EUROPEAN PAYMENT SERVICES: HOW INTERCHANGE LEGISLATION WILL SHAPE THE FUTURE OF RETAIL TRANSACTIONS

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ABSTRACT: *On October 15, 2014, the European Council released a compromise text of the Commission's proposed interchange fee regulation. The most recent text includes welcome changes and is overall likely to benefit consumers, competition, and innovation. However, in light of the underlying rationale for market intervention and the European Court of Justice's recent MasterCard judgment, several final changes should be considered before the full 'payments package' enters into force. First, since three party schemes do not meet any of the market failure identified they should be fully exempt from legislation. There is no evidence that leaving such schemes unregulated will impede the functioning of the single market or result in an "un-level playing field." Second, interchange fees should be banned. Although the proposed weighted--average interchange fee caps for four-party schemes are in line with commitments offered by the (dominant) card schemes in the context of competition law proceedings, interchange fees are currently considered illegal under EU competition law (under certain conditions). Settling for a methodology that can result in constantly changing "optimal" MIF levels will only subject regulatory intervention to continued scrutiny and keep the debate alive. For those worried about possible adverse effects of the regulation on cardholders, additional protection offered by Directive 2014/92 should alleviate concerns that banks will pass on lost revenue to vulnerable consumer groups. Finally, surcharging should be banned entirely as merchants will benefit significantly from lower costs and choice.*

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I. INTRODUCTION

On September 11, 2014, the Court of Justice of the European Union (the "ECJ") confirmed the Commission's 2007 MasterCard Decision[2] and held that the long-standing practice of fixing multilateral interchange fees ("MIFs") for card payment transactions is incompatible with European law.[3] This judgment, in combination with a number of other competition enforcement and regulatory developments, marks the beginning of the end of a fierce battle between the European Commission and four-party payment card schemes that has lasted over two decades.[4]

In parallel to its antitrust investigations, the Commission adopted a comprehensive legislative package on July 24, 2013, consisting of a revised Payment Services Directive ("PSD2") and a Regulation on Interchange Fees (the "IF Regulation").[5] The package aspires to codify a comprehensive solution to the competition concerns and identified market failures in the payment industry, as well as create a common European framework to fill the gap between diverging national regulatory practices. After enduring months of heated debate, the European Parliament ("EP") adopted amendments to both texts on April 3, 2014,[6] and more recently, the Council of the European Union ("Council") released a compromise text of the IF Regulation on October 15, 2014.[7]

This paper will attempt to provide a concise overview of the concerns that have arisen in the market for card-based payments; in particular, those resulting from multilateral interchange fees and related network rules imposed by four--party card schemes. In light of the identified concerns, the latest version

2 Commission Decision of December 19, 2007, Joined Cases COMP/34.579 *MasterCard*, COMP/36.518, *EuroCommerce*, and COMP/38.580 *Commercial Cards*, (together, "MasterCard I").

3 Case C-382/12 P, *MasterCard Inc., MasterCard International Inc., and MasterCard Europe SPRL v Commission*, September 11, 2014. Although this judgment only directly concerns MasterCard's MIFs for cross-border payment transactions within the EU, the effects-based theory of harm, at its core, applies equally to all MIFs. *See also* Commission Decision of February 26, 2014, Case COMP/39.398 *Visa MIF* (Commission secured commitments from Visa to reduce its credit card MIFs to 0.3% in all countries where Visa sets the rate directly) and Case COMP/40.049 *MasterCard II* (Commission investigation into MIFs in relation to payments made by cardholders from non EEA countries).

4 The first complaint concerning MIFs was brought by UK retailers in 1992.

5 See http://ec.europa.eu/internal_market/payments/framework/index_en.htm (accessed on October 30, 2014).

6 European Parliament, 2014.

7 European Council, 2014.

of the proposed legislative package is likely to benefit European consumers and enhance the functioning of the Single Market. In particular, legislation is expected to greatly increase acceptance of card-based transactions, thus enhancing the usage of the most efficient means of payment. The current package will also introduce measures to allow pan-European market entry by third party payment service providers (i.e. non-bank entities). This will allow a wide range of new payment services to compete with the traditional players, which will increase competition and consumer choice.

Some of the proposed measures, however, are slightly misguided and should be amended appropriately before a final version is adopted. The underlying reason for regulating interchange fees is the existence of a "*market failure*" where "*schemes and/or scheme participants* [can exercise market power] *to impose restrictive rules and business practices on other market actors*."[8]

In light of the underlying rationale, in particular, this paper concludes that three-party schemes should be fully exempt from the scope of the IF Regulation and should not be subject to the open access requirement in the PSD II. The exemption of "corporate cards" also seems to be directly at odds with extending regulation to three-party schemes when they use select licensees to issue their cards. Secondly, if interchange fees (as a "mechanism") are conducive to collusion between financial institutions, it would be desirable to either: (i) consider an absolute ban or (ii) adopt certain amendments to the applicable interchange fees for "cross-border acquiring" in the event that Member States will be allowed to impose alternative caps at a "domestic level." From a consumer perspective, considering the significant benefits and choice for merchants that will result from regulatory intervention, surcharging should be banned entirely.

II. TWO-SIDED MARKETS, CARD SCHEMES, AND MIFS

A. Two-sided markets

In all classic examples of two-sided markets there are two distinct user groups that use a certain platform to interact with each other. The platform operator will need to get enough users on both sides "on board" in order to ensure the platform's success (*i.e.* it must create membership or network externalities).[9]

8 European Commission, 2013: 15-16.

9 See e.g. Rochet & Tirole, 2004: 3, 40.

Demand for the platform on one side is dependent on demand on the other side, and vice versa.[10] Generating a critical user base can be achieved by adopting an asymmetric pricing strategy which, for example, takes into account the willingness to pay on each side. According to Rochet & Tirole (2006) for a market to be truly two-sided, a change in price *structure* must affect the volume of transactions on the platform (*i.e.* it must create usage externalities).[11]

When taking the market for card-based payments as an example, the user groups are cardholders on the one hand, and merchants on the other, with the card scheme as the platform. Merchants will, in principle, only choose to accept a certain scheme if enough cardholders are on board, and vice versa, one would expect that cardholders will only use a scheme if enough merchants are "on board". Once there are enough users on both sides, the scheme will try to stimulate usage externalities by adopting an appropriate price structure.

B. Card schemes and interchange fees

Two main types of card schemes can be distinguished; four-party schemes and three-party schemes.

Four-party schemes are the most ubiquitous (*i.e.* Visa, MasterCard) and consist of four distinct parties in addition to the scheme itself: (i) issuing banks, (ii) cardholders, (iii) acquiring banks, and (iv) merchants. Cardholders have a direct relationship with their issuing banks and merchants contract directly with acquiring banks.[12] The card scheme provides its services to issuing and acquiring banks through a system of membership/ joint ownership.[13]

10 One can imagine, for example, that a video game platform would be useless for gamers if no developers would create games for them to play Vice versa, no developers would want to create games for a platform if no gamers were on board.

11 See e.g. Rochet & Tirole, 2006: 35. "*A market is two-sided if the platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount; in other words, the price structure matters, and platforms must design it so as to bring both sides on board*." [Emphasis added].

12 In practice, *inter alia*, where retail banking markets are concentrated, for a given transaction both the acquirer and issuer may very well be the same financial institution. Such transactions are often referred to as "on us" transactions.

13 Four-party schemes such as MasterCard were originally set up by banks to develop a common network for card-based payment services. They later evolved into membership-based organizations that were governed de-centrally by its member banks, where the largest national or regional banks would have the largest influence in determining the applicable network rules and fees. Both MasterCard and Visa respectively floated their organizations on the stock market in 2006 and 2008.

The scheme levies distinct fixed and variable network fees to its members for the processing of payment transactions (including authorization, clearing and settlement), designing product-specific reward and loyalty programs, marketing, and other services.[14]

An interchange fee is a mechanism typically imposed by four-party payment card schemes' "network rules" that contractually binds acquiring banks to "pay" a pre-determined fee to issuing banks for each card transaction. These fees are set at different levels for different types and brands of cards (*e.g.* debit/credit cards subdivided into premium/non-premium or corporate brands) and can vary significantly between Member States.[15] Interchange has been justified by schemes on a number of grounds, among others, as a necessary mechanism to "*reimburse issuers for a portion of their costs*"[16] or *balance costs* to increase the scheme's output. Interchange fees are mostly multilateral, *i.e.*, they are (collectively) imposed through the card scheme for all acquiring member banks alike, as opposed to *e.g.* a "bilateral" alternative that would allow acquiring and issuing banks to negotiate the level of interchange amongst themselves.

At a transactional level, when a cardholder purchases goods or services from a merchant, the issuing bank will transfer the purchase price to the acquiring bank after deducting the applicable MIF. The acquiring bank, in essence, fully passes on the costs of the MIFs to the merchant in the fees charged for acquiring services (the merchant service charge ("MSC")).

On the other side of the platform, the cardholder's account will be debited by the full amount of the purchase price but will ultimately pay its retail bank a "blended fee" for the entire package of retail banking services (usually an annual account fee). Unlike merchants, cardholders often do not know the precise cost they incur from using cards or the benefits they receive from interchange fees.[17]

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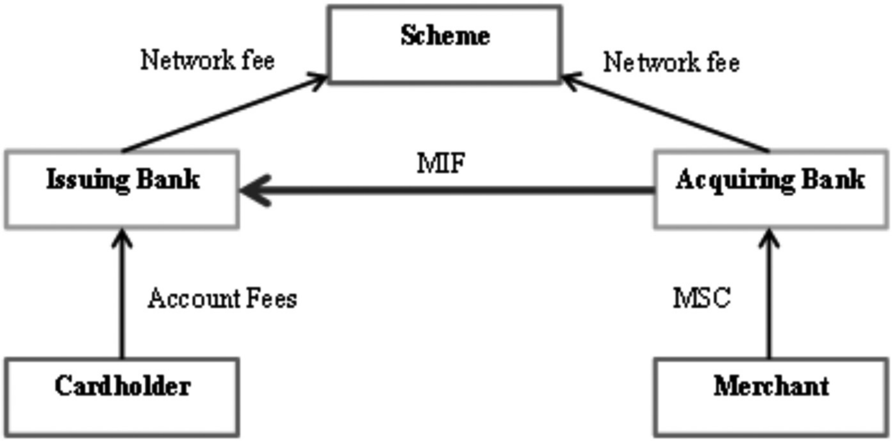
14 See e.g. MasterCard 2013 Annual Report, p. 4, available at: http://www.ezodproxy.com/mastercard/2014/ar/HTML2/tiles.htm (accessed on October 31, 2014).

