EDPIA[1] CALLS ON EU POLICY MAKERS TO ADDRESS THE IMPACT OF COVID-19 ON INDEPENDENT EU PAYMENT SERVICES PROVIDERS

EXECUTIVE SUMMARY

The COVID-19 pandemic has caused a **near collapse of entire sectors of the EU economy**, such as Travel, Tourism and Entertainment. **Retailers (merchants) in these sectors have significantly relied on EU Payment Service Providers (PSPs)** to meet the exponential rise in claims by consumers for reimbursement or deferred (e.g. voucher) solutions. In their "payment acquirer" function, PSPs guarantee the reimbursement of a card holder (chargeback) in case **of merchant failure, thereby ensuring the trust in the payment schemes, especially for goods or services with a delivery significantly in the future after payment is made.**

Despite historical declines in transaction volumes and historical rises in demands for refunds, **EU PSPs have**:

- **secured business continuity for EU merchants** in assuring flawless performance of their obligations as EU PSPs;
- **facilitated changes in consumer behaviour to reduce infection risk**: increase in e-commerce and remote payments as well as in contactless and mobile payments; and
- **ensured EU payment systems continue to operate** smoothly and resiliently.

This, without the benefit of public measures deployed for most impacted merchants and sectors.

Continued deterioration in credit risk puts EU PSPs' in a position where they may no longer be able to support merchants in the sectors most impacted by COVID-19 without additional collateral (such as cash advances or bank guarantees) and/or higher Merchant Service Fees. This is specifically the case for <u>independent</u> EU PSPs who do not benefit from the possibility to issue state guaranteed loans or other public measures to keep merchants solvent.

For merchants already facing a challenging environment, this would present an additional obstacle in their recovery from the lock-down measures.

The EDPIA encourages policy action in 5 areas to ensure adequate support for EU merchants and consumers, as well as draw appropriate lessons from the crisis for the EU payments system:

1. **EU PSPs** who provide financial security to consumers and enable merchants to conduct their business **should directly be able to benefit from public measures for financial stability in case of exceptional circumstances** such as the shut-down of entire sectors, as experienced with COVID-19, on a level-playing field with other financial institutions. Also, **a fundamental re-think of the current functioning of retail payments systems based on a business model created 40 years ago is needed -** to ensure that collective responsibility is shared in a balanced way among <u>all</u> interested parties in such exceptional circumstances.
2. A **common EU approach** is needed **to address the inability of major card schemes and national responses to provide a coherent framework for consumer protection and large-scale merchant insolvency risk** in a way that does not transfer liability solely onto acquirers.
3. EU authorities should **investigate potential distortions of the level playing field** in the EU payments ecosystem resulting from COVID-19, including whether independent EU PSPs may now be at an economic competitive disadvantage versus other PSPs operating in the EU.
4. EDPIA members are ready for and strongly support the implementation of **Strong Customer Authentication (SCA)** under PSD2 due 1 Jan 2021; however, an **extension** is advisable to provide many merchants, consumers and other stakeholders in the payments value chain with more "breathing space" to become SCA compliant and accompany the millions of new online shoppers in their new digital payments experience
5. EU authorities should **establish a COVID-19 payments stability group** to address the above issues as well as the long-term plan to maintain Europe's payment system capability and infrastructure for the duration of the crisis and recovery period.

