EUROPEAN CENTRAL BANK

EUROSYSTEM

THE EUROSYSTEM'S VIEW OF A "SEPA FOR CARDS"

EXECUTIVE SUMMARY

There are currently more than 350 million cards in circulation in the euro area, which are used to make more than 12 billion payment transactions and 6 billion cash withdrawal transactions per year. The Single Euro Payments Area (SEPA) project will have a tremendous impact on the card payment industry, and the Eurosystem's stance will be critical in helping the market to move in a direction which maximises the benefits for Europe's citizens.

THE CURRENT SITUATION IN THE EURO AREA

Currently, there is at least one national card scheme operating in each euro area country. To allow cards to be used outside the country of issuance, national cards are often "co-branded" with Visa or MasterCard. When the card is used within the country of issuance, it is usually the national brand which is activated, whereas outside the country of issuance (within the euro area or beyond), the international brand is used. In Europe, national card schemes are generally very efficient and relatively inexpensive for both cardholders and merchants.

THE EUROSYSTEM'S VIEW OF A SEPA FOR CARDS

A SEPA for cards will have the following characteristics:

1) consumers can choose among a diversity of competing payment card schemes that do not have a pre-assigned priority in use at point-of-sale (POS) terminals;

2) there is a competitive, reliable and cost-efficient card market, including service and infrastructure providers;

3) all technical and contractual provisions, business practices and standards which had formerly resulted in the national segmentation of the euro area have been eliminated. In particular, there is no obstacle for merchants to accept any payment cards compliant with the SEPA Cards Framework (SCF).

THE SEPA CARDS FRAMEWORK

The SCF has been adopted by the European Payments Council (EPC). While acknowledging the usefulness of this document, the Eurosystem however considers that the SCF is rather general and leaves too much room for interpretation concerning practical implementation. Moreover, the Eurosystem is concerned that the implementation of a SEPA for cards may lead to increases in card fees and could thus be paradoxically detrimental to European citizens and merchants. In response, this report seeks to complement the SCF by clarifying a number of public policy provisions.

Ideally, citizens should be able to use their cards anywhere in the euro area. For cardholders and merchants in particular, conditions should not differ within and between euro area countries. The SCF defines three options that a card scheme can follow in order to offer SCF-compliant products (these options may also be combined):

1) replace the national scheme by an international scheme (provided the latter is SCF-compliant). In this case, co-branding is no longer needed, as cross-border and national transactions are automatically covered by the same schemes;

2) evolve through alliances with other card schemes or through expansion to the entire euro area. In the case of card scheme alliances, the participants could agree, for example, on mutually accepted relevant

brands. Should a scheme be expanded to the euro area, the cards in the scheme could be issued and acquired by banks and accepted by merchants located anywhere in the euro area;

3) co-brand with an international card scheme (as is already the case in most countries today), provided that both schemes in question are SCF-compliant.

The Eurosystem expects national card schemes to define their strategy as soon as possible, either by elaborating a business plan to become SEPA-compliant, or by joining an alliance which will elaborate such a plan.

A SEPA FOR CARDS: ISSUES AND CHALLENGES

Option 1, i.e. the replacement of a national scheme by an international one, requires that the international card schemes define and implement a new unified card service for the entire euro area.

Several banking communities envisage sooner or later abandoning their national schemes and moving their business to the international card schemes. The decision to close national card schemes and replace them with an international one may be driven by the following two considerations: 1) this represents a quick and easy way to adapt to the SCF, and 2) this is an attractive solution to banks as international card schemes typically apply higher interchange fees than national schemes (and the latter tend to be partly retained by the banking system). The Eurosystem is however concerned about such an evolution, as this could lead to an increase in the fees paid, in particular by merchants, which directly contradicts the objectives of SEPA. While the Eurosystem welcomes the willingness of Visa and MasterCard to offer domestic card services for the euro area, it is deeply concerned about a possible evolution whereby the two international card schemes progressively become the only providers of card payment services offered by banks in the euro area. Up to now, the two schemes have functioned with very similar business models, with relatively high cost structures and high interchange fees, which leads the Eurosystem to fear that competition limited to these two systems would be insufficient to maintain the present low level of fees in Europe. Additional worries are triggered by uncertainties about the governance of the two systems. For reasons external to Europe, MasterCard has abandoned the user-driven model in favour of a shareholder-driven solution, and Visa has recently announced similar intentions. In a market with insufficient competition, such a decision would lead to upward pressure on fees. However, Visa has not replaced its user-driven model in Europe and this may stimulate competition, since the governance of the two international schemes will henceforth follow two different models. However, Visa Europe's decision is too recent to be thoroughly assessed.