15 See e.g. Börestam & Schmiedel, 2011: 20. In 2010, the ESCB shows that on a €100 debit card transaction fees varied between €0.01 and €1.55.

16 See e.g. MasterCard 2013 Annual Report, p. 6. "*Generally, interchange fees are collected from acquirers and paid to issuers to reimburse the issuers for a portion of the costs incurred by them in providing services that benefit all participants in the system, including acquirers and merchants.*"

17 Merchants often face "blended" fees as well, making it impossible to discern the exact cost per--transaction for accepting distinct cards. Merchants do however see and incur the total costs of card acceptance quite clearly in their invoices.

Figure 1 – Basic operation of a four-party scheme

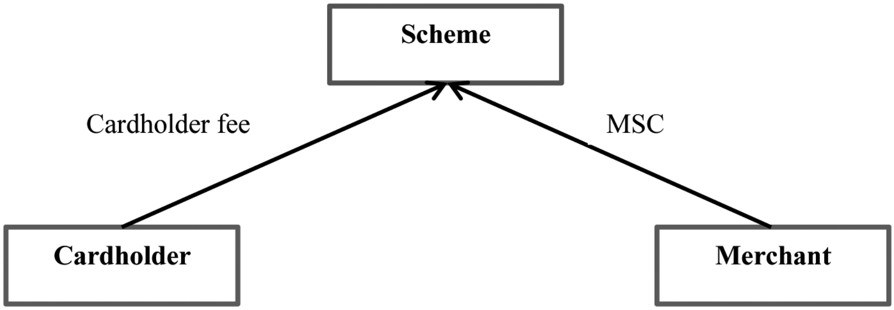


Three-party schemes (such as American Express and Diners Club) are distinct from four-party schemes in the sense that (usually) banks are not involved as intermediaries. The scheme itself serves as an issuer and acquirer and reaches agreement on pricing by (individually) negotiating with both sides. Even when three-party schemes use third party "licensees" to issue or acquire transactions; these are usually limited to select financial institutions with which the scheme will negotiate the applicable costs and services.[18] It is sometimes argued that three party schemes have an "implicit" MIF because they can use the fees levied on one side to subsidize the other. Such statements are slightly misguided as the ability to price discriminate between both sides is an inherent quality of a two-sided market and bears little resemblance to the multilateral nature (M)IFs.[19]

18 See *e.g.* American Express' response to the Commission's Green Paper consultation of April 5, 2012. Available at: https://circabc.europa.eu/sd/a/4756f6e7-66f9-40a8-beed-a26acb64c5bb/non_reg-uk_amex_en.pdf. (accessed on October 31, 2014).

19 Article 28 (2-c) of Directive 2007/64/EC (the PSD I) defines three-party schemes as: "*payment systems where a sole payment service provider (whether as a single entity or as a group) – acts or can act as the payment service provider for both the payer and the payee and is exclusively responsible for the management of the system, and – licenses other payment service providers to participate in the system and the latter have no right to negotiate fees between or amongst themselves in relation to the payment system although they may establish their own pricing in relation to payers and payees* [emphasis added]."

Figure 2 – Basic operation of a three-party scheme



C. Debit vs. credit cards

Debit cards are intrinsically linked to a consumer's personal checking account. These cards have become essential to access the funds available on a bank account. Debit cards can be used to withdraw cash from automated teller machines ("ATMs") or purchase good/services directly at merchant outlets (otherwise known as Points of Sale "POS"). Debit card transactions "immediately" deduct funds from the cardholder's account – usually within 48 hours after authorization. Over the past decades, debit cards have helped to significantly reduce banks' costs by, *inter alia*, allowing them to close unnecessary branches and move away from more costly and insecure means of payment (such as checks). According to the European Central Bank ("ECB"), widespread (debit) card usage beyond a certain "tipping point" reduces the per transaction cost of debit cards to the lowest amongst payment methods in the EU. The ECB concludes that in terms of societal benefit, the countries with the lowest social costs of payments are those in which non-cash payments are predominant.[20]

Credit card transactions are debited from the cardholder's account at regular (often monthly) intervals. A distinction can be made between 'pure' credit cards and 'deferred debit' cards. Credit cards offer a credit facility (a loan) that allows cardholders to pay off their bill in installments (against hefty interest payment).[21] When cardholders do not make use of the revolving credit facility

20 *See* European Central Bank, 2014, p.26.

21 At ING in the Netherlands, for example, the Annual Percentage Rate of Charge ("APR") can range between 13% and 27.5% depending on the card type and credit amount. *See*: https://www.ing.nl/particulier/betalen/creditcards/voorwaarden-gespreid-betalen-cards.html (accessed on November 1, 2014).

on the card, it turns into a de facto 'deferred debit card', and the bill is deducted from their current account in full at a fixed interval.

Corporate cards are only issued to businesses and must be used for 'business related transactions', whereas consumer cards are intended for general use.

III. EUROPEAN ANTITRUST PROCEEDINGS

A. Theory of harm

Since 2002, the European Commission consistently adopted the same underlying theory of harm in its investigations of interchange fees – one which has recently been fully upheld by European Union's highest court.[22] According to the Commission, MIFs form a restriction of competition by effect under Article 101(1) TFEU on the acquiring market as they result in a price floor (or minimum price) on the MSCs charged by all acquiring banks to merchants.[23] The Commission concluded that MIFs could make up as much as 70% of the total cost incurred by merchants for accepting cards.[24] In the absence of MIFs, individual issuing and acquiring banks would be able to determine their own pricing policies under competitive conditions. At the same time, MIFs restrict the ability for merchants to negotiate a price of acceptance below the collectively determined fees.

The Commission concluded that MIFs are not objectively necessary for the viability of four-party schemes (without denying the existence of potential two-sided market specificities). According to the Commission, the only *necessary* conditions that need to be imposed for a four-party scheme to function (in addition to common technical standards) are an obligation to accept payments on the network and a prohibition of ex-post pricing. A mechanism that shifts revenue to issuing banks is not necessary as both sides of the market could simply recover costs from their respective consumer groups. In support of these conclusions, the Commission provided examples

22 Case C-382/12 P, *MasterCard Inc., MasterCard International Inc., and MasterCard Europe SPRL v Commission*, September 11, 2014.

23 See Commission decision of July 24, 2002, Case COMP/29.373, para. 64; Commission decision of December 19, 2007, Joined Cases COMP/34.579 *MasterCard*, COMP/36.518 *EuroCommerce* and COMP/38.580 *Commercial Cards*, para. 400; Commission decision of February 26, 2014, Case COMP/39.398 (*Visa MIF*), para. 23.

24 Joined Cases COMP/34.579 *MasterCard*, COMP/36.518 *EuroCommerce* and COMP/38.580 *Commercial Cards*, paras. 428-438.

of a number of domestic four-party card schemes that operate efficiently without MIFs.[25]

The Commission's analysis of harm under 101(1) TFEU also covers the effects of MIFs on inter-system competition (between schemes). Without a mechanism in place that forces issuing banks to pass-on MIF revenue to cardholders, competition between Visa and MasterCard has a ratchet effect on the level of interchange, which in turn, increases harm on the acquiring market. In four-party systems, issuing banks ultimately dictate which scheme's cards will wind up in cardholders' pockets. Therefore, in order to entice banks to issue one scheme over the other, schemes have the incentive to compete by creating an "upward spiral" in the level of interchange fees.[26]

Although each of the investigations was brought under Article 101 TFEU as a decision of an "*association of undertakings*"[27], the Commission clearly emphasized the respective strong position(s) of Visa and MasterCard on the relevant European markets. This conclusion is not only necessary for finding an 'appreciable effect on competition' under Article 101 TFEU, but also points to a degree of market power that could justify intervention through other means. In its MasterCard decision, the Commission found that Visa was the only other scheme that could match MasterCard in terms of network size in the EEA. In terms of cards issued, Visa and MasterCard each had market shares of roughly 45% in 2004.[28] In terms of acceptance, both Visa and MasterCard were accepted by approximately 5 million merchants in the EEA.[29]

The Commission considers that the anticompetitive effects of MIFs are reinforced by a number of additional scheme rules and transparency

25 Such schemes include: Pankkikorttii (FI), Bancomat (LUX), Dankort (DK), Pin (NL), and Bax (NO). *See* Joined Cases COMP/34.579 *MasterCard*, COMP/36.518 *EuroCommerce* and COMP/38.580 *Commercial Cards*, Table 9 at para. 556.

26 Commission decision of July 24, 2002, Case COMP/29.373, para.80; *See also* Case T-111/08, *MasterCard and Others v Commission,* May 24, 2012, para.255.

27 This was disputed in the MasterCard proceedings as MasterCard changed its corporate form in 2006 and became a publicly traded company. The ECJ, however, held that that given the specificities of the case "*both the banks' residual decision-making powers after the IPO on matters other than the MIF, and the commonality of interests between MasterCard and the banks, were both relevant and sufficient for the purposes of assessing whether, after the IPO, MasterCard could still be considered to be an 'association of undertakings', within the meaning of Article 81 EC.*" Case C‑382/12 P, *MasterCard Inc., MasterCard International Inc., and MasterCard Europe SPRL v Commission*, September 11, 2014, para. 72.

28 Joined Cases COMP/34.579 *MasterCard*, COMP/36.518 *EuroCommerce* and COMP/38.580 *Commercial Cards*, Diagram 1 at para. 110.