[1] Members of the recently formed EDPIA are the leading EU PSPs, who uniquely are 100% European domiciled companies, non-banked owned, and have payments as their primary business. More information about the EDPIA is available at: https://www.edpia.eu/

EDPIA
The European Digital Payments Industry Alliance

EU PSPs' UNIQUE ROLE IN THE PAYMENTS ECOSYSTEM

PSPs are the glue between card issuers, merchants (e.g. retail shops, travel companies) and consumers. Any payment for goods or services made by credit/debit card will generally be handled by a PSP (on behalf of a merchant) who typically performs:

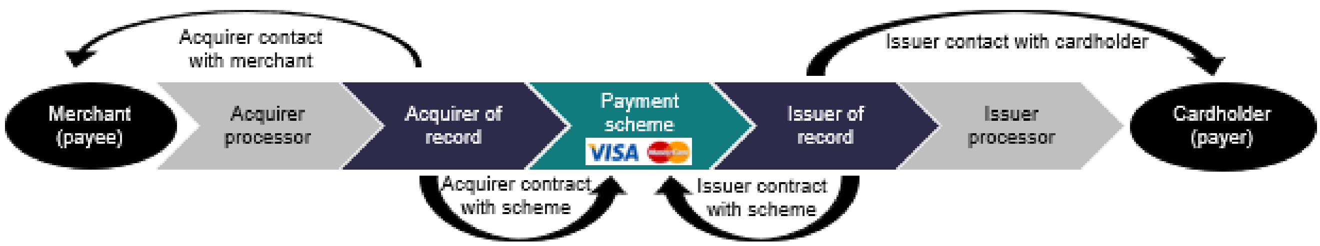
- a **payment processing** function, prior to funds being settled in a merchant's bank account: including authentication, security and fraud checks and settlement; and
- a **payment acquiring** function where, on behalf of merchants, PSPs obtain approval from a consumer's card issuer (e.g. his/her bank) or credit card company before approving or rejecting his/her payment to the merchant. **Acquirers guarantee the reimbursement of funds to the consumer** in case the merchant is fraudulent or becomes insolvent before delivering the goods or services.

ACQUIRER RISK UNDER GUARANTEE, REFUND AND CHARGEBACK MECHANISMS

There are **two core guarantees** provided under international (and some domestic) card scheme rules:

- **Merchant payment guarantee** on issuer authorised transactions, **provided by the card issuer.**
- **Cardholder fulfilment guarantee** on a card transaction, which allows consumers to raise a claim against a merchant through their card issuer via scheme rules to obtain the value of the transaction back: this is known as a **chargeback right, guaranteed by a merchant's acquirer.**

These two contractual rights are enforceable between merchants and cardholders under multilateral contracts (as per the diagram below) that underpin international card schemes and give certainty to parties regarding their rights and the governance mechanism to handle disputes.



In general, **when consumers wish to obtain a refund** for a transaction (e.g. for goods they return or because they believe the goods/services have not been delivered as expected) and there is no dispute, the **merchant initiates a refund request** through its acquirer, which in turn submits the transaction to the card scheme, which in turn makes the appropriate adjustments to the issuer and acquirer positions in the scheme settlement. This **"Business as usual" (BAU) process** is highly automated.

If a cardholder requests a refund and the **merchant does not initiate the refund** (e.g. it is in financial distress or disagrees), under card scheme rules the cardholder can contact its card issuer to dispute the transaction and seek to recover its purchase via a chargeback. If the cardholder wins the dispute and is awarded a chargeback, the acquirer bears significant additional process costs.

The financial risk of the chargeback process to the acquirer, in case the recovery of funds from the merchant is not possible, is covered by the existing internal risk management processes, which are today subject to financial supervision of the acquirers/PSPs.