Co-branding, i.e. Option 3, is already widely used today by national schemes. Co-branding offers banks the possibility of providing a single service to cardholders and merchants throughout the euro area. However, co-branding as a solution would merely perpetuate the present situation, whereby a multiplicity of schemes are protected from competition by national borders. If most schemes were to opt for co-branding and if this situation were to become permanent, SEPA would neither benefit from economies of scale nor from competition, as national schemes would most probably retain national business, and only cross-border transactions would be routed through international card schemes. Therefore, even if all participating schemes are SEPA-compliant, co-branding cannot represent the only or even the main long-term solution for SEPA (although it could help banks to fulfil their SEPA objectives for 2008 and 2010).

THE NEED FOR A EUROPEAN CARD SCHEME

Option 2 of the SCF envisages two sub-options whereby the emergence of a European card scheme could be encouraged: 1) expansion to the euro area, which implies making significant efforts to publicise the brand and get it accepted by merchants outside its country of origin, and 2) alliances, which require agreements between schemes that continue to function independently.

These two solutions would allow the valuable experience of national card schemes in Europe to be retained, and would also create more competition in the European card market. For these reasons, the Eurosystem expects at least one European card scheme to emerge in the coming years. It will be up to the banks to decide whether this scheme (or schemes) has international reach or will simply be co-branded with the international card schemes to offer payment services outside the euro area; in both cases, such (a) scheme(s) would be a key factor in enhancing diversity and competition in the market. With regard to co-branding, Visa and MasterCard should not prevent European banks from co-branding their European card schemes with them, regardless of whether this co-branding is designed to obtain full euro area or international-wide reach.

THE INTERCHANGE FEE ISSUE

Interchange fees, which are paid by the acquirers (and ultimately by the merchants) to the issuing banks, have been an efficient instrument in promoting the adoption of cards by European citizens. However, interchange fees can also be an obstacle to competition as they reduce the ability of merchants to negotiate the fees they pay to their acquirers. The Commission has issued the Sector Inquiry Report on cards, which dealt mainly with interchange fees, and left the general impression that an abolition of interchange fees could be envisaged. The Eurosystem invites the Commission to announce as soon as possible its policy with regard to interchange fees, as such an announcement would give clear guidance for banks and schemes seeking to develop sustainable business models for SEPA. For level playing-field reasons, the decisions of European and national competition authorities should be aligned and a consistent stance should be adopted across the euro area. In case the Commission's policy substantially differs from today's situation, appropriate adaptation times would have to be provided in order to avoid market disruption.

There is no reason why full transparency should not be ensured in the field of interchange fees. Therefore, they should be publicly available on the internet, and the calculation method used to determine them should, if possible, be approved by the competent authorities.

FOSTERING COMPETITION

The move to SEPA should improve the quality of payment services and reduce their cost to society. Competition pressures would contribute to reaching these objectives. Competition should take place at three levels: 1) between issuing and acquiring banks, 2) between card schemes, and 3) in the processing of card payments.

• ACQUIRING AND ACCEPTANCE PRACTICES

In order to ensure a level playing-field at the European level, the Commission is invited to clarify its position with respect to the following acquiring and acceptance practices:

– fee-related restrictions to cross-border acquiring in the euro area;

– fee "blending" practices applied by acquirers to merchants (which hides fee differentiations between schemes and thus hampers competition between them);

– the prohibition on merchants to surcharge card payments if these are more costly than other instruments;

– the application of an "honour all cards" rule concerning merchants (obliging them to accept all schemes of a given brand).

• PROCESSING

In line with the provisions of the SCF, banks should be able to choose between different possibilities to process card payments. The separation between scheme management and processing must be effective and not just on paper. For example, contractual obligations between banks and card schemes requesting the use of a particular processing channel should be eliminated, and cross-subsidisation between card schemes and their processing units must also be avoided.

STANDARDISATION

To ensure that cardholders can use their SEPA cards across the euro area, it is important to ensure that merchants can accept all SEPA cards as long as this makes economic sense for them of course. To secure this objective, there should be no technical barriers to competition. Standards are the basis for open and fair competition. They should cover every phase of the transaction chain (cardholder-to-terminal, terminal-to-acquirer and acquirer-to-issuer), the security evaluation and the certification of devices. Concerning terminals in particular, standardisation and the definition of an adequate and independent certification body is essential to ensure that any card can be accepted at any terminal. The EPC should investigate how the objectives of the SCF, especially interoperability, could be ensured by the card standards which are currently under development. Participation in the definition of standards should be open to all stakeholders. The outcome must be mandatory for the entire market, without any opt-out possibilities and with clear implementation deadlines.

