Giovanni Carosio: Payment cards between the Payment Services Directive (PSD) and the Single Euro Payments Area (SEPA)

Address by Mr Giovanni Carosio, Deputy Director General of the Bank of Italy, at the conference “Carte 2009 – Cards Revolution”, organized by the Italian Banking Association, Rome, 12 November 2009.

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Preamble

The integration of the European retail payments industry has entered a phase of rapid progress, spurred by the regulatory changes contained in the Payment Services Directive (PSD), the Single Euro Payments Area (SEPA) project for cooperation between public and private sectors, and the introduction of new electronic instruments for payment services.

The implementation of the Directive will have a strong impact on competition in the payments industry, stimulating the creation of new instruments and the access of new operators to the market; the migration from national to harmonized SEPA products will give fresh opportunities to service users for comparing instruments and making better informed decisions. Both these developments necessitate an in-depth review of the current product supply mechanisms and are therefore a driver of the operational and technological change already in incubation.

These dynamics are reflected, and in many ways magnified, in the payment cards market; cards are seen as the natural substitute for cash and thus the instrument that more than any other can shift consumers’ habits towards efficient and secure payment services.

Card circuits describe a skein of relationships between a multiplicity of actors whose interests, while not diametrically opposed, do not immediately coincide; ensuring efficiency is therefore a complex objective. A balance must be struck between the needs of the various stakeholders, involving the safeguarding of competition, the profitability of the services offered and the security of the instruments used.

Payment security is the defining element in dealings with customers; traditionally, it is the cornerstone of the fiduciary relationship between savers and financial intermediaries. It must also be guaranteed in the new “virtual” realities; the dangers inherent in the new technologies require harmonized technical and legislative measures that the European standards can provide.

As the market continues to suffer from the financial crisis, the growth potential of the payment card sector remains enormous in countries such as Italy, where cash transactions are still predominant.

Economic conditions

Developments in the retail payment services market have been affected by the financial crisis and unfavourable cyclical conditions.

Since the second half of 2008 global growth in the payment instruments market has declined, a trend apparent in Italy too; cards, however, and in particular pre-paid cards, appear to have weathered the storm best. The annual growth of card transactions at Italian POS terminals (5% in 2008; 7% in 2007) was higher than that for other instruments (1 % in 2008; 3% in 2007) and broadly in line with the European trend. Pre-paid cards continue to be the best performing instrument, with an annual average growth rate of 50 per cent, five times the European rate.

In 2009, while the volume of other payment instruments (credit transfers, direct debits and cheques) declined by around 2%, the payment cards market continued to grow at broadly the same pace as in 2008. The growth rate for pre-paid cards also declined, from 50 to 25 per cent.

These are the conditions in which the payments industry is opening up to new actors equipped to offer innovative products – such as mobile payments – capable of rapidly gaining market share, especially in micro-payments where cash is so common. Some evidence of this can be seen in the case of pre-paid cards (also thanks to their use in Internet transactions) and other new instruments (for example, motorway toll payment devices). Indeed, several studies show that even in countries with advanced credit and debit card systems, cash payments still predominate for transactions below a certain amount, estimated at around €15; in Italy, however, this threshold continues to be considerably higher (around €40), confirming the traditional preference for cash. In view of the many applications that can be combined with the pre-paid function for recurring expenses (rather than with the traditional current account), the micro-payments area appears particularly suited to policies for greater mobile payments coverage – the natural next step of the most advanced products in the world of cards such as “contactless” cards.

The nexus between the cyclical situation and the creation of new market segments lies in the delicate nature of the strategic choices that banks must make. More investment in new sectors, more risks relative to the speed at which such investment can be amortized when profits are lean, but at the same time the need to address the contraction underway in many areas of the financial industry.

The payment services directive and other community regulations

On 28 October the Council of Ministers approved the draft legislative decree transposing the PSD into Italian law. The text is now before Parliament. Within 45 days the competent committees will issue their non-binding opinions, before definitive approval by the Council of Ministers and publication in the *Gazzetta Ufficiale*.

The first set of rules laid down in the Directive concerns the rights and obligations of the parties to payment transactions (Title II). By harmonizing the rules, these provisions remove the obstacles to uniform use of SEPA schemes everywhere in the European Union. These are rules that affect the ways in which payment services are actually provided, the structure of transactions, and the responsibilities of the various parties. They are designed to guarantee the highest possible level of security and protection for users of payment services and to foster efficiency and innovation.