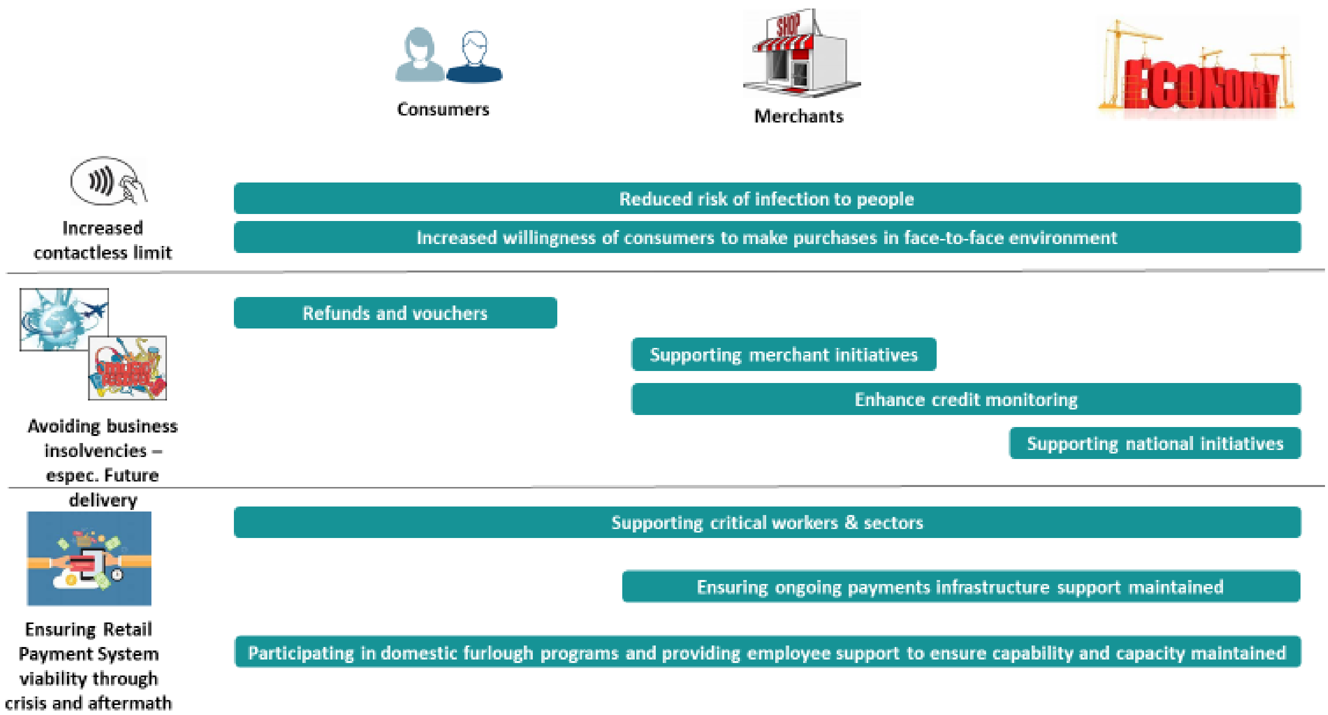
In normal conditions, **contingent risk exposures from future delivery clients** (e.g. airlines, package travel, event organisers) already represents a significant risk to acquirers, which is managed accordingly, particularly where payments are made by consumers well in advance of the receipt of the goods or services (e.g. flights, hotel bookings). **In the current crisis, these risks have materialised to a much higher extent.**

HOW WE ARE SUPPORTING OUR STAKEHOLDERS IN THE MIDST OF COVID-19

EDPIA members are taking actions to mitigate and manage COVID-19 impacts on consumers, merchants and the wider economy. The key pillars of this are:

- **Maintaining a viable European retail payments infrastructure**
- **Minimising merchant insolvencies**
- **Reducing infection risk**

The following table outlines specific initiatives already being undertaken by the EDPIA members in conjunction with actions taken by regulators, card schemes and merchant bodies.



