About CMSPI

CMSPI is a global leader in retail payments consulting. Our expert team works to empower the retail community and payments industry with insights, expertise, benchmarking, and analysis to drive value in their payments partnerships. This consultation response was constructed by CMSPI’s market-leading ‘***Insights Team’***, which is made up of economists, data and statistical experts, and experienced payments professionals. We have structured our response to reflect the key areas of the consultation document in which CMSPI can offer unique insights.

CMSPI Response to the European Commission

As outlined in the consultation document, the PSD2 was intended to produce a more ‘integrated, competitive, and innovative’ EU payments market with particular aims to:

* Make it easier and safer to use online payment services
* Better protect payment services users against fraud, abuse, and payment problems
* Promote innovative payment services
* Strengthen the rights of payment services users

Whilst PSD2 regulation provided an important step in realising these goals, in particular by creating a foundation for Open Banking across the EU, there are certain areas in which merchants’ experiences could be improved in response to market developments following its implementation. In this response, we focus on three key areas: security, surcharging practices, and Open Banking.

1. The Security of Online Payments Services

One of the core tenets of the PSD2 was the introduction of Strong Customer Authentication (SCA) requirements across Europe. In prioritising fraud prevention, particularly in the online environment, this goal is strongly aligned with merchants’ aims. Our estimates suggest that in 2021, the average European merchant spent three times more on fraud prevention than they lost to fraud itself (Figure 1).

*Figure 1. Estimated annual merchant expenditure on fraud prevention compared to merchant fraud losses over time. Source: CMSPI estimates and analysis.*

## SCA Implementation

During the roll-out of SCA, CMSPI worked closely with merchant advocates who raised concerns around industry readiness and the potential for adverse impacts on online sales and the customer experience. The core focus was on a lack of readiness, clarification regarding complex use cases, and flexibility once these issues were raised by parties across the payments ecosystem.

Our estimates suggest that the failure rate (which includes both declined transactions and those in which a customer drops out of the payment process following the new friction) remained above 24% on a weighted average basis across Europe between January and September 2021 (Figure 2). This represented a significant challenge for many merchants, particularly in markets such as Belgium, Italy, and Germany. This was observed even in cases where National Competent Authorities recognised the potential impact and delayed SCA implementation.

*Figure 2. Estimated failure rates on 3DS transactions and challenged transactions (i.e. those ‘stepped up’ to require two-factor authentication). Source: CMSPI SCA Economic Impact Assessment.[[1]](#footnote-2)*

From CMSPI’s discussions with the broader industry, a number of the factors contributing to high failure rates resulted from challenges faced by the payments supply chain. For example, CMSPI heard reports of some issuing banks rejecting TRA exemptions based on their own fraud rate, as opposed to assessing the exemption based on the acquirer’s rate as specified by regulation.

Merchants in certain verticals also experienced sector-specific challenges. For instance, merchants processing a large volume of Merchant-Initiated Transactions faced lack of clarity around ‘reasonable customer expectations’ of price changes, as well as the application of the Grandfathering Provision in countries where SCA was implemented gradually for different transaction thresholds. These challenges are outlined in more detail in CMSPI’s MIT report.[[2]](#footnote-3)

Whilst a certain level of friction is to be expected with any new regulation, today merchants are still facing difficulties in minimising the friction associated with SCA – in particular through the application of exemptions intended to facilitate transactions with a lower fraud risk. Recent data from the EHI Retail Institute suggests that of the top online retailers in Germany, just 9% use exemptions or otherwise bypass two-factor authentication.[[3]](#footnote-4) If the current SCA requirements stay in place, merchants (especially small and medium-sized business who may lack the resources or expertise to conduct the necessary analysis) would benefit from additional clarity and support in accessing exemption options.

## Fees for SCA Compliance

Another factor increasing the difficulty merchants face following the introduction of SCA is the various fees now charged for compliance. CMSPI has observed the introduction of charges for the use of 3DS technology, as well as fees for exemption usage (including explicit exemption fees, as well as those for the use of Address Verification and CVC data, which merchants may use to minimise fraud risk on non-3DS transactions), and fees for declined transactions. We have also seen fees introduced for when a minimum threshold of transactions going through 3DS is not met.[[4]](#footnote-5) Merchants have raised concerns that, while there may be initial sunk costs for the creation of these technologies, ongoing per-transaction fees can continue indefinitely given enforced merchant dependence, highlighting broader concerns around competition in the industry.