29 *Ibid*, para. 115.

issues. These include the so-called Honor all Cards Rule[30] ("HACR"), the Non-Discrimination Rule[31] ("NDR"), the restriction of cross-border acquiring[32], and the practice of offering "blended fees" to merchants.[33]

B. Remedies

In its 2002 Visa decision, the Commission acknowledged the two-sided nature of the market and granted Visa a temporary exemption subject to a modified MIF. The Commission accepted, in theory, that a MIF set at an appropriate level could contribute to technical and economic progress by stimulating usage on the cardholder side (by reducing costs for issuing banks) which could create positive network externalities.[34] In 2007 the Commission took a more reasoned and restrictive approach, finding that the evidence put forward by MasterCard was (ex-ante) insufficient to justify the applicability of Article 101(3) TFEU. MasterCard, simply said, only based its efficiency claims on a general assertion that balancing demand through a MIF is necessary to optimize system output. Although MasterCard also provided theoretical models on which its interchange fees would be based, the Commission found that these failed to include relevant variables that would lead to a justifiable level of MIFs. In its assessment of potential consumer benefits, the Commission did not find sufficient proof that network externalities would offset merchant harm, nor did MasterCard produce objective data to quantify the willingness to pay on the cardholder side that would justify interchange at the prescribed level.[35]

MasterCard temporarily repealed its cross-border MIFs in 2008 and offered unilateral commitments to set its interchange fees at a level that

30 The HACR requires merchants to automatically accept all brands of cards issued by a given scheme.

31 The NDR limits the ability for merchants to surcharge cardholders for using a specific form of payment card.

32 Cross-border acquiring restrictions limit the ability and incentives for merchants to use the services of an acquiring bank in another Member State, as the scheme rules will force merchants to pay the MIF rate in the country where the transaction takes place (as opposed to the rate applicable in the acquirer's country or the cross-border MIF)

33 See Commission Decision of February 26, 2014 (2014/C/1199), paras. 23-25.

34 Commission Decision of July 24, 2002, Case COMP/29.373, para. 83.

35 See Joined Cases COMP/34.579 *MasterCard*, COMP/36.518 *EuroCommerce* and COMP/38.580 *Commercial Cards*, paras. 731-751.

would, essentially, mitigate the harm on the acquiring market in 2009.[36] The Commission and MasterCard agreed to use an economic model developed in the literature called the "tourist test" that caps the weighted average interchange fee at a level at which merchants would be indifferent between accepting cards and cash.[37] The Commission accepted that the cumulative conditions of Article 101(3) TFEU could be met when applying this methodology. The commitments resulted in a reduction of MasterCard's cross-border (intra-EEA) credit and debit card MIFs to 0.3% and 0.2% respectively.[38] This same basis was later used in 2010 and 2014 to secure commitments from Visa for *all* its domestic, cross border, and international[39] debit- and credit card MIFs (where Visa sets the fees itself).[40]

In 2009, MasterCard committed to introduce transparency measures that would allow merchants to distinguish the applicable interchange fees for each type of card in their invoices from acquirers (as opposed to "blended" rates). Visa offered similar, if not more far-reaching transparency measures in 2010 and 2014. Visa and MasterCard also offered to *inform* merchants that the acceptance of debit card transactions is not conditional on the acceptance of credit cards, and vice versa (a clarification that the HACR does not apply between card *types*). In addition, Visa committed to open cross-border acquiring for all transactions at either (i) the intra-EEA averages of 0.3% and 0.2%, or (ii) the domestic rates applicable in the country of the acquirer. This commitment will enter into force on January 1, 2015. MasterCard's cross-border acquiring rules are still under investigation, as well as the HACR (with respect to its credit card *brands*) and the MIFs applicable to international transactions.[41]

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36 See European Commission, 2009.

37 Also referred to as the Merchant Indifference Test ("MIT"). For the theoretical basis, see: Rochet & Tirole, 2008.

38 Prior to the commitments, depending on the card, MasterCard's cross-border MIFs for credit cards ranged from 0.80% to 1.90% in 2007, and its debit card MIFs ranged from 0.40% to more than 0.75%. *See*: http://europa.eu/rapid/press-release_IP-09-515_en.htm?locale=en (accessed on November 6).

39 Where the cardholder's issuer is located outside the EEA.

40 *See* Commission Decision of December 8, 2010 (2011/C 79/05); Commission Decision of February 26, 2014 (2014/C/1199). In countries where Visa does not set the MIFs itself, these are usually determined multilaterally by domestic bank associations. When the commitments were proposed in 2010, the countries concerned were Greece, Hungary, Iceland, Ireland, Italy, Malta, Sweden, Luxembourg and the Netherlands.

41 See European Commission Press Release of April 9, 2013, available at: http://europa.eu/rapid/press--release_IP-13-314_en.htm?locale=en.

C. Conclusions

The recent Court of Justice ruling confirms that MIFs, under certain conditions, are incompatible with European law. This could be rephrased by stating that MIFs are now *illegal* in the EU. This conclusion, however, is potentially limited by the specificities of the MasterCard case.

First, the judgment only concerns *multilateral* interchange fees. It is after all the multilateral nature that brings these fees within the scope of Article 101(1) TFEU. The European Commission has never, to my knowledge, scrutinized *bilateral* interchange fees (*i.e.* fees individually negotiated between issuing and acquiring banks). The Commission even uses examples of schemes based on bilateral fees to support the commercial viability of lower cost domestic systems. The Court explicitly mentions this consideration in paragraph 11 when it summarizes the scope of the Commission's infringement decision.

Second, the MasterCard decision only covers intra-EEA (cross--border) MIFs. The cross-border scope of the investigation is a result of the jurisdictional "effect on trade" criterion embedded in Article 101 TFEU. This limitation, however, does not necessarily affect the broader implications of the judgment. The Commission's theory of harm is fundamentally based on the price-floor effect of MIFs on the acquiring market, set by a scheme that is able to exert (collective) market power. This will hold true for any multilateral interchange fees, including those set at a Member State level. Since harm on the acquiring market will also arise when non-EEA cardholders use their cards at merchant outlets in the EEA, the scope would seem to extend to 'international' MIFs as well.

As briefly alluded to above, the theory of harm seems to be intrinsically linked to the notion of *market power*. I find it hard to imagine that merchants would feel obligated to accept cards at high prices than their marginal perceived benefit if they were not ubiquitous or forced upon them by scheme rules such as the HACR. The reason why merchants may be willing to pay to accept cards above their marginal convenience is because some cards have become 'must--take cards'. If a merchant chooses not to accept a must-take card, he would be likely to lose customers to a competitor (the 'business stealing effect').[42] The business stealing effect is supported by the Commission's analysis and the economic literature.[43] The HACR makes things worse because merchants,

42 See Vickers, 2005: 231–247.

43 See e.g. Rochet & Tirole, 2011: 462–495.

when choosing to accept the 'must-take' card, will instantly be forced to accept all brands within the same scheme (including 'premium' cards that come paired with the highest levels of interchange).

Market power might also be an explanation as to why MIFs are not optimally used as a 'balancing tool' in a two-sided market. Especially in markets where acceptance is falling behind (and the issuing side is saturated), the 'balancing theory' would dictate that it would be rational to *reduce* costs to attract more merchants – which in turn would benefit the scheme by creating additional positive network externalities. Instead it would seem to be more profitable for banks to adopt monopolistic pricing as opposed to optimizing two-sided demand.

In contrast, card schemes that *do not* have market power should not fall within the scope of the Commission's theory of harm.

As a final note on the Court of Justice ruling, the General Court was criticized for relying on the same counterfactual hypothesis (a prohibition of ex-post pricing[44]) when it examined MIFs as an ancillary restraint as well as in its examination of the restrictive effects of MIFs.[45] In particular, the Court could not confine itself to considering the mere *viability* of the scheme with a prohibition of ex-post pricing when examining the anticompetitive effects of MIFs, but also whether the counterfactual would be a *plausible* or *likely* market outcome. In doing so, it was required to take the economic and legal context of the concerned market into account (in particular the existence of the HACR which was not under investigation in the present case, and would have prevailed in the absence of the MIFs[46]). However, this was pardoned as the General Court properly assessed the relevant factual context earlier in its judgment by showing that a prohibition of ex-post pricing would be a more realistic market outcome than letting the MasterCard system collapse.[47]

44 A rule prohibiting issuers and acquirers from defining the amount of the MIF after a purchase has been made.

45 Case C-382/12 P, *MasterCard Inc., MasterCard International Inc., and MasterCard Europe SPRL v Commission*, September 11, 2014, paras 163-164.

46 The argument being that without a MIF, the HACR (which forces acquirers to accept all transactions carried out with a MasterCard card) would have the effect of "*putting acquirers at the mercy of issuers, who would be able to determine the level of the interchange fee unilaterally, since merchants and acquirers would be bound to accept the transaction.*". *See* Case T-111/08, *MasterCard and Others v Commission,* May 24, 2012, para. 94.

47 *Ibid,* paras. 95-96. See also: Case C-382/12 P, *MasterCard Inc., MasterCard International Inc., and MasterCard Europe SPRL v Commission*, September 11, 2014, para. 173-174.

IV. EUROPEAN REGULATION OF INTERCHANGE FEES

On July 24, 2013, the Commission published two separate proposals for a revised PSD ("PSD II") and an IF Regulation. The proposals were preceded by a Green Paper published on January 1, 2012, in which the Commission sought input from key stakeholders on the desired scope of regulation.[48] This section will focus mostly on the latest MIF proposal, while taking certain interrelated measures in the PSD II into account.

A. The need for legislation

The IF Regulation proposal has its roots in the Commission's antitrust investigations, as well as in similar regulatory initiatives abroad (*i.e.* Australia[49] and the US[50]).

The legal basis for regulatory intervention can be found in Articles 114 TFEU, 26 TFEU, and 3(3) TEC which call for the establishment of a single market. Market regulation of interchange fees forms part of a larger plan to create an integrated market for payments[51] which requires "*a Union-wide approach as the applicable principles, rules, processes and standards have to be consistent across all Member States in order to achieve legal certainty and a level playing field for all market participants*."[52] The Commission proposal highlights that the application of existing rules, including competition enforcement at a national level, has not been sufficient to address the concerns on the internal market.

Market failures. The Impact Assessment accompanying the legislative package rephrases the theory of harm as a "*market failure*" where "*schemes and/or scheme participants* [can exercise market power] *to impose restrictive rules and business practices on other market actors*."[53] It is not surprising that these "restrictive rules" concern the same interchange fees and scheme rules briefly

48 Commission, 2012.

49 *See* http://www.rba.gov.au/payments-system/legal-framework/current-regulations.html (accessed on November 7, 2014).

50 *See* http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm (accessed on November 7, 2014).

51 Existing legislation includes rules for credit transfers, direct debits, cross-border payments, electronic money and credit institutions, and settlement finality. *See* http://ec.europa.eu/finance/payments/legislation/index_en.htm (accessed on November 14, 2014).

52 See European Commission, 2013: 35.

53 European Commission, 2013: 15-16.

touched upon in section III of this paper.[54] In contrast to the investigations under Article 101 TFEU (*i.e.* tackling collusive behavior), the Regulation aims to tackle (collective) "*market dominance of card schemes*" that has created obstacles to effective competition and functioning of the single European market.[55] The economic literature, under the right assumptions, supports the conclusion that market power can lead to sub-optimal two-sided pricing that can affect (consumer) welfare.[56]

Restriction of cross-border acquiring. One of the main obstacles to market integration is that Visa and MasterCard (and their member banks) have each been able to partition the internal market by setting different interchange fees in each Member State for similar card transactions.[57] I think the point here is that there is no discernible difference between a plain 'Maestro' branded debit card issued in Poland or in the Netherlands (from the perspective of cardholders and merchants). Interestingly though, the average debit card MIF in Poland was 1.6% in Poland and 0.06% in the Netherlands in 2013.[58] As we have seen, interchange fees create a price floor on the acquiring costs, while scheme rules prohibit merchants from 'shopping abroad'. In essence, the prohibition of cross-border acquiring (in combination with technical barriers) restricts trade between Member States by locking-in merchants to high domestic fees, and ultimately prevents price convergence throughout the Union.[59]

Competition enforcement has failed to create a level playing field. A second barrier to market integration flows from the Commission's own antitrust investigations. Decentralized competition enforcement at a national level has produced mixed results as well.[60] The commitments offered by Visa and MasterCard all differed in scope and timing which has, in some cases, resulted in major artificial shifts in the competitive landscape of certain

54 In addition to interchange fees, the Commission places particular emphasis on the detrimental effects of the HACR and the NDR. *See* European Commission, 2013: 120-122.