THE MAGNITUDE OF THE IMPACT OF COVID-19 ON INDEPENDENT EUROPEAN PSPs

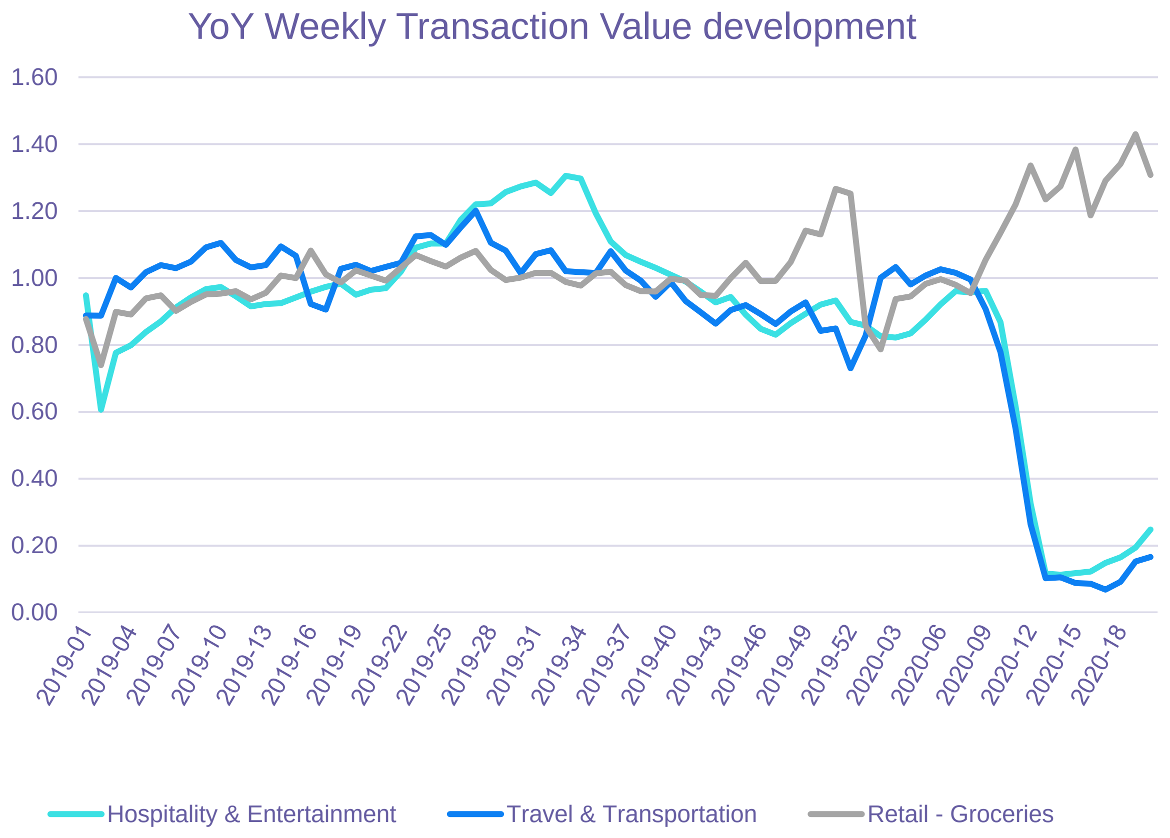
Acquirers servicing sectors that rely on future delivery need to tighten their management of their credit risk exposure to merchants in these sectors, especially in the travel and entertainment sectors due to restrictions on air travel, or hotel and events cancellations, **with numbers of chargebacks expected to rise significantly resulting from the thousands of bookings that can no longer be fulfilled** (and potential business failures that could follow). In many cases, without access to public guarantee mechanisms, the acquirers will need to factor this increased risk into the commercial conditions towards the merchants.

In Annex, we attach a specific **case-study** of the significant impact of COVID-19 on PSPs supporting the **packaged-travel sector**. **Below we provide unique aggregated anonymised data from EDPIA members on the impact on transaction volumes and refunds.**

Transactions Volume impact

The following is revealed when looking at members' business volumes since January 2019 until week 20 of 2020, with a base value corresponding to the 2019 weekly average:

- In the **Hospitality & Entertainment** sector, net transaction volumes between weeks 10-20 fell on average -67% vs week 10-20 of 2019, peaking at **week 16 with -84% reduction**.
- The **Travel & Transportation** sector started seeing significant reductions in week 9 and averaged -75% between week 9-20 vs same weeks last year, with as much as **-98% reduction in week 14** and since then seeing some slight recovery.
- **Grocery** panic buying surged above the traditional Christmas peak starting in week 9, with an average of 28% increase between weeks 9-20 vs last year, peaking in week 19 at **41% higher than same week 2019** which is 17% stronger than the Christmas peak.