In addition to technical standards, additional requirements in terms of business rules and practices are needed to ensure that cardholders have access to many POS terminals. This will also contribute to creating a level playing-field for inter-scheme competition.

DATA PROTECTION

Card payments contain personal data, something which is extensively protected in the EU. The conditions under which the transfer of data outside the EU is organised have to be clarified. The transfer of non-aggregated data outside the EU for statistical purposes or for marketing purposes should be avoided under any circumstances.

FRAUD

Combating fraud is an important aspect of SEPA. Fraud increases card payment fees and may even threaten the acceptability of the instrument. Apart from the agreement to implement EMV, the EPC is invited to define a clear strategy for combating fraud, placing special focus on the objective of bringing cross-border levels of fraudulent incidents down to national ones.

MONITORING OF CARD PAYMENT FEES

As explained above, there is a genuine risk that the solutions chosen by banks to comply with SEPA could lead to price increases. Moreover, in the absence of any appropriate statistical framework, bank customers and public authorities could experience increases in some countries, while fees could decline elsewhere. As a result, the Eurosystem will investigate with the relevant stakeholders the possibility of establishing a framework to monitor card fees in the coming years.

SEPA COMPLIANCE

In view of the above, a SEPA-compliant card scheme is one that complies with the provisions of the SCF and takes into consideration the following needs:

– to offer the same service to merchants and cardholders, wherever the scheme operates in the euro area – the various add-ons should not hamper interoperability;

– to have a single interchange fee (if any) for the whole euro area within a given brand;

– to define and publicly disclose a medium to long-term strategy which is consistent with the long-term objectives of the SEPA project;

- to disclose interchange fees and their calculation methodology, and submit them, if possible, to the relevant authorities;

- to be compliant with the future European Commission position about acquiring and acceptance practices in order to enhance competition and transparency;

- to separate effectively card scheme management and processing services without any possibility for cross-subsidisation or other practices that could give an advantage to own processing services;

- to contribute to the design of consensus-based selection of standards with a clear commitment for implementation on time;

- to avoid any transfer of personal data in a non-aggregated form to countries that are not compliant with the EU rules;

- to put in place a strategy on how to reduce fraud, especially cross-border fraud.

INTRODUCTION

There are currently more than 350 million cards in the euro area, which are used to make more than 12 billion payment transactions and 6 billion cash withdrawal transactions per year. The SEPA project will have a tremendous impact on this industry. In this regard, the Eurosystem's position will be critical in steering the market in the right direction, ensuring future growth and innovation and maximising benefits for Europe's citizens.

This report is structured as follows. Section 1 explains the current situation in the card market; Section 2 presents the work carried out so far by the EPC; Section 3 describes the main current trends concerning schemes and banks' approaches in view of SEPA compliance; Section 4 develops the Eurosystem's view of a SEPA for cards; Section 5 identifies some of the risks that could stem from SEPA migration; and Section 6 concludes with a list of public policy provisions.

1 CURRENT SETTING OF THE EURO AREA CARD MARKET

Currently, the card market in Europe is characterised by a high degree of national fragmentation. There are a series of national four-party and three-party schemes. Four-party schemes comprise banks that issue cards for cardholders, banks that acquire card transactions for merchants, and the cardholders and merchants themselves (there are also possibilities of indirect participation which are not described here). This differs from a three-party scheme, where cardholders and merchants are joined by a company that both issues cards and acquires card payments.

Four-party card schemes can be subdivided into two types: national and international:

- national four-party card schemes serve national markets. In the euro area, there is at least one national card scheme operating per country (e.g. Cartes Bancaires in France, Electronic cash in Germany, and COGEBAN in Italy; Spain however is a special case as there are three national card schemes in operation). National card schemes are mainly owned, directly or indirectly, by banks. Cards issued under national schemes can only be used within the country of issuance, with a very limited number of exceptions. In relatively few countries, national debit cards are issued under Visa (Visa Electron or V-Pay) and MasterCard (Maestro), but this is much more the case for credit cards. For this reason, the fragmentation of the card market into national schemes is more of an issue for the debit than for the credit card market;

– international four-party card schemes, i.e. Visa and MasterCard, are used for cross-border payments, either within or outside the euro area. In such cases, national card schemes and international card schemes are co-branded, meaning that cards bear both brands; when the cardholder makes a payment in the country of issuance of the card, the brand that gets activated is the national one; whereas when the cardholder makes a payment in another country than the country of issuance, the brand activated is the international one. Until recently Visa and MasterCard used to be membership associations owned by banks; MasterCard has however since converted into a publicly-listed company, while Visa has also announced similar intentions (although Visa Europe will maintain its membership association structure).