55 See European Commission, 2013: 29.

56 See *e.g.* Wright, 2012.

57 Country average MSC rates range between 0.3-0.4% to 1.9%.

58 See European Commission, 2013: 35.

59 For a graphic illustration of the different fees applied in each Member State, *see* European Commission, 2013: 21.

60 See European Competition Network, 2012.

Member States. For example in Hungary, when Visa's debit card commitments became public in 2010 (capping its MIFs to 0.2% per transaction), domestic issuing banks shifted to MasterCard (with non-regulated fees), reducing Visa's market share of issued cards by 45% within a very short period of time.[61]

Interchange fees stimulate 'reverse competition'. Empirical evidence shows that interchange fees, when left to the market, can trigger "reverse competition" in the fight to attract issuing banks with additional revenue. In the absence of scheme rules that require interchange to be passed on to cardholders, this additional revenue can simply 'disappear' into retail banks' revenue pools. As shown in the previous paragraph, issuing banks are therefore likely to shift to whichever scheme is able to provide the highest interchange revenue. The Impact Assessment provides a good example of such a 'natural' shift in the issuing market for debit cards in the UK where a failure to react to a strong bump in interchange from Visa cost MasterCard roughly 90% of its market share within just a few years.

Barriers to entry and disappearance of domestic schemes. A third issue worth mentioning is the disappearance of (efficient) domestic card schemes that have gradually been replaced by Visa and/or MasterCard. It would seem more beneficial for issuing banks to accept higher multilateral fees set for them collectively by a 'third' party (the larger international schemes) than to succumb to competitive pressure from bilateral negotiations with domestic acquirers and accept lower interchange revenue. The Commission provides examples of national schemes that have disappeared in the UK, the Netherlands, Austria, Finland, and Ireland. In the Netherlands, for example, banks decided to discontinue PIN and switch to Maestro and V-Pay in their migration plan towards SEPA Card Framework compliance,[62] while the domestic PIN scheme was already technically capable of becoming compliant. This decision resulted in heavy scrutiny from the Dutch competition authority who considered that a collective decision to discontinue "*one of the cheapest and most efficient schemes in Europe*" could be caught under the national equivalent of Article 101

61 See European Commission, 2013: 175.

62 The SEPA Cards Framework was designed to create a pan-European set of rules and principles that card schemes would have to comply with to allow interoperability across Europe. *See* http://www.europeanpaymentscouncil.eu/index.cfm/knowledge-bank/other-documents/sepa-cards-framework-v-21/ (accessed on November 13, 2014).

TFEU.[63] Ultimately, PIN was discontinued, but only under the condition that the existing low fees would be maintained through a cooperation agreement between retailers and banks.[64] The same enticing nature of MIFs is also seen as a barrier to entry, as any new scheme would have to convince issuing banks to issue their cards by offering the same interchange fees.[65] In practice, this would seem impossible as a new scheme would also need to create a broad enough acceptance network to be commercially attractive to issuing banks. It would seem highly unlikely that merchants would accept a brand new scheme with the same high costs as the ubiquitous 'must-take' cards they are already paying for.

Lack of interoperability. The Commission highlights the divergence of standards and messaging protocols used in various national markets as an additional barrier for domestic schemes or new entrants to expand their operations across the EU.[66]

B. The Commission proposal

In light of the identified concerns, the Commission adopted its IF Regulation proposal on July 7, 2013 ("the Proposal").[67] In broad terms, the Proposal intends to (i) cap interchange fees for debit and credit card transactions, (ii) separate schemes from processing, and (iii) limit the application of restrictive business rules.

Interchange fees. Articles 3 and 4 of the Proposal introduce an absolute, value-based cap on domestic and cross-border interchange fees of 0.2% for debit and 0.3% for credit card transactions (in line with the commitments offered by Visa and MasterCard), where both the issuer and acquirer are located in the EU. These caps will apply to *all* types of interchange fees, i.e. multilateral, bilateral, and "implicit" interchange fees.

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63 *See* https://www.acm.nl/nl/publicaties/publicatie/5280/NMa-waarschuwt-banken-lopen-risico-bij-gezamenlijke-afspraken-over-afschaffen-PIN/ (available in Dutch only) [Accessed on November 13, 2014].

64 The agreement called the "Convenant Betalingsverkeer" was recently renewed in September 2014. *See* http://www.khn.nl/nieuwsberichten/2014/sep/verlenging-convenant-betalingsverkeer-meer-pin-dan-contant-over-vier-jaar (accessed on November 13, 2014).

65 European Commission, 2013: 21.

66 European Commission, 2013: 17-18.

67 Available at: http://eur-lex.europa.eu/legal-content/EN/ALL/;ELX_SESSIONID=B31GJp5Vs6Vgb5pTphZV1Bc6JCJpRFGyPQnsQpMDlCwVdj11v92J!-2121910930?uri=CELEX:52013PC0550 (accessed on November 14, 2014).

The interchange caps will only apply to the "regulated area", defined as "*all card transactions that are widely used by consumers and therefore difficult to refuse by retailers, i.e. consumer debit and credit card, and card based payment transactions*" [emphasis added]. The proposed caps would not apply to commercial cards, cards used within "limited networks" (such as in-store credit cards), cash withdrawals at ATMs, or cards issued by three-party schemes. However, when a three-party schemes use licensees to issue or acquire card transactions, they are considered "*as a four-party scheme*" and would fall within scope of the cap. Three party schemes do not have interchange fees, making it quite difficult to see how and why the caps would apply.

The Commission also introduces an anti-circumvention measure prohibiting issuers from receiving "*net compensation*" from payment card schemes. Net compensation is defined as the difference between the fees paid by an issuer to the scheme and any payments or other benefits received by the issuer from the scheme. This was introduced as a mechanism to prevent four-party schemes from compensating issuers in for the loss of interchange in alternative ways, which could have the same effect as a MIF (*e.g*. marketing rebates and discounts). A similar rule was introduced in § 235.6 of Regulation II (Debit Card Interchange Fees and Routing) in the U.S.[68]

Separation of scheme and processing. Article 7 calls for effective unbundling of four-party schemes and processing entities. Card schemes will be required to create processing entities that are separate from the scheme in terms of corporate form, organization, and management. The scheme and processing entity will have to provide services to third parties on non-discriminatory basis, as well as ensure interoperability across the EU according to standards that will be developed by "*international or European standardisation bodies*".

Business rules. Chapter III of the Proposal introduces measures that will unwind many of the restrictive "scheme rules". In particular, the HACR will be limited by allowing merchants to refuse non-regulated card *brands* when they chose to accept a certain scheme (*e.g.* corporate cards). Merchants will also retain the ability to only accept certain *types* of cards within the overarching scheme (such as debit or credit cards).[69] Issuers will also be required to make all brands and types of cards identifiable for merchants, both visually and electronically.

68 *See* http://www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16861.pdf (accessed on November 16, 2014).

69 Once a merchant has chosen to accept a certain "basket" of products, he will still be bound by the Honour All Issuers Rule – i.e. merchants cannot discriminate among financial institutions that issue the same card.

Merchants will also be empowered to steer cardholders towards their preferred payment method at the point of sale and to inform consumers of their card costs. Acquirers will have to offer merchants "unblended rates" so merchants can make informed choices as to what brands they will choose to accept.

Any scheme rules that currently prevent the issuance of cards or other devices with more than one brand or scheme will also be prohibited ("co-badging"). This will allow issuers to offer cards, mobile applications, or other devices that can contain multiple payment methods (*i.e.* a single card that can be used as a Visa, MasterCard, or other payment service). In principle, the choice of payment application will be up to the cardholder, subject to any steering mechanisms in place at the point of sale.

The Regulation will also remove territorial licensing restrictions. Once a scheme provides a financial institution with a license it will cover the entire EEA and can no longer be limited to a single Member State.

C. Changes adopted by the Parliament and Council

Slightly more than a year has gone by since the Commission Proposal was made public, and both the European Parliament and Council have made use of their respective powers to adopt amendments. As it stands, the latest compromise text was adopted on October 15, 2014.[70] The following changes deserve particular attention.

Interchange fees.

Caps

As opposed to the *absolute* interchange fee caps of 0.2% and 0.3% per transaction, the latest text calls for *weighted average* caps instead (recital 19a, and Articles 3 and 4). This will allow Member States and schemes to define different interchange fee categories for card brands and/or merchant segments, as long as the total annual weighted average remains below the set caps. Member States will also be allowed to define a specific cap for "micropayments" (although this term has not yet been defined).[71] All caps remain without prejudice to a Member State's choice to set lower interchange fees (which could, as I read it, also be zero).

70 European Council, 2014.

71 Papal defines micropayments as payments "*under 5 GBP*". *See:* https://www.paypal.com/uk/webapps/mpp/micropayments (accessed on November 18, 2014).

Scope

So-called "universal cards" have also been defined and brought within the scope of the debit card caps. Such "universal cards" can be used as debit or credit, depending on when the cardholder choses to instruct the issuer to debit his/her account.

The entire regulation has been streamlined to make it clear that all provisions apply to "card-based" transactions (Article 2(7)). Although this terminology was included in the original proposal, this has been emphasized more consistently throughout the text. 'Card based transactions' capture *any* service used to complete a transaction, regardless of physical form, that will result in a debit or credit card transaction (*i.e.* through the infrastructure used by card schemes).

Timing

The staggered introduction of cross-border and domestic caps has been discarded in favor of a uniform introduction of all caps after 6 months. The original proposal called for an introduction of cross-border IF caps after 3 months, while the caps for domestic transactions would only enter into force after 24 months.

Three-party schemes. The revised text still treats three-party schemes "as if" they are four-party schemes when they "*license other payment service providers for the issuance and/or the acquiring of payment cards, or issues payment cards with a co-branding partner or through an agent*" (Article 2(15)). This means that, in principle, when three-party schemes use licensees to issue their cards, the interchange fee caps (or at least the prohibition of "net compensation") will apply. Nothing in the revised text addresses the issue of why and how interchange fee caps would be applied to three party schemes.