The result has been that many merchants now face unavoidable, additional costs regardless of which SCA strategy they choose. These act to increase the cost of payments acceptance online, and regularly alter the business case for different strategies when a new fee is introduced. These changes are often not communicated clearly or in advance, and merchants often lack the expertise or resources to understand the impact they will have on their cost base at a time of record inflation across the Eurozone.

## Fraud

Finally, the main aim of SCA requirements was to increase the security of online transactions for consumers, as specified in the PSD2 regulation. In its work, CMSPI has not observed a material reduction in merchant fraud levels since the introduction of SCA despite significant increases in merchant fraud prevention expenditure (see Figure 1). Whilst we have heard reports of fraud improvements for specific local card schemes, there is a concern amongst merchants that SCA has increased the cost of doing business online without improving the customer shopping experience or mitigating the required investment in their own fraud prevention strategies.

1. Surcharging

## Overview of Surcharging

In the PSD2, the Commission notes that different national practices had led to heterogeneity in surcharging practices across the EU. There were also concerns around surcharges set at levels that did not reflect the underlying cost of payment instruments.

Article 62(3) therefore states: “The payment service provider shall not prevent the payee from requesting from the payer a charge, offering him a reduction or otherwise steering him towards the use of a given payment instrument. Any charges applied shall not exceed the direct costs borne by the payee for the use of the specific payment instrument.”

Article 62(4) states: “In any case, Member States shall ensure that the payee shall not request charges for the use of payment instruments for which interchange fees are regulated under Chapter II of Regulation (EU) 2015/751 and for those payment services to which Regulation (EU) No 260/2012 applies.”

Reducing inhibitors – both regulatory and operational – to surcharging is an opportunity to curb rising scheme fees. As evidenced in other geographies[[5]](#footnote-6)[[6]](#footnote-7), even the temporary application of a brand-level surcharge has impacted business' ability to negotiate card acceptance rates. While these high-profile cases typically relate to the largest merchants, we discuss below how rising fees and technical limitations increase their relevance for smaller businesses.

## Rising Scheme Fees on Regulated Payment Methods

PSD2 prevents Member States from requesting surcharges for payment methods that are regulated under the EU’s Interchange Fee Regulation on the basis that interchange fees, which “constitute the main component of merchant charges for cards and card-based systems”,[[7]](#footnote-8) are regulated. This is under the implicit assumption that the IFR addressed the problem of high card fees in Europe. However, despite interchange fee regulation, our analysis suggests that the average merchant service charge (MSC) has increased in the period following regulation. Figure 3 shows how the average MSC, largely owing to increases to its unregulated components, is now estimated to be higher than it was pre-IFR.

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*Figure 3. Estimated evolution of the Merchant Service Charge (EU28). Source: CMSPI & Zephyre Scheme Fee Study (2021).*

Observing this trend in the rising cost of acceptance for the average card transaction, CMSPI notes the importance of expanding surcharging accessibility to payment methods currently regulated by the IFR. This is because preventing cost differentials from being reflected between payment methods can represent a failure of the pricing mechanism in the economic sense; customers may be unknowingly increasing the overall price of goods, even when they are indifferent between choosing a cheaper or more expensive payment method.

Discriminating between exempt-and non-exempt transactions may also limit the ability of merchants to steer towards options that allow them to keep costs (and therefore prices) lower. In some cases, operational difficulties with respect to merchant terminal integrations can prevent merchants from being able to identify the card type as either consumer or commercial. With limited visibility into card types, merchants may not be able to utilise a surcharging solution given the inability to identify commercial cards.

1. Open Banking and Competition Between Payment Instruments

Evidence of rising card costs (as well as pre-existing differentials between domestic and cross-border transaction scheme fees) makes it more important than ever that the PSD2 is successful in its aim to ‘open up [the European payments] market to more competition’.[[8]](#footnote-9) This is especially so as CMSPI analysis suggests that pre-existing competitive pressure is declining in the absence of policies to protect local card schemes, whose market shares are estimated to have diminished significantly over time (Figure 4).