The PSD will have a powerful impact on payment cards, owing in part to specific provisions of Italy’s transposition decree, which characterize its content with respect to the general provisions of the Directive. Some of these national “qualifications” are distinguished by the objective of enhancing guarantees for users, in order to strengthen confidence in advanced, non-cash instruments. For instance, the decree recognizes the need to adapt some of the PSD’s general clauses (as in the case of compatibility of cost-sharing with interchange fees) and offers incentives for the use of the most secure, technologically advanced instruments. From this standpoint, one noteworthy feature is the possibility for the merchant to offer discounts to customers who use only the electronic payment instruments covered by the decree. Further, in order to promote the use of more efficient and reliable instruments, the Bank of Italy can authorize merchants to make it more costly for customers to use the less efficient instruments, in derogation to the general “no surcharge rule” that the circuits impose on merchants to prevent discrimination against their cards.

In any case, the aim of promoting the most advanced forms of payment is not exclusive to the PSD but runs throughout recent Community regulations. The Electronic Money Directive, whose transposition is scheduled for the end of April 2011, represents in some respects an extension of the PSD. It modifies the concept of e-money to embrace all the different possible forms (card-based and server-based) and allows future electronic money institutions to do business under a regime analogous to that covering payment institutions under the PSD, as regards both the types of activities they can engage in and the possibility of combining payment and commercial services. This could produce a fully competitive market situation, propitious to the rapid technological advance of the competitive frontier, with direct benefits for the quality of services.

Another feature of the overall reform of European payment regulations is the aim of ensuring effective protection for payment service users by designating an authority with specific powers of control, complaints handling, and sanctions; for our country, the authority will be the Bank of Italy. These new responsibilities are grafted onto the payment system oversight powers of the Bank under Article 146 of the Consolidated Law on Banking, which the PSD transposition decree amends to make user protection an express objective along with the traditional ones of efficiency and reliability; the regulatory and control powers that the Bank needs to perform this function effectively are specified.

SEPA and payment cards

The authorities (the Eurosystem, the Commission) and the market organizations (e.g. the European Payments Council) have long since agreed that the basic approach to SEPA as regards payment cards must rest on varied, ramified models of integration: adequate governance of pan-European schemes; transparent, non-restrictive business models (and fee mechanisms); and higher operational standards for security and processing. The greatest progress has come in raising standards, as is shown by the migration to smart cards – microchip technology is now installed on some 80 per cent of card acceptance devices – which has produced encouraging data on payment card frauds, as well as further advancing the relatively high degree of technological integration that has historically marked the payment card industry internationally.

There should soon also be an acceleration of convergence of fee mechanisms thanks in part to the progress being made in the debate on the multilateral interchange fee (MIF).

The measures affecting governance and the creation of pan-European alternatives to the Visa and Mastercard circuits have been less significant. Although some interesting initiatives have been taken under the logic of "federating" the national debit card circuits (e.g. EAPS, Payfair, Monnet), by far the most prevalent approach still remains co-branding with the international circuits. In this context, further gains in efficiency can be sought by separating the governance of the schemes (domestic or international) from payment processing, thus increasing the transparent supply of unbundled services that are not binding upon users and should therefore foster the ability to select the most efficient structure.

The integration process is being closely followed by the Eurosystem as payment instrument overseer. The approach is designed to verify the circuits' level of efficiency and technical-operational security.

Efficiency

To achieve real advances in card scheme efficiency and fee profiles, the debate on the Multilateral Interchange Fee and its relationship with the effective costs of instrument acceptance (also from the standpoint of the "war on cash") remains crucial.

The MIF, preset for each circuit, is relevant both to interbank and to bank-customer transactions as a component of the final price. According to the European competition authority, the MIF constitutes a de facto lower limit to the service fees charged to merchants on debit, credit and prepaid card transactions. However, the theoretical literature is not at all unanimous on the effects of multilateral interchange fees, and empirical studies are of little help. This suggests the need for a prudent approach, with case-by-case evaluation before any decision for substantial intervention on payment network mechanisms is made.

This is the necessity that has shaped the Commission's recent initiatives to find a practical method for setting the interchange fee at an efficient level that truly takes account of the costs (and the benefits) of accepting a card in lieu of other instruments (especially cash) at points of sale – the so-called "tourist test". The aim is twofold: to help guide the European competition authority in assessing compliance of cross-border MIFs with the EU Treaty and to stimulate convergence of fees for SEPA card use by applying the new method to national circuits.

The Eurosystem too has undertaken a study on the costs of using various payment instruments and cash, in order to measure the potential savings to the economy of replacing the more costly instruments with those considered more efficient. The survey will permit comparisons between countries and instruments (for instance, calculating threshold levels that make it economic to choose any given instrument) and to highlight the effects of technological innovation.

