POSITION PAPER

A compromise on interchange fees, no compromise on SEPA

Explaining a key amendment to the draft SEPA migration Regulation

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ESBG

A compromise on interchange fees is no compromise on SEPA:

Explaining a key amendment to the draft SEPA migration Regulation

In its 16th December Proposal for a Regulation on SEPA migration[1], the European Commission bans interchange for normal direct debit transactions. Interchange is a fee which compensates (in the absence of a contractual relationship between the bank of the debtor and the creditor) the bank of the debtor for the costs it incurs when rendering the collection service[2] to the creditor. Interchange fees are either set bilaterally between a debtor bank and a creditor bank, or unilaterally by a debtor bank, or multilaterally by agreement between the adherents to a direct debit scheme. Interchange fees are levied either for "normal" direct debit transactions (i.e. the collections presented by creditor banks to debtor banks), and/or for "R" transactions (i.e. collections which cannot be processed or debited to a debtor for a number of reasons).

ESBG objects to the proposed ban of interchange for "normal" direct debit transactions – the justification for this objection is summarised again in this Paper. Although ESBG maintains its fundamental concern about ruling on interchange in a regulation ESBG recognises that removing dispositions on interchange from the draft Regulation text during the co-decision process at European Parliament and Council will probably not be possible. ESBG believes that a compromise approach to interchange in the Regulation could still give direct debits a chance for success in SEPA.

This Paper therefore – having first highlighted why the European Commission's position on interchange is misguided – presents ESBG's amendment proposal to Art. 6 of the draft Regulation, and then explains in as plain language as possible this amendment proposal, and the positive effects it will have on the acceptance and use of direct debits in SEPA.

In the remainder of this Paper the term "interchange" will mean "interchange for normal direct debit transactions", as defined above.

1- A ban on interchange for direct debits is not justified by existing competition legislation

In its proposal for a Regulation the European Commission provides on 5 occasions reasons for banning interchange for direct debits. These call for the following remarks:

- "The perceived lack of legal certainty on an appropriate long term business model for SDD complying fully with EU competition rules" (Explanatory Memorandum): it is surprising and disturbing that the Commission in this debate never refers to its

[1] The Commission's Proposal is formally called « Regulation establishing technical requirements for credit transfers and direct debits in euros and amending Regulation 924/2009 ». It can be accessed via the following link: http://www.esbg.eu/uploadedFiles/Announcements/EC_Regulation_SEPA_EndDate_16December2010.pdf

[2] A description of the components of this service can be found in Annex.

Guidelines on the applicability of At. 101 TFEU[3]. The Commission stated in several occasions, yet never demonstrated (and no Court whether in Europe or elsewhere in the world ever found) that interchange for direct debits would be anti-competitive by object. The Guidelines demand that in the absence of a restriction by object the restrictive effects on competition of a horizontal agreement such as interchange must be substantial, taking into account both actual and potential effects. There are restrictive effects when at least one of the parameters of competition (price, output, product quality, product variety, innovation,...) is adversely affected, i.e. where competitors either raise profitably prices or reduce output, product quality, product variety, or innovation:

- With interchange for SEPA direct debits debtor banks do not raise prices (consumer charging is capped by Regulation 924/2009 and national dispositions) but cover their costs;
- Because consumer pricing is already capped (see immediately above) interchange is consumer-neutral. A 8,8 eurocent interchange represents only 0,0001121 (!!) of the average value of a direct debit in Europe[4], so interchange can only be neutral for creditors as well. Maintaining or introducing an interchange for direct debits would not have an impact on output;
- The "product quality" is set by both the Payments Services Directive and the technical requirements of the draft SEPA migration Regulation. Maintaining or introducing an interchange for direct debits would not have an impact on product quality from that perspective;
- On one side debtor banks will be mandated by the Regulation under discussion to be technically reachable for any direct debit. On the other side it is widely acknowledged by policymakers that only active support by payment service providers can foster acceptance, hence in the absence of due cost compensation (i.e.: interchange) such support will not be coming forth. This would affect "product variety", i.e. effective choice for consumers amongst several potential payment instruments.
- The same argument as immediately above applies to the "innovation" dimension.

As demonstrated here interchange for direct debits would not produce any of the adverse effects which would qualify it for being considered anti-competitive by effect under the Commission's Guidelines on the applicability of Art. 101 TFEU.