There are several national three-party schemes as well as the international ones (American Express, Diners and JCB) in most countries, whose cards can be used for transactions within and between countries. There is no co-branding as in the case of four-party schemes.

The national fragmentation of card schemes goes hand in hand with fragmentation in terms of standards and business practices in use. The situation is similarly fragmented for technical infrastructure providers such as payment processors, authorisation platforms and providers of cards and POS terminals.

Nevertheless, most national card schemes have managed to offer a very efficient service at low cost; their business model, expanded to the whole euro area, should in principle, allow a further reduction in costs because of economies of scale. The challenge for SEPA implementation is to combine the transition to a more integrated market with the preservation of high efficiency and low cost levels.

2 EPC'S WORK IN THE FIELD OF A SEPA FOR CARDS

The EPC has adopted the SCF which banks, as members of card schemes, have committed themselves to implementing. The SCF defines a series of high-level principles and rules which "will enable banks, schemes and other stakeholders to move towards SEPA" and which banks and card schemes need to apply in order to pursue card business activity within SEPA.

The SCF defines the following three options among which card schemes should choose in order to position themselves in the SEPA card market (combinations of these are also possible):

Option 1: To replace the national scheme by an international card scheme, provided the latter is SCF-compliant. In this case, Visa or MasterCard cards would be issued and acquired in the country, meaning that there is no need to co-brand as cross-border transactions would automatically be covered by the same schemes.

Option 2: To evolve through alliances with other schemes (as is the case with the Euro Alliance of Payment Schemes (EAPS), for example) or through expansion to the entire euro area. In the case of an alliance of SEPA-compliant card schemes, the participants would follow an open interconnectivity approach (e.g. by mutually agreeing to accept brands). Should a SEPA-compliant card scheme be expanded in the euro area, its cards would be used and accepted by cardholders and merchants located anywhere in the euro area.

Option 3: To co-brand a national scheme with an international scheme (provided that both are SCF-compliant).

3 CURRENT DECISION TRENDS OF MARKET PARTICIPANTS REGARDING A SEPA FOR CARDS

Through a series of meetings with national and international card schemes, as well as with banking communities, the Eurosystem has gathered information on the main decision trends in view of SEPA migration, on the issues at stake and on some aspects for which banks/schemes requested the guidance/assistance of the Eurosystem.

Many card schemes and banks expressed their preference for co-branding. There is also some support for the second option, which is currently represented by only one initiative, EAPS. For the moment, the banks in two countries (Belgium and Finland) have decided to replace their national card schemes by international ones.

REPLACEMENT BY INTERNATIONAL BRAND

Card schemes/banks which have opted to replace the national brand by an international one were motivated by time and easiness considerations. However, another factor might have been interchange fees, which are typically higher in international schemes than in national ones. In principle, interchange flows should be neutral for the banking sector, but they are too often seen as a source of guaranteed revenues for the banks participating in the scheme (especially issuers, of course).

THE EURO ALLIANCE OF PAYMENT SCHEMES (EAPS)

Several card schemes/banks have recognised the political importance of building a euro area scheme. For the moment, the only existing initiative under Option 2 is EAPS, which comprises as its founding members Electronic Cash and Deutsches Geldautomaten-System (Germany), the Convenzione per la Gestione del marchio Bancomat (COGEBAN, Italy), Eufiserv (a European supplier of processing services for ATMs, based in Brussels), Link (the UK's ATM switch), Euro 6000 (Spain) and Multibanco (Portugal). Three more members – Interpay (Netherlands), Laser (an Irish POS system) and Activa (another POS system in Slovenia) – are also expected to join. Implementation projects have already been set up by processors in Germany, Italy and the Netherlands.

Those card schemes that support the EAPS justify their decision on the grounds that they incur higher costs within international card schemes, and lack control over their governance. They also claim that the EAPS approach offers the possibility to enhance pan-European reach at lower costs, since it relies on existing infrastructures and national market acceptance, simply enabling interconnectivity. EAPS may therefore offer a way to maintain the efficiency of existing national card payment systems within SEPA.