The debate on the MIF and, more in general, on the fee structure of payment networks must not obscure the objective of expanding electronic payments and reducing the use of cash in retail payments. The MIF covers a significant part of the costs sustained by the issuer (brand management, technological innovation, clearing, authorizations, revocations) and can therefore serve to avoid levying a charge directly on the cardholder. Indeed, in order to encourage the use of cards, the MIF structure posits that the holder is to be exempt from charges upon making purchases; this argument is completed on the normative plane with the PSD's surcharge rule, also incorporated into the Italian government's draft legislative decree.

Although it goes beyond the debate on the MIF, another important explicit recommendation of the Eurosystem and the European competition authority that can enhance the efficiency and competitiveness of the system in the SEPA process is the adoption of "open" fee structures. The aim is to give merchants ample room for choice in negotiating acceptance fees differentiated by instrument (for example, prepaid card or credit card) and circuit (for instance, PagoBANCOMAT and Maestro), thereby undoing the widespread practice of blending the rates on transactions with different cards even under competing schemes.

This is an approach that has found a counterpart at national level in the action of the Bank of Italy and the Antitrust Authority to open up the market to the new "multi-bank" technologies that allow transactions carried out at a POS to be transmitted for settlement to a selection of banks rather than to a single reference bank, in order to enable merchants to negotiate fees on a competitive basis.

Security

The other key feature for the adequacy of card circuits within the SEPA context is security, i.e. a scheme's capacity to reduce the risks of fraudulent or illicit use of payment instruments. As I noted earlier, the overall incidence of fraud is declining thanks to the changes connected with the migration to SEPA. The ratio of fraudulent to total transactions carried out with debit, credit or prepaid cards now stands at 0.05 per cent in Italy, in line with the international standards and down from the peak of 0.07 per cent in 2006. The improvement is surely due to faster replacement of cards that only have a magnetic stripe with cards equipped with an EMV chip, in compliance with the common standard for SEPA and for the international card circuits.

A factor contributing to this result has been the action of the Bank of Italy in its oversight function to encourage circuit operators to adopt technologically more secure devices as swiftly as possible, consistent with the expectations of SEPA, accompanied by the application of mechanisms aimed at shifting the pecuniary liability for losses caused by fraud to the operators that are non-compliant with the new security standards. Among payment cards, prepaid cards have lower rates of fraud (0.02 per cent), which has evidently favoured their popularity.

Renewed threats are being posed especially for online transactions: cases of phishing and hacking to acquire sensitive personal data for the illegal use of payment instruments are on the rise. Strengthening users' confidence requires preventive action, with recourse to new technologies and to incentive mechanisms (such as "liability shift" clauses) that have produced good results in the world of "physical" payments and can be enhanced and extended to the virtual world. The PSD's provisions on issuer liability also move in that direction and should spur the banking system to invest new resources in preventive technologies. For Internet payments in particular, the risk of fraud should be reduced by widespread adoption of central authentication systems, with the use of two or more access keys, security tokens and one-time passwords, as well as specific site data protection programs.

The bodies promoting the SEPA project can intervene more effectively in these respects with shared rules of conduct.

The theme of security includes measures to prevent use of payment instruments for illegal purposes such as money laundering. The objective of the various authorities is to combine operational flexibility and technological development in the field of payment services with adequate integrity of circuits and traceability of transactions. In this sense, the scope for marketing anonymous products, both single-load and reloadable, under the new legislative context is limited both in the maximum amount that they can handle and in their function capabilities, especially for so-called card-to-card transfers. In a globalized market, fraudulent activities can rapidly reposition themselves and concentrate on the weak links of the chain. For this as well as for other reasons, it is important that intermediaries (banks, issuers and all operators in the sector) not merely comply formally with the rules but take a risk-based approach in setting corporate policies to prevent improper use of instruments and circuits, with the associated risk of severe reputational repercussions, which can undermine customer confidence not only in the entities involved but in the payment instruments and circuits themselves.

Conclusion

Considering the still very high level of use to cash, Italy is among the countries that stand to benefit most from the integration under way in the European market in payment cards. The completion of the new legislative framework creates the conditions for the market to offer highly standardized , technologically advanced products that can capture a mass customer base, such as persons making micro-payments.

For their extensive distribution and user friendliness, payment cards are able to make the most of technological innovation, including through both cooperative and competitive interaction with the new service providers coming into the market, such as mobile telephone service operators; this can make it possible to attack the threshold of micro-payments with services that are really alternative to cash.

The payment system oversight function intends to accompany this development, by involving all the stakeholders in defining instruments, services and solutions that can enhance the reliability and efficiency of the payment system.