*Figure 4. Estimated market share of domestic vs global card schemes over time across Europe.[[9]](#footnote-10) Source: CMSPI estimates and analysis based on Euromonitor International data.*

A key step taken to encourage competition in the PSD2 was laying down the rules for Open Banking throughout the EU, representing a significant step forward in the global landscape for this form of payment.

However, there remains significant variation across Europe in the viability of Open Banking technology for merchants. According to data from Mastercard’s Open Banking Tracker, just 5% of the 529 third-party Open Banking registrations in Q4 2021 were from Payment Initiation Service Providers (PISPs), falling from 6% the previous quarter. The UK remains the market with the greatest third-party home registrations with 216, followed by Germany with 37.[[10]](#footnote-11) Inconsistency across API standards, as well as variation in requirements from different countries (e.g. in data fields, number of redirects, user consent requirements) leads to difficulties for both merchants and their PISPs in expanding across markets or offering cross-border payments. In CMSPI’s experience, merchants are therefore reluctant to be first-movers in accepting Open Banking, especially as it has yet to build the economies of scale seen in card payments.

If unaddressed, this limitation could worsen as CMSPI has heard concerns that new commercial structures could be introduced for Open Banking to facilitate the market’s development. In particular, this could include the introduction of multilaterally-set fees charged to PISPs by issuing banks for the use of Open Banking technology, which may be passed on to merchants similarly to interchange but without equivalent regulatory protections. Rather than removing fee income which could stifle market incentives (as the IFR intended), this could replicate the same structure in a new sphere. This could further stifle merchant adoption, intended benefits for consumers, and the competition provided by Open Banking as an alternative payment instrument.

Summary

The Second Payment Services Directive represented a significant shift in the European payments market. Its goals of creating a more secure, competitive, and innovative market are closely aligned with those of merchants across the continent, who continue to invest in fraud prevention and advocate for competition-based policies and regulation.

However, there are a number of areas in which the regulation could be strengthened for merchants and consumers to access its full benefits. In particular, there is limited evidence that SCA requirements have reduced payments fraud in CMSPI’s experience, and those merchants attempting to reduce SCA friction face a number of informational, cost, and technical difficulties when accessing exemptions. Similarly, there is a concern that surcharging provisions that limit merchants from signalling the true cost of acceptance for a payment card type could have had the effect of limiting competition between payment methods, which could adversely affect consumers in the long-run by limiting their ability to make informed choices. This competition is equally important in promoting Open Banking technology, which would benefit from greater consistency across standards, as well as protection from the introduction of non-negotiable charging structures reminiscent of those it hopes to replace.

1. https://cmspi.com/eur/en/resources/content/strong-customer-authentication-sca-impact-assessment-september-2021/ [↑](#footnote-ref-2)
2. https://cmspi.com/eur/en/resources/content/retailer-challenges-in-implementing-an-mit-strategy-cmspi-insights/ [↑](#footnote-ref-3)
3. EHI Online Payment Study 2020-2022 [↑](#footnote-ref-4)
4. Please reach out to CMSPI for additional detail regarding these fee structures. [↑](#footnote-ref-5)
5. https://www.cbc.ca/news/business/visa-walmart-1.3923039 [↑](#footnote-ref-6)
6. https://www.channelnews.com.au/visa-removes-surcharge-from-amazon-australia-sales/ [↑](#footnote-ref-7)
7. Article 66 [↑](#footnote-ref-8)
8. European Commission (2022). TARGETED CONSULTATION ON THE REVIEW

   OF THE REVISED PAYMENT SERVICES DIRECTIVE (PSD2). https://ec.europa.eu/info/sites/default/files/business\_economy\_euro/banking\_and\_finance/documents/2022-psd2-review-consultation-document\_en.pdf [↑](#footnote-ref-9)
9. Data includes Austria, Belgium, Denmark, France, Germany, Greece, Hungary, Italy, Netherlands, Poland, Portugal, Romania, Spain, Sweden [↑](#footnote-ref-10)
10. https://b2b.mastercard.com/news-and-insights/open-banking-tracker/q4-2021/ [↑](#footnote-ref-11)