However, some national card schemes have so far declined the invitation to join EAPS because they consider that the cost and level of complexity of establishing bilateral arrangements are too high, in conjunction with the perceived lack of a business case.

CO-BRANDING

Those card schemes/banks that have opted for co-branding were motivated by the following considerations:

- most cards are already co-branded and this is a factor of ease; this option requires less investment in terms of adapting;
- there is (near) universal acceptance of cards issued under international card schemes;
- co-branding allows schemes and banks to retain some degree of "internal governance" or local autonomy;
- it is possible to meet specific local requirements without any deterioration in the service level;

– it is relatively easy to declare SEPA-compliant.

4 THE EUROSYSTEM'S VIEW OF A SEPA FOR CARDS

In a SEPA for cards, card schemes will operate as if in a single country. A SEPA for cards will have the following characteristics:

1) consumers can choose among various competing payment card schemes which do not have a pre-assigned priority in use at POS terminals;

2) there is a competitive, reliable and cost-efficient card market, including service and infrastructure providers;

3) all the technical and contractual provisions, business practices and standards which had resulted in a national segmentation of the euro area have been eliminated. In particular, there is no obstacle for merchants to accept any SCF-compliant payment cards.

Three-party schemes such as American Express and Diners are also expected to abide by the SEPA compliance principles. The rules and conditions for the same card cannot differ for reasons of geographical location.

When SEPA becomes a truly integrated card market, the two key characteristics will be card acceptance and competition.

CARD ACCEPTANCE

Within SEPA, there should not be any technical hurdle (or any other kind of obstacle) for any card to be used at any terminal. The technical acquiring conditions of competing schemes in SEPA should be such that merchants are indifferent to what brand of card they accept. Schemes should ensure that the necessary technical standards are in place for this.

Actual acceptance should only depend on the perceived business case for the merchants. It is up to each merchant to decide which brands/types of cards to accept. However, in a competitive, integrated and mature market, it will be in the commercial interest of merchants to accept most euro area brands – as is currently the case for national brands in national markets. Therefore, acceptance will not be compulsory, but it is expected that it will gradually reach its development potential.

SEPA compliance for card schemes does not entail that their cards have to be issued and/or acquired in all euro area countries. The degree of expansion is a business decision. However, schemes should lay down fair and open access criteria for potential member banks located anywhere in the euro area, under the same conditions as national commercial banks. It is also seen as a natural long-term development that in a competitive, integrated and mature market, the remaining schemes will broadly cover the entire euro area, in the same way that national schemes are currently largely accepted in their national markets.

COMPETITION

The conditions which lay the ground for SEPA should be in place and should address technical, legal and commercial aspects:

Technical conditions

Uniform standards will ensure a technical level playing-field for all euro area card schemes and infrastructure/service providers. Standards should cover every phase of the transaction chain (cardholder-to-terminal, terminal-to-acquirer, acquirer-to-issuer) and the security evaluation and certification of technical devices (in particular concerning terminals whereas standards and an adequate and independent certification body need to be set up in order to ensure that different payment applications coexist) and also focus on preventing fraud.

It is important that all stakeholders are free to participate in the definition of standards, which should be neutral, future-oriented and not nationally biased, with the aim of guaranteeing universal adoption and avoiding placing particular infrastructure/service providers in a better starting position. Standardisation will empower competition forces (which up to now have been limited within national borders), and will encourage efficiency, innovation, and better services and prices. The EPC is currently working on such standards, which the Eurosystem expects will be compulsory for all stakeholders.

Legal conditions

Current regulatory differences across the euro area create legal uncertainty for cross-border operations and function as barriers. The Payment Services Directive will fill the current void and provide the necessary legal certainty for the expansion of operations across the euro area. Even if the transposition of the Directive into national law is not completed by 1 January 2008, the Directive itself will provide sufficient legal certainty to the parties concerned. In addition, the Commission needs to define interchange fee principles that apply to the entire euro area as soon as possible. The decisions of national and European authorities on specific interchange fee cases need to be aligned and coherent.

Commercial conditions

The elimination of commercial barriers such as diverging national business rules and practices is also intrinsic to the emergence of a SEPA for cards; these barriers should therefore be eliminated by 1 January 2008. Diverging national commercial practices obstruct the development of SEPA-wide business proposals. The EPC has addressed this problem by agreeing on the SCF, although this is rather general when it comes to practical implementation.