The Council, however, explicitly allows Member States to exclude such schemes from the scope of the caps if (and only if) they "*have an insignificant relevance*" in terms of "domestic" market share (recital 22). Article 1(4-bis) clarifies that the "insignificant market share" criterion is to be interpreted as a 5% market share "*of the yearly value of all domestic payment card transactions*" [emphasis added]. It is not entirely clear on what grounds the 5% threshold is based. It is equally unclear why such a threshold would be defined at a Member State level and not at a European level. After all, the Regulation seeks to create a "single European payments market."

In addition, the new text emphasizes that where three-party schemes use "*a single licensee or franchisee for both acquiring and issuing of specific card-based payment transactions*", the interchange caps will not apply (recital 22). It is unclear whether this provision concerns a single licensee in the *Union*, or a single licensee *per Member State*.

D. Interrelated changes in the PSD II

The PSD revision[72] was driven by gaps in the original scope, the desire to enhance security requirements and consumer protection measures, and, notably, to enable "non-banks" to enter the market for payment services. The PSD II includes a number of changes that will be intrinsically linked to the new IF Regulation. In particular, I will briefly touch upon the proposed changes concerning (i) steering mechanisms, (ii) open access requirements, and (iii) third party service providers ("TPPs").

Surcharging

One of the "steering mechanisms" merchants can adopt to affect a consumers' choice for a particular form of payment is the practice of "surcharging" (a markup charged by the merchant upon payment for using a specific instrument). In the latest text as amended by the Parliament in April 2014, Recital 63 seems to call for an *absolute ban* on surcharging (while the IF Regulation would allow surcharging for "non-regulated" card-based transactions). However, Article 55 (3) requires that payment service providers *shall not prevent the payee from requesting from the payer a charge*" as long as it does not exceed direct cost or is applied to a regulated category of card-based products. In any event, although clarity would be welcome, Member States will still retain the ability to impose an absolute ban on surcharging of non-regulated payment mechanisms.

The original PSD allowed Member States to determine the applicable rules for surcharging which resulted in diverging practices across Member States. Only 13 Member States opted for an all-out ban on surcharging. Consumers using cards or other online payment means would be "surprised" by additional fees from online retailers in certain Member States. The divergence

72 The latest version, as amended by the European Parliament is available at: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2014-0280 (aAccessed on November 17, 2014).

of surcharging practices was exacerbated by opportunistic retailers that would impose excessive surcharges at check out (at which time consumers are more or less "locked-in" to the purchase). The current proposal eliminates the latter by capping surcharges at *direct cost*, although enforcement might be problematic. Diverging practices might however still plague consumers using corporate cards or cards issued by three-party schemes. A loophole might exist for three--party schemes that use licensees and fall under the 5% market share threshold. In principle, these would fall under the "regulated area", but can be exempted on a Member State basis.

Open Access

The original PSD called for open access to payment systems in Article 28 for any registered or authorized payment service provider on an "*objective, non-discriminatory and proportionate*" basis. This would allow any PSPs to gain access to the essential payment infrastructure owned by MasterCard, Visa, and domestic systems. Smaller networks were exempt in Article 28, paragraph 2, which included three-party systems. The PSD II proposal, however, removes the exemption for three-party schemes. It is unclear why this has been removed as it would force smaller (non-essential) schemes to offer their services to a potentially unlimited number of financial institutions. It may be unlikely that large numbers of PSPs would make use of this provision, but it does not seem to make much sense. The rationale behind the open access requirement is to allow PSPs to offer their clients access to the most essential payment systems needed to conduct business across the Union.[73]

Broader scope: TPPs

The PSD II brings third party service providers within the scope of the directive. Of particular relevance, the directive seeks to cover "payment initiation" services (Article 4(32)). Payment initiation services, in essence, form a "bridge" between a merchant website and the consumer's trusted online banking portal. A good example of such a service is iDeal[74] in the Netherlands, and potentially Sofort in Germany.[75] The rationale is to allow such providers

73 *See* Recitals 16-17 of the PSD 1, available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32007L0064 (accessed on November 19, 2014).

74 *See* http://www.ideal.nl/en/ (accessed on November 17, 2014).

75 *See* https://www.sofort.com/eng-DE/buyer/su/how-it-works/ (accessed on November 17, 2014).

to extend their services beyond national borders and offer consumers and merchants a viable and cheap(er) alternative to the current most widely used pan-European online payment service (credit cards). At the same time, these services will have to adhere to strict common security and consumer protection rules, as well as fall under the supervision of the "responsible supervisory authorities".

Access to account information

One of the challenges to establishing new payment services is the "monopoly position" that banks currently possess when it comes to accessing the information (on funds) available on a consumers' personal checking account. Banks are, of course, the gatekeepers that must ensure the security of current accounts and can, in that context, prohibit access to account information. On the other hand, consumers should be able to access their funds in whichever way they see fit (after all, we do not have many other options to store our earnings these days). The PSD II will require banks to allow their customers to grant TPPs access to their current accounts, under strict security conditions (Article 58). The purpose is to open up the market for new forms of competition, while alleviating any security concerns that might objectively justify a denial of access. A possible downside, however, is that banks will likely face additional costs in, e.g., setting up authentication systems and legal costs relating to unauthorized transactions.

V. The Effects of Regulation

The idea of regulating interchange fees has been fiercely debated by many actors. The economic literature on two-sided markets has developed substantially over the past decades, and a certain amount of empirical data is finally available to analyze the effects of regulation abroad on an ex-post basis. It goes without saying that card schemes and financial institutions are patently against any form of regulation or downward pressure on interchange fees. On the other side, we have competition authorities, national governments, retail (and consumer) associations that show varying degrees of opposition towards interchange.

In the following section I will briefly touch upon a number of studies that were conducted following regulatory intervention in the US and Australia and conclude with an analysis of the potential effects of the proposed IF Regulation as it currently stands.

A. Empirical evidence from regulatory intervention in the US and Australia

1. The Durbin Amendment in the US

On July 20, 2011, the Federal Reserve Board published "Regulation II" in the context of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which required the adoption of rules on debit card interchange fees and network routing restrictions.[76] The regulation entered into force on October 1, 2011. In essence, the regulation capped debit card interchange fees at $0.21 plus 0.05% of the transaction value for PIN and "signature" (i.e. where authentication requires a signature) debit card transactions.[77] The provision only applies to banks that hold assets in excess of $10 billion ("regulated banks"). All other banks fall outside the scope of the regulation. Regulation II also prohibits "network exclusivity" arrangements, requiring all banks to make at least two unaffiliated networks available for processing any debit card transaction.

According to a two-part study published Fumiko Hayasi at the end of 2012/ spring 2013, the average debit card interchange fees decreased by 52% for regulated banks and remained roughly equal for non-regulated banks.[78] Card schemes immediately adopted a two-tier interchange fee structure to discriminate between regulated and exempt banks. As a result, the nature of competition between small and large banks changed, offering larger incentives for consumers to switch to smaller financial institutions. Another observation was that Visa's market share for debit transactions declined in favor of MasterCard, signaling increased competition as a result of the removal of "network exclusivity" arrangements. Merchants were able to make use of network choice by routing debit card transactions through whichever scheme (infrastructure) offered the lowest *network fees*. Among merchants, a large number experienced significant savings from lower interchange fees, while certain merchant segments faced increased costs. This could be explained by the Regulations' choice for an absolute cap.[79] Whereas schemes originally adopted different interchange fee scales for different merchant segments (e.g. according to size), post regulation, the incentives were such as to fix all interchange fees

76 See http://www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16861.pdf [Accessed on November 18, 2014].

77 Credit card interchange fees were not covered by the regulation.

78 See Hayashi, 2012: 90.

79 See Sablik & Wang, 2013.

at the maximum permitted level. In particular merchants with many small transactions (<$10) saw an increase in cost.[80]

On the consumer side, initial attempts by large banks to increase cardholder fees (to recoup interchange losses) failed as they faced uproar from consumer organizations. The overall effect on *consumer welfare* depends on whether cost savings on the merchant side are passed on to consumers in the form of lower retail prices. The likelihood of pass-through depends on the level of competition among merchants, which is difficult to measure empirically. Overall merchant cost savings were estimated at $8.3 billion, which would amount in a reduction of 7 cents on a $40 purchase in case of perfect pass--through.[81] Overall impact on consumer welfare should be measured as the difference between total merchant pass-through and the increase in bank fees as a result of revenue loss.[82]

Evans and others (2013) published an event study that attempts to measure changes in price as a result of reduced interchange fees passed through to consumers from both 'sides' of the market, *i.e.* banks and merchants. The study is based on the "plausible assumption" that banks pass-through around 70% of cost *increases* to consumers, while merchants only pass-through about 50% of cost savings. Under these assumptions, the best estimate result of the event study is that consumers lost between $22 billion and $25 billion (from both sides of the market) as a result of Regulation II. It might paint a different picture if the 'two-sided impact' on debit card *users* were calculated (i.e. merchants on the one side and cardholders on the other). Under such an assumption, the two-sided price of debit card transactions might have actually decreased. Moreover, it is difficult to empirically substantiate the so-called "plausible assumption" that banks would pass-through a larger percentage of benefits from interchange than merchants, considering the level of competitive pressure and possibilities of consumer switching in both segments.

In more recent papers, a number of unintended consequences have come to light. There seems to be (close to) unanimous consent that Regulation II has led to higher banking costs, which has especially taken its toll on

80 F. Hayashi, 2013: 94.

81 Such small changes in price across a broad variety of retail products are almost impossible to measure. Moreover, if retailers invest cost savings into other retail services, innovation, or customer care, empirical testing is out of the question.

82 F. Hayashi, 2013: 101-102.

low-income households. Zywicki and others (2014) show that the covered banks have recouped their losses by reducing the amount of free current accounts by as much as 50% between 2009 and 2013.[83] They also show that the average monthly fees on current accounts doubled, and consumers shifted their payment usage towards (unregulated) credit cards. The same paper also contends that the interchange cap *contributed* to an increase of unbanked Americans by almost 1 million between 2009 and 2011. Although the effects of regulation could have been anticipated, it is hard to see how the increased cost of retail banking could be causally linked to the regulation (these effects mostly took place before the Regulation entered into force).