Refunds ratios

Looking at members' monthly refunded transaction value in relation to total value processed since January 2019, the below key findings can be observed:

- The Hotel/lodging sector is experiencing stable refund levels throughout the year, with spring **2019 at ~0.5%** of total processed volume. In March-April 2020, refunds reached **6-11%.**
- The Airline sector has been hit the hardest, with refunds ratios jumping from **1,8% to 12% YoY in March and 2% to 35% in April**, and May and June figures continuing to look weak.

There have been cases of individual travel merchants having refund values exceeding purchase values (above 50% of processed volume), causing **negative net transaction values, i.e. situations where merchants end up with a balance owed to acquirers.**

MAIN LESSONS TO DATE AND MAIN CHALLENGES AHEAD

COVID-19 has laid bare the dysfunctionalities of both major card scheme rules and divergent national responses in the face of exceptional, large-scale business failures and sector insolvency risk – as experienced in future delivery sectors such as the package travel, airline, events and accommodation sectors.

Key implications from transaction volumes and refunds ratio data

- **Exponential escalation of requests for refunds and chargebacks** due to COVID-19. This is particularly the case in the sectors highlighted above where services are delivered after payment is received - and where PSPs' fulfilment risk is the highest. Like in normal times, these risks are part of PSPs' risk management BAU, but with the crisis **operational requirements and insolvency risk of merchants have created unprecedented operational and credit risks to be managed by all actors in the payments system.**
- Whilst EU PSPs have so far been able to effectively manage surges in refunds and chargebacks, the normal way of passing the financial effects of these additional efforts to protect consumers on to their merchant clients, especially in the most impacted sectors, bears a risk of unfortunately negatively impacting the speed of recovery in these sectors.

Vouchers: several Member State responses involve allowing for vouchers in place of refunds. However, **no changes to chargeback rights have been made in the rules of the card schemes** in line with this; in addition, issuing vouchers **merely defers the immediate risk of insolvency**, thereby effectively forcing the acquirers to extend the financial exposure without any additional guarantees.

As to the package travel sector specifically: although EU law requires EEA Members to implement security mechanisms in the event a package travel company becomes insolvent, **implementation of these provisions and funding models are heterogeneous across countries,** creating uncertainty for PSPs in identifying risk and managing business processes. In addition, **statutory Domestic Insolvency Funds (DIFs) for package travel are often structured for a business failure not a market collapse;** however, the fund may not be sufficient to cover statutory obligations.

Card schemes: their rules are **equally structured for a business failure, not a market collapse**, whichever the sector. Furthermore, in the package travel sector, the chargeback scheme rules in case of DIF insolvency would effectively put Member States security obligations onto PSP's using the card network.

The case study in annex illustrates how insolvency risk is being “passed around” under current refunds card schemes and DIFs structures.

The consequence of inaction is that when an insolvency takes place, confusion between parties arises that could result in a **domino of insolvencies**, in some cases increasing the risk on parties such as EU PSPs who do not have a liability.

WHAT EUROPEAN POLICY MAKERS CAN DO TO HELP ADDRESS SUCH ISSUES

EU PSPs have delivered and continue to deliver significant business continuity to merchants and consumers while ensuring that payment systems continue to operate smoothly during and in the aftermath of COVID-19. Not only have they assured a flawless performance of their own critical systems in following government sanitary measures, they have also facilitated the increase of e-commerce and remote, contactless and mobile payments in the remaining points of sale.

However, these actions have exposed independent EU acquirers to undue risk where public measures have effectively shut down entire sectors of the economy, without them being able to benefit from public measures deployed for merchants, or from credit protection and other resources available to bank-owned PSPs.