5 RISKS RELATED TO SEPA MIGRATION

Concerning the feasibility of the options:

– the replacement of a national scheme by an international one, i.e. Option 1, is relatively easier and quicker to implement from the point of view of banks, since most of them are already cooperating with Visa/MasterCard within the current co-branding framework;

– expansion or alliances, i.e. Option 2, need to overcome some difficult challenges such as explaining to cardholders the use/acceptance of such cards in other countries (e.g. the establishment of a brand) or designing agreements between schemes that partly function in different ways. Furthermore, the success of such initiatives depends on participation: in the case of expansion, the number of foreign banks issuing and acquiring the cards and of merchants accepting them is critical for success. In the case of alliances, the number of participating schemes is crucial;

– co-branding, i.e. Option 3, seems to be a relatively easy option to follow as this is currently the case in most countries; however, SEPA should allow international schemes to compete with national ones for national transactions.

Concerning the degree of SEPA compliance of the options:

– the replacement of a national scheme by an international one, i.e. Option 1, is fully SEPA-compliant, provided that transactions within the country and between different euro area countries are not subject to different conditions for the same card. There has to be a euro area service that is fully adjusted to the SEPA requirements (of course, the scheme is free to adapt its service outside SEPA to the SEPA requirements in order to simplify its operations);

– expansion or alliances, i.e. Option 2, are fully SEPA-compliant, provided that the SEPA requirements are met and that national markets are open to competition;

– co-branding, i.e. Option 3, is in principle SEPA-compliant, provided that the SEPA requirements are met by all national card payment schemes and that national markets are open to competition.

However, even if Options 1 and 3 can clearly help banks and card schemes to be SEPA-compliant by 1 January 2008, they nevertheless give rise to concerns in the long run.

Concerning Option 1, the Eurosystem welcomes the willingness of Visa and MasterCard to offer a domestic service for the euro area. However, the Eurosystem is concerned about the emergence of a situation whereby the two international card schemes would progressively become the only providers of card payment services offered by banks in the euro area.

Indeed, interchange fees are higher with Visa and MasterCard than with national schemes. Therefore the extension of the use of these two schemes at the domestic level creates the risk that merchants could have to pay higher fees. For this reason, merchants have expressed significant concerns about the side-effects of SEPA migration. In Belgium, for example, it was decided that Bancontact/MisterCash, a very efficient and low-cost scheme without interchange fees, will be replaced by Maestro. Belgian merchants have expressed fears that this may lead to the introduction of interchange fees, thus raising merchants' service charges.

As a result, the Eurosystem fears that competition limited to the two systems would be insufficient to maintain the present low level of fees in Europe. Concerns about competition conditions have been exacerbated by governance aspects. MasterCard recently changed its ownership structure from a membership user-driven model to a shareholder-driven solution. Visa has also announced similar intentions, though Visa Europe will preserve its membership association structure. The Eurosystem is not opposed per se to any shareholder-driven solutions, but it does consider that these could lead to excessive price increases if the number of competitors is insufficient. The existence of at least one more European bank-owned scheme would lessen the risk of price increases.

Finally, Option 3 could crystallise national fragmentation. If the card industry massively opts in favour of co-branding and this situation becomes permanent, economies of scale would not materialise in the euro area, and competition between national schemes would remain limited. Therefore, co-branding cannot be the only, or even the main, solution in the long term. Rather, it should mostly be seen as a short-term solution designed to facilitate SEPA compliance by 2008 and 2010.

6 PUBLIC POLICY PROVISIONS

Given the risk that SEPA migration could translate into a deterioration of conditions for both cardholders and merchants, which would in turn also affect banks and could give SEPA a very negative image, the Eurosystem deems it necessary to clarify a series of policy provisions that need to be taken into consideration by schemes/banks, in addition to the requirements of the EPC's SCF, in order to operate within SEPA.

EMERGENCE OF A EUROPEAN CARD SCHEME

National card schemes generally offer efficient and inexpensive card payment services in the national markets. A SEPA for cards could capitalise on this in order to ensure an equally efficient and inexpensive service for the entire euro area market.

As a result, the Eurosystem expects at least one European card scheme to emerge in the coming years. It will of course be up to the banks to decide whether this scheme should have international reach, or whether the scheme will co-brand with international card schemes to offer payment services outside the euro area.

