to stimulate further entrants to the market.. Although payment institutions cannot take deposits, they will be able to issue payment cards and offer acquiring services to merchants as well as access to payment systems. Now that the PSD has been adopted by the European Parliament and by the Council, Member States must implement the Directive by November 2009 at the latest.

Competition enforcement against payment card systems

The Commission's final report on the sector inquiry on retail banking clearly acknowledges the positive role of the payments industry in creating SEPA and abandoned the idea of abolishing the interchange fee. The interchange fee is a fee paid between the retailer's and cardholder's bank which is used as a balancing tool to attract the optimal number of users. Furthermore the interchange fees can be used to incentivise certain behaviour such as migration to chip.

In addition to the above actions, at the European level DG COMP continues to investigate MasterCard Europe's cross-border interchange case. Commission officials have publicly stated that they hope to issue a decision in the MasterCard case by the end of 2007. A number of national competition authorities are scrutinizing domestic interchange fees mechanisms or are waiting for the Commission's decision.

Continued uncertainty about interchange fees could slow down banks' investment in SEPA and the replacement of cash – more expensive and less secure a payment method than cards – which goes against the goal of creating an integrated, modern and efficient European market for payments.

Without the interchange fee, the cardholder's bank will see substantially less benefit in continuing to offer payment cards to consumers under current conditions. Innovation and investment or indeed the so-called 'third European scheme', may be delayed or even scrapped if interchange fees are capped through regulatory intervention. Whilst the Commission still seems to believe that interchange fees should be reduced significantly, the result could be the return of cash instead of cards. Cash not only costs more than card payments, it also lends a hand to potential money launders and shadow economies, leads to the potential loss of tax revenue to EU Member States, and represents a security risk all along the handling line (for money transports, ATM points, stores, banks, etc.).

Conclusion

Especially given the heightened level of scrutiny of payment cards over the last few years, additional regulatory initiatives aimed at the payment industry would seem premature. Established public policy principles of promoting competition and intervening only in cases of clear market failure remain unchallenged. Most important, current market developments should be evaluated carefully as part of regulatory impact assessments before developing new regulations for payment systems – as encouraged by Commission policy concerning better regulation.

The policy foundation for secure, modern and efficient payments markets in Europe could be strengthened, however, with attention to a few key areas. Further public policy efforts to foster the integration of national markets in payments could be useful, in particular:

- The commitment by regulators and policy makers to ensure a level playing field for all competitors in payment markets, whether new entrants or established players, irrespective of their business model.
- Resolution of remaining concerns about the role of interchange in payment systems. Interchange fees provide the basis for a balanced pan-European payment system by allocating costs in a transparent manner along all participants.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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