It would indeed seem logical that banks will seek to recoup lost revenue, although as certain authors rightly suggest, *causality* is hard to prove.[84] Smith (2014) argues that the debit card system prior to the amendment helped make banking accessible to low income households, as they are normally less profitable for banks (lower account balances translate into lower interest revenue). Interchange from higher income households (historically) helped to subsidize account fees for lower income households when debit cards were on the rise. In his paper, Smith points to a reduction in the amount of free checking accounts, as well as increased fees and minimum balance requirements as a result of Regulation II.[85] The paper also finds that banks have shifted spending incentives towards credit cards by dismantling debit card reward programs.[86]

This reaction could alternatively be explained by contending that banks have been able to cunningly leverage their "*oligopolistic market power*".[87] Interestingly, banks overall managed to achieve continued growth in the number of debit card transactions and the number of current accounts (which might mean that debit card interchange was indeed set too high). Retail banking will remain profitable, and although it would seem logical to increase prices of the least profitable accounts, this is not a socially welcome reaction and should be condemned by society.

83 Although this was offset to a certain degree by an increase in the share of exempt banks that offered free accounts. Zywicki, Manne & Morris, 2014 p. 10.

84 Smith, 2014: 375.

85 *See also*: Evans, Chang & Joyce, 2013.

86 *Ibid*, p. 375-379

87 See e.g. Kay, Manuszak & Vojtech, 2014.

Certain recommended actions to fix Regulation II include: additional regulation of credit card fees, introducing transparent consumer banking fee structures (including access to banking services for low income households), and a cap based on "all costs related to debit card use."[88]

2. The Reserve Bank of Australia – card reforms

The Reserve Bank of Australia ("RBA") has, by far, gained the most experience when it comes to payment card regulation. The RBA gradually introduced a series of measures over a 10 year period between 2003 and 2013 covering, *inter* alia, debit and credit card interchange fees, the HACR, and the NDR.[89]

The RBA first intervened in the credit card market in 2003, mainly to steer consumers towards increased use of (cheaper and more socially desirable) debit cards. The RBA capped Visa and MasterCard's interchange fees at a weighted average maximum of 0.5% per transaction (at about half of the pre-regulated average) and abolished the HACR.[90]

In 2006, the RBA introduced a weighted average cap on Visa and MasterCard's debit card interchange fees of AUD 0.12, and a cap of AUD 0.04-0.05 for the domestic scheme (called EFTPOS). Although debit card usage proportionally increased as a result of prior the credit card reforms, a number of developments warranted intervention. Australia's domestic debit card scheme traditionally operated through (low) bilaterally negotiated interchange fees that flowed in the opposite direction (from issuer to acquirer).[91] The reverse EFTPOS interchange fees were roughly 20 cents per transaction prior to the reforms.[92] The RBA was concerned that Visa and MasterCard's average interchange fees (0.95% per transaction) would cause issuing banks to discontinue or at least significantly discourage the use

88 Smith, 2014: Section III.

89 *See* http://www.rba.gov.au/payments-system/legal-framework/index.html (accessed on November 19, 2014).

90 Only in relation to conditional acceptance of debit and credit cards of the same scheme.

91 This may indicate that the operators of EFTPOS considered that in order to create an efficient payment system, it was the merchant side of the market that needed to be stimulated (as opposed to the cardholder side).

92 *See* TransAction Resources, Review of the impact of Australian Payment Reform, Federal Reserve System Docket Number R-1404. Available at: http://www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67474_559255029499_1.pdf

of EFTPOS.[93] In its 2009 Annual Report, the RBA concluded that despite the small difference in previously implemented caps between EFTPOS and Visa/MasterCard, a significant amount of issuers were indeed favoring the international schemes (also in part because EFTPOS could not be used for online payments).[94] Not surprisingly, given the different caps assigned to EFTPOS and Visa/MasterCard, the RBA amended the EFTPOS cap in 2010 to correspond to the same 12 cent weighted average that applied to the international schemes.

In 2002, the RBA allowed merchant surcharging. Although evidence shows that this has been a descent *steering mechanism*, the RBA became concerned after finding evidence that merchants abused the practice. In 2013, it introduced a rule that would limit surcharges to "*reasonable cost*".[95]

Impact of the reforms

The impact of the reforms can best be exemplified by a series of statistics from the RBA. First, a clear result of the credit card reform is that the merchant service charges (MSCs) for accepting credit card payments declined by the same amount (see figure 3). An interesting observation is that the average MSCs also fell for the non-regulated three-party schemes (by 71 basis points for American Express and 31 basis points for Diners Club), likely as a result of increased pressure from merchants.[96]

Even though American Express and Diners Club remained unregulated by the credit card reforms, evidence from a 12 year period does not suggest that the market has tipped in their favor. To the contrary, market shares (in terms of the value of all credit and charge card purchases) have remained fairly stable over the past decade (see figure 4).

Merchant acceptance increased dramatically as a result of lower card acceptance costs, almost doubling the number of payment terminals in

93 See RBA – *Reform of the EFTPOS and Visa Debit Systems in Australia: Final Reforms and Regulation Impact Statement*, April 2006, available at: http://www.rba.gov.au/payments-system/reforms/debit-card-systems/impact-stmt-apr06/key-issues.html (accessed on November 19, 2014).

94 Available at: http://www.rba.gov.au/publications/annual-reports/psb/2009/html/index.html (accessed on November 19, 2014).

95 See Australia Payment System Board Annual report 2014. Available at: http://www.rba.gov.au/publications/annual-reports/psb/2014/pdf/2014-psb-ann-report.pdf (accessed on November 19, 2014).

96 See e.g. Worthington, 2013: 11.

FIGURE [3] – Source: Payment Systems Board Annual Report 2014

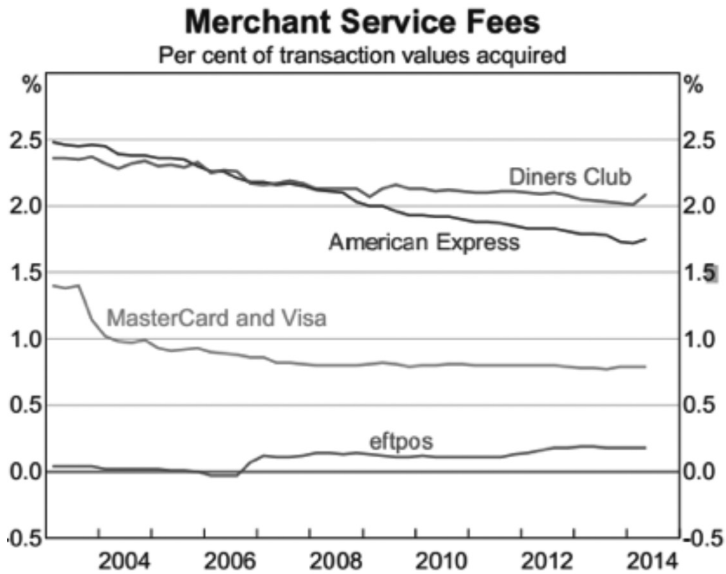
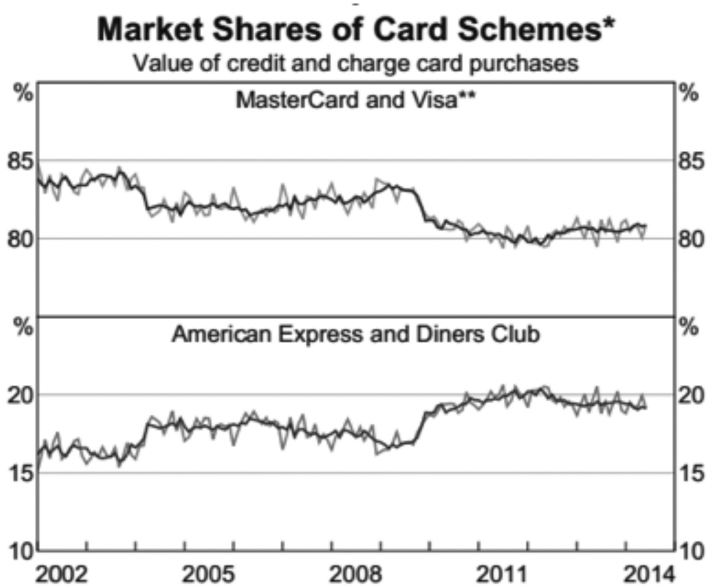


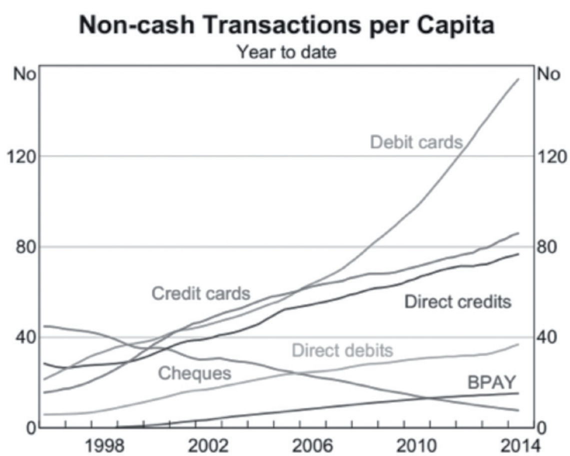
FIGURE [4] – Source: Payment Systems Board Annual Report 2014



Australia from 433,640 in 2003 to 826,769 in 2014 (see figure 5). Merchant acceptance and lower costs of acquiring have driven continued and increased growth of non-cash payments in Australia. In particular, the effects of regulation on debit card growth seem to have been exactly what the RBA intended (see figure 6).

Figure [5] – Source: RBA Statistics (2014)[97]

Figure [6] – Non-cash transactions per capita Source: Payment System Board Annual Report 2014



97 Available at: http://www.rba.gov.au/payments-system/resources/statistics/index.html (accessed on November 19, 2014).

On the consumer side, banking fees in Australia have clearly risen since the RBA's first intervention in 2003, and a number of authors directly link this to the RBA intervention.[98] Allan Shampine (2012) casts doubt on whether there is a clear causal link between the intervention and rising cardholder fees. In his analysis of annual fees, reward schemes, late payment fees, and overdraft fees, banks were already increasing these fees prior to the RBA intervention.[99] In a different report, data shows that the increase of cardholder fees between 1997 and 2002 was 218% as opposed to a significantly lower increase of 122% after the reforms (between 2003 and 2008).[100] Shampine's econometric analysis of the overall impact of the regulatory reforms on the two-sided price of card usage supports positive overall benefits. The combined savings as a result of interchange fee caps for both users (merchants and cardholders) was estimated at 38 basis points.[101]

The RBA Payment System Board 2014 annual report claims that pricing for transaction accounts remained "*largely unchanged over the past few years*" with an average "unlimited transactions account" costing AUD 4.50 per month, while some banks also offer these accounts for free.[102]

The weighted average nature of the caps has triggered schemes to introduce a wide range of interchange fee categories. The flexibility offered by the weighted average caps has allowed the different schemes to actively compete for merchant and cardholder business.[103] Certain categories of "strategic" merchants are even exempt from paying interchange. It is interesting to note that the domestic EFTPOS debit card scheme overall seems to apply maximum interchange fees of 4.5 cents per transaction, as opposed to the highest MasterCard debit rate 0.91%. According to the RBA statistics, the total amount of debit card transactions between July 2013 and July 2014 was 3.9 billion, of which EFTPOS claims to have made 2.4 billion (61%).[104] Despite

98 See e.g. Evans, 2011: 67.

99 Shampine, 2014.

100 TransAction Resources, *Review of the impact of Australian Payment Reform*, Federal Reserve System Docket Number R-1404, p. 19.