For such a scheme or schemes to emerge, the SCF provides two sub-options as examples: 1) expansion to the euro area, which implies important efforts to make the brand known and accepted by merchants outside its country of origin, and 2) alliances, which require agreements between schemes that typically do not function the same way. Both strategies are certainly highly challenging, as a series of elements will have to be put in place that are taken for granted in existing business proposals. The Eurosystem is well aware of the degree of complexity and the risks of such an undertaking in terms of governance, decision-making and the creation of a brand. Nevertheless, the Eurosystem expects that the respective national card schemes should define their strategies as soon as possible, despite the clearly complex nature of the issue.

THE INTERCHANGE FEE ISSUE

Interchange fees, which are paid by the acquirers (and ultimately by the merchants) to the issuing banks, have been an efficient instrument in terms of promoting the adoption of cards by European citizens. However, such fees can also be an obstacle to competition as they reduce the ability of merchants to negotiate the fees they pay to their acquirers.

The current uncertainty with respect to how interchange fees will evolve in the future is considered by banks and schemes to be one of the main factors delaying SEPA-related decisions and hampering the completion of business proposals. The Commission issued the Sector Inquiry Report on cards, which dealt mainly with interchange fees, and gave the general impression that an abolition of interchange fees could be envisaged. The Eurosystem would like to invite the Commission to announce as soon as possible its policy with regard to interchange fees. In case this policy substantially differs from current conditions, the Commission is invited to provide appropriate adaptation times, in order to avoid market disruption. The decisions of European and national competition authorities also urgently need to be aligned, especially in terms of adopting a coherent stance across the euro area. This would greatly facilitate new market initiatives in particular.

The policy principles that apply to interchange fees should also contribute to a level playing-field for all card schemes. Furthermore, transparency needs to be enhanced: interchange fees should be made publicly available on the internet. The calculation method which led to their determination should, if possible, be submitted to the competition authorities for approval.

FOSTERING COMPETITION

The move to SEPA should not consist just in making current national payment services accessible throughout the euro area. SEPA, given its user-oriented nature, should be seen as an opportunity to improve the quality and efficiency of payment services by reducing costs. To ensure the dynamism of the European card market, European payments need to retain their competitive edge, and a forward-looking approach must be adopted. Competition would contribute in terms of reaching these objectives, and would take place at three levels: between card schemes; between issuing and acquiring banks; and in processing card payments.

• ACQUIRING AND ACCEPTANCE PRACTICES

To ensure a level playing-field for all at the European level, the Commission is invited to clarify its position with respect to the following acquiring and acceptance practices which are linked to competition and transparency:

– any fee-related restrictions to cross-border acquiring in the euro area; any rules that reduce the benefits and thus the incentives for cross-border acquiring need to be removed;

- the "blending" of card scheme fees applied by acquirers to merchants (meaning the offer to acquire transactions under different brands/schemes against a single (package) merchant service commission). This measure conceals fee differentiations between schemes, and thus hampers competition;

- the prohibition on merchants to surcharge payments by cards if the latter are more costly than other instruments;

- the application of an "honour all cards" rule to merchants (making it compulsory to accept all schemes of a given card brand).

- **PROCESSING**

In line with the general policy of the Eurosystem in the field of market infrastructures, banks should have different possibilities to process card payments. Contractual obligations between banks and card schemes that request the use of a particular channel should be eliminated. Vertical integration needs to be replaced by more open and flexible market structures, fostering competition and allowing economies of scale to be realised. The separation of scheme management and processing services, as required in the SCF, needs to be actual and not just on paper. For example, cross-subsidisation between card schemes and their processing units or offers of bundled services are not acceptable.

STANDARDISATION

To ensure cardholders can use their SEPA cards across SEPA, it is important to ensure that merchants are able and willing to accept all SEPA cards, or at least all the cards that are relevant for them. To secure this objective, work on standardisation is of the utmost importance. Technology should not be a barrier to competition. Uniform standards will entail a technical level playing-field for all euro area card schemes and infrastructure/service providers. Standards should cover every phase of the transaction chain (cardholder-to-terminal, terminal-to-acquirer, acquirer-to-issuer), as well as the security evaluation and certification of technical devices. Interoperability standards should be mandatory, and should be finalised swiftly in order to facilitate migration to SEPA. The EPC should investigate how the objectives of the SCF, especially interoperability, could be ensured by the card standards which are currently being developed.

Concerning terminals in particular, standards plus an adequate and independent certification body should be set up to ensure the coexistence of different payment applications, so that there is no technical hurdle for any card to be accepted at any terminal. Harmonised and adequate security requirements are needed for a common evaluation process. Two general problems facing a new European card scheme and the current national schemes in the SEPA environment are euro area-wide reachability and the establishment of a transaction-processing network. The industry could also study the possibility of using the current payment infrastructures, in particular the direct debit ones for the processing of new SEPA card products/schemes.