- "In order to provide guidance to the banks the Commission and the ECB issued a joint statement in March 2009, followed by a Commission Working Document in November 2009" (Explanatory Memorandum): neither the March 2009 joint statement nor the November 2009 Working Document can have the same standing as the Commission's Guidelines referred to above – to which the Commission strangely refrains to refer to throughout the interchange for direct debit debate. It must also be noted that the Commission constantly refused to publish the responses to the consultation on its November 2009 Working Document. One can only conclude that the Commission intents to treat interchange for direct debit outside any established procedure.

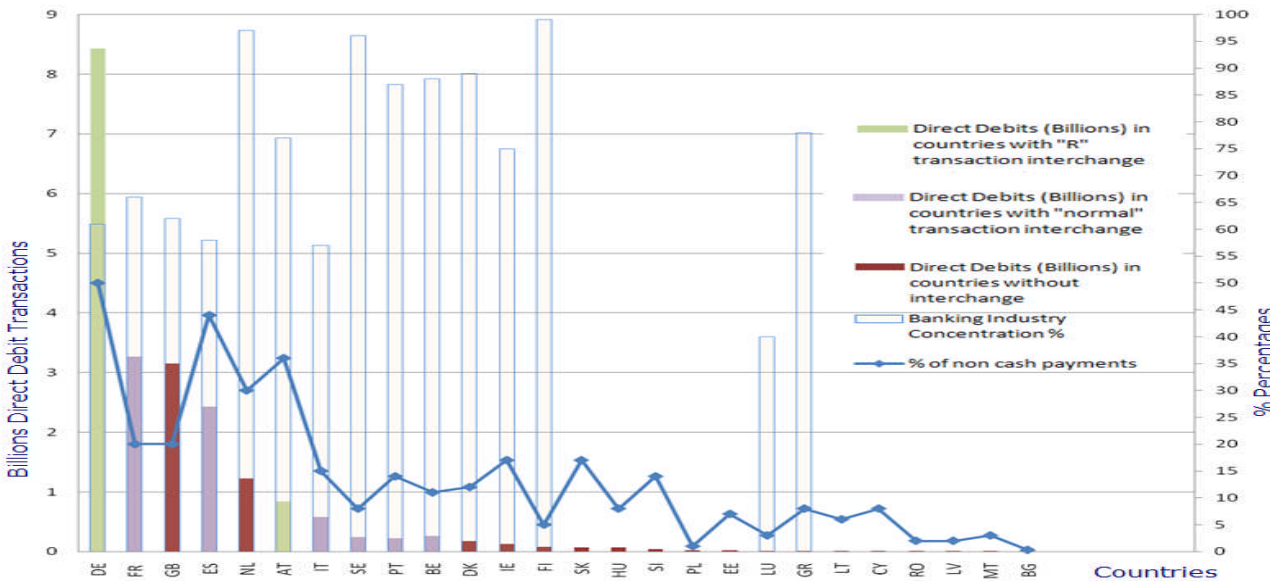
- "Responses...confirmed that there is a strong need to clarify the validity of a long-term business model for direct debits which complies with EU competition rules" (Explanatory Memorandum): the uncertainty about the business model has been created

[3] European Commission Guidelines on the applicability of Art. 101 TFEU to horizontal co-operation agreements (revised version released in January 2011)

[4] Source of data : 2010 CapGemini World Payments Report (this average amount rose 8,7% from EUR 722 between 2008 and 2009)

by the Commission itself. No market participant would deny that there is a strong need for certainty regarding the long term business model – however this cannot be the argument for reducing interchange to zero – a move only creditor banks in a dominant market position are likely to support.

- "Regulation of multilateral interchange fees (MIF) for direct debits is essential to create neutral conditions of competition between the payment service providers and so to permit the development of a single market for direct debits" (Recital 14): as demonstrated with the chart below[5] (entirely based on 3rd party data), direct debits are generally far more accepted in countries with interchange. It should be stressed that the distinction made by the Commission between countries with interchange for "normal" direct debits and countries with interchange for "R" transactions is – in the absence of any interchange for "normal" transactions in the latter – wholly artificial and cannot be retained for the purpose of justifying a ban on interchange for "normal" transactions.



[5] The green, purple and red bars represent the number (billion) of direct debit transactions per Member State[5].