101 *Ibid*, p. 22.

102 See Australia Payment System Board Annual report 2014, p. 31.

103 *Ibid*, p. 27-28.

104 *See* EFTPOS Annual Report 2014, p. 2. Available at: http://www.eftposaustralia.com.au/docs/annual-reports/eftpos-2014-annual-report.pdf and RBA Statistics Available at: http://www.rba.gov.au/payments-system/resources/statistics/index.html (accessed on November 19, 2014).

lower interchange and a declining relative market share, EFTPOS has still been capable of increasing usage and retaining the largest share of debit card transactions. Increased usage is likely to be a result of being able to attract greater merchant acceptance with lower fees. However, if EFTPOS is serious about keeping its 'number 1' position, it will inevitably be forced to bring its interchange fees up to par with Visa and MasterCard to remain attractive to card issuers.

The most recent reform in Australia concerns surcharging. In the RBA's experience surcharging has been abused by merchants, often used as a tool to recover more than only the costs of acceptance. In response, on March 18, 2013, the RBA limited surcharging to 'the reasonable cost of acceptance', which includes the merchant service fee that the merchant pays to its financial institution.[105]

B. Potential effects of the proposed European Payments Package

At a European level, the key rationale for regulating the (card) payment market is essentially twofold: (i) to create a true internal market for payments, and (ii) to correct market failures that have arisen as a result of (collective) market power. In light of the lessons we have learned from European competition enforcement and regulatory intervention abroad, the 'payments package' will reach most of its goals if the latest Council text is adopted. However, a number of issues remain that warrant further deliberation before the package is adopted.

The underlying ratio for regulating interchange fees stems, in part, from the Commission's enforcement of the competition rules. The theory of harm that was recently upheld by the Court of Justice confirms that *multilateral* interchange fees that are set by a scheme with *market power* (in the collective interest of its members) restricts competition by creating a price floor on the acquiring market, to the detriment of merchants. The restrictive effects are aggravated, *inter alia*, by the "ratchet" effect of interchange on inter-system competition.

Bilateral Interchange fees. The IF Regulation extends the scope of the Commission's theory of Harm to all interchange fees (including bilateral IFs). Although there is no precedent to support intervention against bilateral interchange fees, I will speculate as to why they have been included. The

105 *See* http://www.rba.gov.au/payments-system/surcharging/index.html.

rationale might be found in the "must-take" nature of ubiquitous cards in combination with market power of issuing banks and other scheme rules (i.e. the HACR). Issuing banks are still "in the driver's seat" when it comes to determining the type of card that will wind up in a consumers wallet – which in turn will also depend on the relative market position of a scheme. Merchants and acquirers will have little bargaining power as the "honor all issuers" element of the HACR will force a merchant to accept all card transactions from a certain scheme regardless of the issuing entity. As a result, issuing banks will then be able to "hold up" negotiations with the acquirer and force higher interchange fees upon them.[106] Therefore, even in bilateral negotiations, issuers and acquirers (who are often issuers as well) will have the same "communality of interests" in adopting "high" interchange fees.

Extending the scope to bilateral interchange fees makes sense in light of the first objective mentioned above (creating a single payments market). Adopting a rule that will apply to all inter-bank agreements on fees will create a level playing field, as domestic schemes that set fees on a bilateral basis will also be caught. Ex-ante, domestic bank schemes (to the extent they still exist) might also meet the "market power" condition at a national level.

Corporate cards. Why have corporate cards been excluded from the 'regulated area'? Surely the theory of harm/ market failure must apply equally to corporate cards issued by member banks of the major schemes. Support can be found in the preamble of the Regulation which defines the "regulated area" as comprising all cards that are <u>widely used</u> by consumers (or "must-take" cards). Corporate cards can only be used for business-related transactions, and as such, cannot be "widely used" for consumer purchases (i.e. overall market share will remain low). Corporate cards are however used in many "niche" sectors that cater to business needs. The dissolution of the HACR with respect to the "non-regulated" area seems to be the main factor that would mitigate harm to merchants in these niche sectors that will continue to face non-regulated interchange fees. This will allow merchants to <u>choose</u> whether or not to accept these cards based on normal conditions of demand.

Three-party schemes. Three party schemes do not work with interchange fees. They do not facilitate coordination between banks and there is no "automatic compensation mechanism" that resembles the interchange fees paid between issuing and acquiring banks. Typically these schemes have internal

106 See e.g. Small & Wright, 2002.

issuing and acquiring departments that negotiate prices and conditions on each side with the respective user groups. This mode of operation is as close as it gets to the classic example of a two sided market, and as such, they should be free to negotiate differential pricing on both sides. This is why, in principle, they fall into the "non-regulated area".

However, when three-party schemes license banks to issue their cards (or enter into agency/ co-branding agreements) the Regulation treats three-party schemes "as if" they are four party schemes. Even under such arrangements three-party schemes do not facilitate fee coordination among financial institutions. They negotiate pricing with banks and merchants individually and there is no "mechanism" in place that resembles interchange. Since three-party schemes do not have interchange fees it is quite difficult to see how and why the caps would apply. Let me start with the question "how" the caps will apply. The assumption would be that instead, the "prohibition of net compensation" would apply, with an exception up to 0.3% of the annual transaction value. It is difficult to tell how such "net compensation" would be measured, even if the most recent text includes information requirements that will be imposed on schemes.

It is unclear why these smaller three-party schemes have been brought within scope when they use licensees. As I understand it, three-party schemes only choose to work with a select number of financial institutions[107] after engaging in individual negotiations on the applicable terms and services. These schemes are far from being ubiquitous and have a market share of less than 5% throughout the Union.[108] In Australia, even after more than a decade has passed since the introduction of interchange caps, three-party schemes have not "taken over" the market despite remaining unregulated. Their business models revolve around attracting a "niche" type of cardholder (affluent consumers and businesses) who are brought in touch with specific merchant segments who in turn benefit from attracting "big spenders". I find it hard to believe that such schemes would even want to become "widely used" within the meaning of the Regulation's rationale as this would mean changing their business models and facing reputational damage. What is strange is that four-party scheme's corporate cards seem to have been excluded *entirely* for

107 See e.g. Evans, 2014: Table 1.

108 *Ibid*, p. 3.

this very reason (*i.e.* they can only be used by a select group of cardholders for select types of purchases).

In sum, in the absence of interchange fees (or a similar *coordinating* mechanism) and market power, there is not a single element of the identified market failure that would apply to three-party schemes. Therefore, three-party schemes should be excluded from the scope of the IF Regulation entirely.

The most recent Council compromise text reflects the considerations above to a certain extent by allowing Member States to exempt three-party schemes when they use licensees, but only if their *domestic* market share does not exceed 5% of all domestic payment transactions, or if the scheme uses a single licensee for all issuing/acquiring (the "on-us" exemption). From an internal market perspective, it does not make sense to allow diverging practices between Member states, especially if the rationale for regulation is to create a "true internal market" for payments. If the conditional market share threshold has been introduced to ensure that three-party schemes do not become ubiquitous, I could see the policy reasons for introducing a threshold. However, first, it is unclear on what basis the 5% threshold has been established. If the threshold is meant to ensure that such schemes do not become dominant/ exert market power, why not establish a higher (Union-wide) threshold in line with, *e.g.* the Article 102 guidelines? Second, such fears seem unwarranted in light of the Australian experience and the business models of three-party schemes. Even in the absence of regulating three-party schemes in Australia, the interchange fee caps on four-party schemes has resulted in downward pressure on the MSCs of American express and Diners Club.

With respect to the "on-us exemption", it is unclear in the current text whether the single-licensee requirement will apply at a Member State level or Union-wide. This should be clarified in the final text while taking consistency into consideration.

In light of the above, a suggestion would be to consider the following options:

(i) Completely exempt three-party schemes, or;
(ii) Establish a Union-wide market share threshold set at a level which has a concrete basis in fact or law, or;
(iii) If the market share threshold is set at a Member State level, then the "on-us" exemption should also apply at a Member State level.

Interchange fee caps. The Commission has remained open to the idea that a certain "balancing mechanism" might be able to fulfill the conditions of Article 101(3) TFEU as long as harm is mitigated on the merchant side. The proposed weighted-average interchange fee caps of 0.2% and 0.3% in Articles 3 and 4 of the IF Regulation are clearly based on the commitments offered by Visa and MasterCard in the context of the Commission's antitrust investigations.

The theoretical model (the MIT) used to calculate these fee levels is based on the cost of cash and the underlying data was sourced from a few central bank studies that were available in 2009. The Commission outsourced a more recent and extensive pan-European cost study that yielded lower interchange fees, based on preliminary results.[109] The cost of cash, however, is a fairly awkward variable in the model, especially because cash costs rise as more efficient payment methods become prevalent (such as debit cards with low fees).[110] The cost of cash (as well as the efficiency of other payments) is also highly dependent on specificities at a Member State level. Although the MIT find support in the economic literature, it is still a model that will always be subject to discussions on the optimal variables, assumptions, data, etc.

The goal of the IF Regulation is to create a "working internal market" for payment cards. As we have seen, the current levels of interchange fees differ significantly between Member States and merchants cannot make use of cheaper acquiring 'abroad'. Bringing all interchange fees down to a common threshold will at least solve the "diverging MIF" problem and is a good step towards creating an internal market. At least, despite any arguments that can be raised against the MIT, it has been "accepted" by Visa and MasterCard in the context their antitrust commitments and allows some "balancing" between the issuing and acquiring sides of the market.

Luckily the Council introduced the option for schemes to apply a "weighted average" MIF, which will circumvent the "cartel-like" effects of introducing an absolute cap. For example, in the US, absolute caps resulted in all firms applying the exact same fees (which in some sectors actually raised acceptance costs for merchants). As we have learned from the Australian intervention, the ability

109 The preliminary results of this test show MIT compliant MIFs ranging between 0.02% and 0.11% for debit and between 0.07% and 0.15% for credit cards. *See* http://ec.europa.eu/competition/sectors/financial_services/presentation_results_en.pdf (accessed on November 20, 2014).