The payment function needs to be clearly defined, and the various add-ons such as loyalty programmes should not hamper interoperability. Participation in the definition/choice of standards must be open and the outcome mandatory for all parties in order to ensure that standards, especially in the terminal-to-acquirer domain, adequately satisfy the needs of all stakeholders, particularly merchants and cardholders. There cannot be any opt-out options, and a clear implementation deadline needs to be defined. Technical standards alone cannot ensure that the aim of making it possible for every cardholder to use his or her card throughout SEPA is realised. Additional requirements might be needed, for example in the field of business rules and practices, to ensure that cardholders can use their card at every terminal. This will also contribute to creating a level playing-field for inter-scheme competition.

DATA PROTECTION

Card payments contain personal data, a topic that is extensively protected by EU legislation. The EU has set up a legal framework enabling both the protection of personal data and the free circulation of such data among Member States, by means of the adoption of Directives 95/46/EC and 2002/58/EC. With regard to data flowing outside the EU, the European framework in principle only allows transfers to third countries that guarantee an adequate level of protection which corresponds to the standards applicable within the EU. Transfers to third countries that cannot guarantee an adequate level of protection may nevertheless be possible by way of a contract or via the adoption of a binding code of conduct (e.g. binding corporate rules). However, the transfer outside the EU of non-aggregated data for statistical purposes or for marketing purposes should be avoided. Reputational risks linked to data transfers outside the EU should also be taken into account, as these could jeopardise the confidence of users in card payments. The conditions under which the transfer of data outside the EU is organised have to be clarified.

FRAUD

Combating fraud is crucial for the building of SEPA; in particular, differences in fraud levels between transactions within and between euro area countries need to disappear. Fraud increases card payment fees and may even threaten the acceptability of the instrument; therefore, combating fraud is linked to the reliability of cards as payment instruments.

The EPC has agreed to implement EMV and the migration procedure has been streamlined. However, it needs to be ensured that EMV is applied in a uniform way and that add-ons and updates operated at national level do not distort interoperability. In addition to the agreement to implement EMV, the EPC is invited to define a clear strategy for combating fraud, with special focus on bringing cross-border levels of fraudulent incidents down to national ones. In addition, the EPC should clarify the need to develop a card fraud database.

At the same time, other fraud prevention measures need to be pursued in a centrally coordinated way, targeting other types of fraud than those tackled by EMV (such as fraud on card-not-present transactions).

MONITORING CARD PAYMENT PRICES

As explained above, there is a non-negligible risk that the solutions chosen by banks to comply with SEPA could lead to price increases. This risk is more acute for merchant fees, but it also concerns scheme membership fees and possibly cardholder fees too. Merchants have alerted the ECB and the Commission to such a development, as there have already been cases of interchange fee increases following the shift of some national card scheme markets to international card schemes. Such a development would certainly stigmatise the SEPA project in the eyes of the public. SEPA should not present an opportunity for price increases, nor should the quality of service deteriorate.

Statistics on card fees could also help banks to respond to a possible asymmetry in users' perception of the evolution of card fees (i.e. they are more likely to detect price increases than price decreases). The Eurosystem will investigate with stakeholders the feasibility of computing such figures in the future.

SEPA COMPLIANCE

In view of the above, a SEPA-compliant card scheme is one that complies with the provisions of the SCF and takes into consideration the following needs:

- to offer the same service to merchants and cardholders, wherever the scheme operates in the euro area – the various add-ons should not hamper interoperability;

- to have a single interchange fee (if any) for the whole euro area within a given brand;

– to define and publicly disclose a medium to long-term strategy which is consistent with the long-term objectives of the SEPA project;

– to disclose interchange fees and their calculation methodology, and to submit them, if possible, to the relevant authorities;

– to be compliant with the future European Commission position about acquiring and acceptance practices in order to enhance competition and transparency;

– to separate effectively card scheme management and processing services, without any possibility for cross-subsidisation or other practices that would give an advantage to own processing services;

– to contribute to the design of consensus-based standards, with a clear commitment for implementation on time;

– to avoid any transfer of personal data in a non-aggregated form to countries that are not compliant with the EU rules;

– to put in place a strategy on how to reduce fraud, especially cross-border fraud.

All card schemes are invited to define their SEPA compliance plans by mid-2007 and to explain whether these plans require additional action (e.g. standardisation, development of harmonised business practices) in order to ensure a level playing-field.

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