- According to the Commission's December 2010 Impact Assessment supporting the SEPA migration end-dates Regulation Proposal there are 6 countries[5] (Belgium, France, Italy, Portugal, Spain, Sweden – "purple" bars) in which debtor banks receive a remuneration from creditor banks for processing direct debit transactions. However, according to banking industry sources, interchange is also levied in the Netherlands.
- There are 2 countries (Austria and Germany – "green" bars) in which creditor banks will be charged by debtor banks for direct debit transactions which fail to be processed automatically ("R" transactions). In some of the countries (France, Portugal, Spain) listed under the previous bullet interchange for R-transactions may also be charged.
- Reportedly the handling of direct debits does not give rise to interchange arrangements in any of the remaining countries ("red" bars).
- The blue line represents direct debit transactions per Member State as a percentage of all non-cash transactions in that Member State[5].
- The transparent bars are a representation of the concentration of the banking industry in each country[5].

- "Per transaction MIF for direct debit restrict competition between payees banks and inflate the charges such banks impose on payees and thus lead to hidden price increase to payers (Recital 14):
  a) As demonstrated again with the above chart the existence of interchange is generally the mark of a lesser concentration of the banking sector – hence the claim that "Per transaction MIF for direct debit restrict competition between payees' banks" must be rejected as groundless.
  b) Remembering that interchange represents on average only 0,0001121 (!!) of the average value of a direct debit in Europe (see footnote 4 in this Paper), the claim that "the charges such banks impose on payees and thus lead to hidden price increase to payers" is equally groundless.

Prohibiting debtor banks to recoup directly from creditor banks the costs they incur for accepting and processing direct debits will result in lesser pricing transparency (as debtor banks will have to recoup these costs from their debtor customers through the pricing of other banking and financial products).
The argument that debtor customers could be charged directly by debtor banks does not hold – as existing Regulations prevent debtor banks to price SEPA services differently from existing national-only services, where in a majority of cases there is no charge for direct debits[6].
The argument that creditors may compensate debtors by granting rebates on their invoices does not hold either, as creditor representatives have publicly[7] rejected this option.

2- ESBG's amendment proposal for Art. 6 of the draft Regulation

The Commission's reasons for banning interchange have been shown to be without ground. There is little rationale either for having such a disposition included in a Regulation on migration end dates, yet ESBG acknowledges that both co-decision makers (the European Parliament and Council) would now expect the Regulation to nevertheless address this topic.

ESBG accordingly proposes to build on the approach taken by the European Parliament Rapporteur in her draft Report dated 30. March 2011, and complement the proposal of a multilateral interchange fee with the option for payers' payment service providers to claim a different yet still capped interchange fee, provided they are able to cost-justify such fee. Both arrangements could be reviewed 5 years after the end date for legacy direct debits, on the basis of an analysis of the acceptance of SEPA direct debits, including if relevant an objective evaluation of the reasons for limited acceptance.

ESBG's proposal for amendment of Art. 6 of the draft Regulation is presented here, as well as the amendments to the related recital (only additions are shown in bold, deletions are not shown for readability purposes):

<u>Amendment of Article 6 of the draft Regulation</u>

1. Without prejudice to paragraph 2, ***by….* the maximum MIF shall b 6,6 eurocents per direct debit transaction. By…**, that maximum level shall be 4,4 eurocents per***

[6] See European Commission DG Health and Consumer Protection August 2008 study « Preparing the monitoring of the impact of the Single Euro Payment Area on consumers » - performed by Van Dijk Management Consultants
[7] See proceedings of the 17th November public hearing on SEPA – European Commission DG Internal Market & Services Website

transaction and by … it shall be 2,2 eurocents per transaction. Payer's payment service providers who individually can evidence that their direct debit transaction support costs (including cost of capital) could not yet be reduced to the above ceiling may charge an interchange fee of maximum 8,8 eurocents per direct debit transaction, provided this interchange fee is made public and that no charge is levied from the payer for the same transaction. After …**** the level of a MIF per direct debit transaction, interchange fee or other agreed remuneration with an equivalent object or effect which shall apply to direct debit transactions will be set in function of the reviews to be conducted by the Commission as per Art. 6.3 below.***

2. For direct debit transactions which cannot be properly executed by a payment service provider because the payment order is either rejected, refused, returned or reversed (R-transactions carried out by payment service providers), a multilateral ***or bilateral*** interchange fee ***(or, in their absence, a unilateral interchange fee charged by the payment service provider of the payer)*** may be applied provided that the following conditions are complied with:

   (a) the arrangement shall be aimed at efficiently allocating costs to the party that has caused the R-transaction, while taking into account the existence of transaction costs and the aim of consumer protection

   (b) the fees shall be strictly cost based

   (c) the level of the fees shall not exceed the actual costs of handling an R-transaction by the payment service provider ***charging the interchange fee per R-transaction***

   (d) the application of the fees in accordance with points (a), (b) and (c) shall prevent the payment service providers to charge additional fees related to the costs covered by these interchange fees to their respective payment service users

   For the purposes of the first subparagraph, only cost categories directly and unequivocally relevant to the handling of the R-transaction shall be considered in the calculation of the R-transaction fees. These costs shall be precisely determined. The breakdown of the amount of the costs including separate identification of each of its components shall be part of the collective agreement to allow for easy verification and monitoring.

3. ***The Commission shall monitor across Member States the effects of MIFs, interchange fees and R-transaction MIFs referred to in paragraphs 1 and 2, and report as part of the review process defined for this Regulation. Whilst a convergence of fees may be expected over time due to market forces in its analysis the Commission shall focus on the objective reasons which would have prevented such convergence.***

   <u>Amendment of related recital (Recital 14 in the draft Regulation)</u>

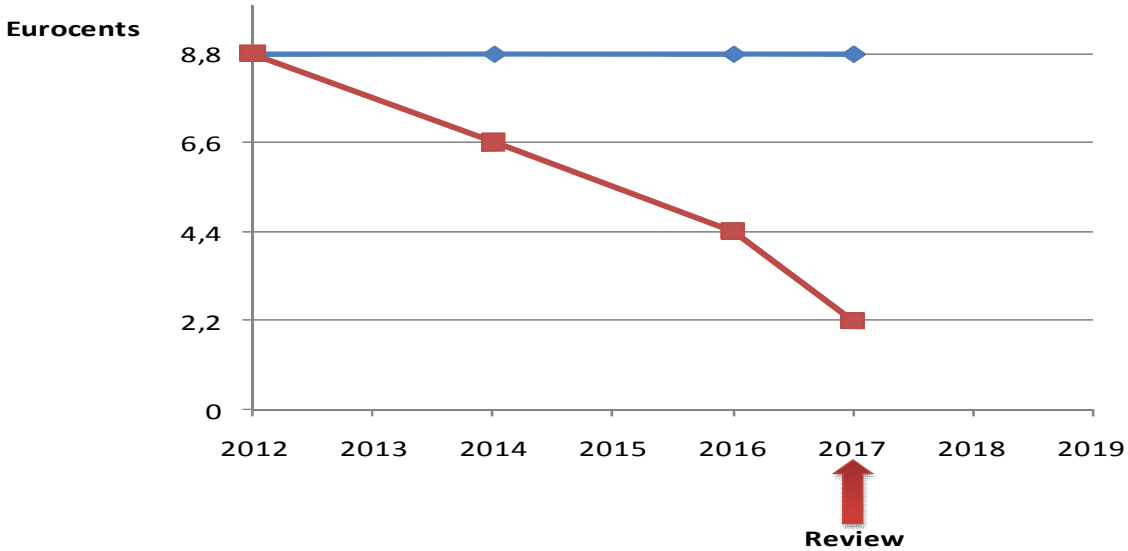
   Regulation of multilateral interchange fees (MIF) for direct debits is essential to create neutral conditions of competition between the payment service providers and so to permit the development of a single market for direct debits. MIFs for direct debit ***could*** restrict competition between payees' ***payment service providers*** and ***are – as for any other means of payment accepted by payees - included in the fees such payment service providers charge*** to payees. ***MIFs per transaction or MIFs*** for transactions which are

rejected, refused, returned or reversed because they cannot be properly executed (R-transactions)could nevertheless help to allocate costs efficiently within the single market. Therefore it would appear beneficial for the creation of an effective European direct debit market to ***allow MIFs, provided they comply with certain conditions***. In any event, rules should be without prejudice to the application of Art. 101 and 102 of the Treaty of the Functioning of the European Union (TFEU) to multilateral Interchange Fees.

3- Explaining the amendment proposal

ESBG's amendment proposal responds to all the objections which have been raised against interchange – even though these are not founded, as demonstrated in section 1 of the present Paper.