110 See Bolt, Jonker & Plooij, 2013.

to introduce a variety of fee categories can be beneficial to merchants and cardholders while allowing scheme differentiation. In the US, introducing a fixed cap resulted in mixed results, and mainly increased costs for the smallest merchant categories.

Interestingly, the Regulation gives Member States the option to apply lower MIFs at a domestic level (all the way down to zero as I understand it). This seems to be slightly contrary to the ratio of adopting a Regulation (why not a Directive, if minimum harmonization is the goal?). It also seems to be at odds with the goal of creating a single payments market (why still allow diverging IFs?). Certain Member States currently have schemes in place that operate efficiently with much lower interchange fees, or none at all. These Member States fear that introducing the cap will have adverse effects on 'domestic' schemes and create the incentive to introduce, or raise interchange fee levels. If a compromise solution is desirable, allowing Member States to adopt lower caps will make sense if the rules on "cross-border acquiring" are amended to allow the domestic cap to apply (as opposed to the fixed caps currently called for in Articles 3(1) and 4 of the IF Regulation). Such a rule would increase the bargaining power of acquirers towards the schemes and could ultimately result in downward pressure on IFs towards zero.

Why not simply ban interchange fees?

If indeed interchange fees as a "mechanism" are conducive to restricting competition and are now considered *illegal* under EU law, why not simply ban the mechanism?

For debit cards, unlike in the US, European cardholders do not typically receive rewards. Debit cards are issued with every checking account and are necessary to access funds on a bank account (either in the form of cash withdrawals at ATMs or purchasing good/services from merchants). Consumers are well aware of the benefits of using cards and do not need to be "stimulated" to use them. Throughout the EU there were 727 million cards in circulation (1.44 per capita) of which 63% were debit cards.[111] Evidence would suggest that stimulating increased usage is best achieved on the merchant side. Although banks will lose revenue from the abolition of interchange fees, issuing and acquiring is likely to remain profitable. The EU Sector Inquiry on Retail Banking (2006) concluded that "*if that part of total income due to*

111 See European Commission, 2013: 12.

interchange fees were to be taken out, 62 of the 100 institutions reporting positive ratio profits would nevertheless remain profitable. These findings may partly be explained by the likelihood that the income from cardholder fees and interest may make issuing profitable anyway."[112]

Even though it is still likely that banks will try to recover lost revenue, the detrimental effects on account fees that we have seen in the US will not occur for two reasons. First, Directive 2014/92 entered into force on October 28, 2014, which will ensure that low income households will have (free) access to basic retail banking services.[113] Recital 46 states that "[i]*n order to ensure that payment accounts with basic features are available to the widest possible range of consumers, they should be offered free of charge or for a reasonable fee*." Article 17 clarifies that one of those "basic features" is access to a debit card with POS functionality and access to an online payment method that is valid throughout the Union:

> *(c) services enabling cash withdrawals within the Union from a payment account at the counter or at automated teller machines during or outside the credit institution's opening hours;*
>
> *(d) execution of the following payment transactions within the Union*
>
> *(ii) payment transactions through a payment card, including online payments*

Second, when examining account fees on a Member State level, there seems to little or no correlation between the existence of (high) MIFs and lower account fees. The Impact Assessment shows that in Denmark, for example, while the domestic card scheme does not have interchange fees, current account fees are "*well below the EU average*".[114] In the 2006 Sector Inquiry, the Commission did not find a significant negative correlation between cardholder fees and interchange fees.[115]

Credit cards, on the other hand come paired with additional services and rewards that may benefit cardholders. Card schemes could still offer a portfolio of card products with different "benefit packages" to banks at a predefined cost

112 European Commission, 2006: 70.

113 See Directive 2014/92/EU of the European Parliament and of the Council of 23 July 2014 on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features, OJ L 257 (August 28, 2014).

114 See European Commission, 2013: 56.

115 See Sector Inquiry, section 2.1.1, p. 56.

(or even for free). Issuing banks would simply offer such additional services at a <u>price they think they could sell it for</u> (under the normal conditions of supply and demand) to consumers – or even offer them for free in premium payment packages subject to a blended price of services (which again would be the consumers' choice).

In light of the identified "market failure" and internal market considerations, the final Regulation should either:

(i) Ban all interchange fees, or;
(ii) Impose the current weighted average caps for both debit and credit cards, while allowing lower MIFs at a Member State level if – and only if – the interchange fees for cross-border acquiring are set at the level applicable in the country of the acquirer. The entire purpose of a regulation (as opposed to a directive) is to ensure harmonization. If Member States can continue to define "domestic" fee levels, this issue of diverging prices across the EU will remain unless merchants can make use of these lower fees in other Member States.

Surcharging. If the ubiquitous "must take" cards are regulated it makes perfect sense to ban surcharging for these cards. For the non-regulated cards, the removal of the HACR will allow merchants to choose whether to accept non-regulated cards, which in turn will depend on the perceived benefits of acquiring additional payment services. There is no reason to allow surcharging at all if there is sufficient merchant choice for non must-take cards. Even capping surcharges at "reasonable cost" will be impossible to enforce. A more desirable option would be to allow steering in the form of merchant rebates. Merchants would be able to offer consumers a discount if they pay with the most efficient card type.

Suggested change:

(i) Ban surcharging entirely and allow merchants to offer rebates instead.

Open Access. As hinted at earlier in this paper, it is unclear why the open access exemption for three-party schemes has been removed. The rationale seems to be to allow PSPs to offer their clients access to the 'most essential payment systems' needed to offer clients the ability to pay throughout the Union. It is also unclear whether the access requirement only applies to the *infrastructure* or also access to the *brand*. If the former is true, open access might allow acquiring institutions to 'route' transactions through the cheapest available network which will stimulate price competition. However, if the requirement relates to *brand access*, it might force smaller "niche" schemes to offer ubiquitous services to all PSPs on a non-discriminatory basis. This does not seem to be a desirable consequence and the text should therefore be amended accordingly.

TPPs. The inclusion of TPPs within the scope of the PSD will stimulate market entry and innovation, to the benefit of consumers throughout the Union. Since TPPs will be subject to strict security requirements and supervisory oversight there should be little to complain about.

VI. CONCLUSION

The European Commission, Parliament, and Council should be applauded in their ambition to create a single market for European payment services. As it currently stands, the latest drafts of the PSD II and IF Regulation will effectively change the retail payment landscape throughout the Union and will seek to correct market failures in the market for payment cards. The PSD II will particularly increase competition by allowing third party payment service providers (TPPs) access to payment accounts. Such TPPs will be able to actively compete with traditional payment service providers (PSPs) that have been able to lock-up the market. This will result in more consumer choice, competition and innovation, while all players will be subject to the same strict security requirements and supervision.

The IF Regulation will result in increased merchant acceptance of "must take" cards throughout the Union by removing the collectively imposed mechanism (interchange fees) that has created a price floor on the cost of acceptance. Evidence from Australia shows that increase acceptance will in turn significantly increase (debit) card usage which is a favorable result in light of its efficiency compared to other payment methods. Moving towards a cashless society will increase social welfare throughout the Union and arguably the best way to achieve this is to stimulate acceptance on the retailers' side.[116] The IF Regulation also removes other restrictive business rules that "tie" more expensive cards to the ubiquitous credit and debit cards. For all non-regulated

116 Jonker, Nicole, 2013 "*Social Costs of POS Payments in the Netherlands 2002-2012: Efficiency gains from increased debit card usage*", DNB Occasional Studies, Vol. 11/No. 2.

cards, merchants will be free to accept such payment methods as long as they see clear benefits in doing so. Whether we will see new pan-European players emerge as a result of the Regulation remains to be seen. In any event, new schemes will not be forced to offer issuing banks ever increasing revenue streams to be able to compete with the dominant incumbents. The nature of competition will surely change and the incentives will be in place to compete on the basis of efficiency and lower (two-sided) prices. The European Central Bank has conveyed its preference for the emergence of a new pan-European card scheme.[117] Visa and MasterCard however, remain at an advantage despite the inclusion of access requirements and separation of scheme and processing. This is largely due to their vast global and membership-based networks that will also continue to support payments from EU cardholders outside of the EU. If new card schemes emerge in the future, Visa and/or MasterCard products will, if nothing else, always be co-badged with such cards to ensure interoperability beyond our borders.

Admittedly, banks will seek to recover lost revenue from interchange fees elsewhere. Financial institutions have become subject to many new regulatory requirements following the financial crisis. However, in the attempt to recover profitability, the most vulnerable consumers should not pay the price. Directive 2014/92 will work alongside the payment package to prevent this from happening and will subject banks to further transparency requirements that will facilitate competition on a European level. The unintended consequences of Regulation II in the US will not prevail in the EU.

Despite the significant efforts that have been made to date, a number of issues remain that warrant further deliberation before the package is adopted.

The key rationale for regulating the (card) payment market is essentially twofold: (i) to create a true European market for payments, and (ii) to correct market failures that have arisen as a result of (collective) market power. In order to fully bring the legislative package in line with the identified objectives, the following amendments should be considered before it enters into force:

Three-party schemes: Since three-party schemes do not have interchange fees (or a similar *coordinating* mechanism) and are far from being "ubiquitous", there is not a single element of the identified *market failure* that would objectively justify extending the scope of the IF caps to them when they license select institutions to issue or acquire cards or enter into agency/co-badging

117 *See* ECB, 2014, p. 32.

arrangements. As far as internal market considerations are concerned, there is no evidence that leaving them unregulated will result in an "un-level playing field." Therefore, three-party schemes should be excluded from the scope of the IF Regulation entirely. It is understandable that four-party schemes have pushed hard for the regulation to apply to all card schemes alike in order to preserve their relative market shares. However, the European legislative process should be based on sound points of fact and law. Alternatively, a pan-European market share threshold should be introduced to bring the currently proposed exemption in line with single market considerations. When applying the same rationale (*i.e.* a lack of market power) to the open access requirements in Article 29 of the PSD II, three-party schemes should be exempt.

Interchange fee caps. If indeed interchange fees as a "mechanism" are conducive to restricting competition and are now considered *illegal* under EU competition law, why not *simply ban the mechanism*? Two-sided "balancing" will still be possible by applying differential scheme fees between issuers and acquirers. The parameters of competition will change and take place on objective grounds such as efficiency, pricing, and branding.

Surcharging. Since the IF Regulation will mitigate merchant harm and increase transparency and choice, surcharging should be banned across the board. A more desirable option would be to *allow steering in the form of merchant rebates*.

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