- Each payment service provider could choose between the default interchange as set by the Regulation, or a higher yet capped interchange which the said payment service provider must be able to cost-justify. The proposed approach is summarised in the following chart (the red line represents part of the "interchange depreciation" proposed by the European Parliament Rapporteur in her draft Report, the blue line the optional, capped interchange level proposed by ESBG – hereafter called "individual interchange" as opposed to the "by default" interchange):



- Any interchange used by a payment service provider would have to be published – the default interchange as part of the regulation, and any "individual interchange" by the payment service provider applying it.

- Any payment service provider opting for the "individual interchange" would not be allowed to levy a fee from a payer for the same transaction.

- The impact of this proposed approach would be assessed on the basis of an evaluation performed 5 years after the deadline which will be set for the migration of legacy direct debit schemes.

The advantages of the approach proposed by ESBG are:

- This approach provides all stakeholders with the comfort that there will be no "race to the highest level", a situation where all payment service providers would always apply the only rate which exists, thus "artificially" increasing prices and not being motivated to reduce costs – an objection sometimes heard about interchange.

- Indeed the "default" interchange will serve as benchmark – even though its level has been determined arbitrarily. There will be a de facto competition between payment service providers opting for the default interchange, and those opting for the "individual interchange" approach.

- This "default" interchange can also be seen as setting a direction for possible convergence – should pan-European direct debits prove a success.

- The "individual interchange" approach allows payment service providers to be encouraged and promote the direct debit service knowing that they can recover their costs – provided they are able to justify the level they claim.

- The "individual interchange" approach provides this motivation also for payments service providers of Member States not yet using direct debits, or using them only little – in effect the majority of Member States - to implement and promote this service.

- The review after 5 years will provide clear indications for future action – if required:
  - Will pan-European direct debits be effectively in use, will they be used more than legacy direct debits today?
  - How many payment service providers will have opted for applying the default interchange, and how many the "individual interchange"?
  - What evolution and convergence if any of the "individual" interchange fees can be observed?

  In essence, ESBG's proposal enables payment service providers to differ provided they are both transparent and public about their costs and charges yet prevent any impact in consumer charges – a key objective of policymakers in their payment system change agenda towards SEPA.

Annex:

Functional work flows of payer/debtor bank in support of SEPA direct debit

- Provision by debtor bank of prior information to potential debtor about direct debit conditions
- Acknowledgment by debtor bank storing of every debtor opposition to a future collection from a designated creditor covered by a designated mandate, or to any collections related to a designated creditor or to any collection of a direct debit
- Receipt of collection(s) by debtor bank directly from creditor bank or via a CSM
- Verification of the collection to be debited from the debtor account to ensure it can be executed (as per Rulebook) – including notably: operation transaction code, file format, bank identifier code; status of debtor (deceased?, account closed?), account identifier, direct debit prevented on this account for regulatory reason(s), account blocked, insufficient funds, mandate data missing or incorrect, no mandate, duplicate collection, reason not specified
- (when relevant), debtor bank performs controls as agreed with debtor (as a function of the service to the debtor any or all of the following could be checked: missing or incorrect mandate data, absence of mandate, account blocked by the debtor for direct debits, refusal by the debtor, specific service offered by debtor bank)
- verifies validity of Creditor Identifier
- Debtor bank may reject some collections prior to presentment to debtor(s) and settlement
- Reporting by debtor bank of anomaly(iers)/issue(s) to debtor
- Verification of the availability of funds on the debtor's account at maturity
- Debtor bank debits debtor account
- Debtor bank reports to debtor the execution of the direct debit collection
- Debtor bank sends returned collection back to creditor bank/CSM after settlement
- Handling of debtor complaints and disputes for authorised transactions within 8 weeks
- Debtor banks sends refund message(s) to creditor bank directly or via CSM following debtor's complaint on authorised transaction
- Debtor bank re-credits debtor's account further to a complaint on an authorised transaction
- After the 8 week refund period debtor bank analyses request for refund received from debtor
- (when relevant) debtor bank sends a request for refund to creditor bank, and requests copy of the mandate
- Debtor bank analyses the situation, decides on the claim and sends the refund of an unauthorized transaction to the creditor bank/CSM
- Handling by debtor bank of account switching instructions
- Implementation of risk mitigation measures by debtor bank
- Provisioning of creditor/creditor bank risk by debtor bank

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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