When considering policy initiatives to assist companies and sectors most impacted by COVID-19, due regard should also be had to industry participants, such as independent EU PSPs, who continue to help such companies and sectors remain open for business, while at the same time managing the consequences of the worsened financial profile of a potential chargeback risk.

More specifically, the EDPIA makes the following **five recommendations**:

1. **Provide those who are safeguarding merchants from insolvency and consumers from potential losses with appropriate protections in cases of exceptional large-scale crisis, such as COVID-19**

The **management of merchant risk is part of the regular business of acquirers**. They should of course remain economically fully responsible for any improper credit assessment they have performed regarding a given merchant or for any insufficient monitoring of the daily operations or risk evolution of a particular merchant.

However, acquirers should not be expected to face alone (as it is the case today) the massive financial consequences of events of a macro-economic magnitude that affect transversally and equally all merchants in a given country or sector, irrespective of their risk profile or of the quality of the checks done by the acquirers – such as governmental measures shutting down or imposing extreme restrictions on entire sectors of the economy. Otherwise acquirers could be discouraged to service such sectors except at high costs for these merchants.

The current entirely unbalanced situation is to a large extent **the result of the lack of adaptation of the business model created 40 years ago** when schemes, issuers and acquirers were fundamentally belonging to the same entity or to the same communities, i.e. the banks. In such a set-up, all the payment card revenue streams (i.e. scheme fees, issuers’ subscription fees from cardholders, interchange fees, acquirers’ fees) were ultimately ending in the “same pocket” and were allowing to cover all the costs associated with the functioning of the cards rails, including of course the costs of potential chargebacks reimbursed by the acquirers to the cardholders.

The progressive independence of the schemes, and then the emergence of independent acquirers of size over the last decade have broken this set-up and therefore challenges the revenue streams, costs and risk exposure model of 40 years ago.

The COVID-19 crisis has laid bare this imbalance, showing that **acquirers have become the de facto guarantors to consumers in extraordinary cases of public shutdown measures in certain sectors** – since they bear the risk of merchant insolvency (as explained earlier). Addressing this imbalance will be important to Europe’s ability to not only recover (in particular in the most affected sectors like airlines, transportation, hospitality, events), but also better manage any future crisis of this magnitude.

As this potentially requires a **fundamental re-think of the current functioning of retail payments systems**, the EDPIA will further work to formulate ideas on how to remediate these shortcomings (which could also form part of the agenda of the COVID-19 payments stability group recommended below), and look at solutions that do not require public spending, and/or how such solutions may also be integrated into new potential future European Payment Schemes.

In the meantime, when considering the deployment of EU resources already announced[2], e.g. in the tourism sector, or to come[3], **account should be taken of the effect of managing exceptional levels of chargeback requests from consumers which may not being honoured by merchants on independent EU PSPs' ability to support EU merchants and consumers in most impacted sectors.**

2. Provide a common EU approach to consumer protection across EU markets in the handling of insolvency risk

Some governments are taking measures to allow the use of vouchers instead of actual reimbursement. Not only is the heterogeneous approach between member states causing a problem for EU acquirers operating across the EU, these measures also increase their credit risk for an extended time period. Consumers who paid for their travel or event with a card can expect full chargeback rights if the operator offering the voucher becomes insolvent at a later stage. As seen earlier, the financial risk to cover the chargeback in case of an insolvency is generally borne by the acquirer.

EDPIA therefore makes the following recommendations:

- If **voucher solutions** are to become the norm, such solutions need to a) be **implemented in a harmonised manner** across all member states; b) be backed by a financial guarantee or, as proposed by Commissioner Reynders, by **insurance**; and c) to **apply to all sectors operating on a forward purchasing basis**, beyond the travel sector.
- EU authorities should **review the interaction of card schemes rules and domestic legislation as it relates to** refunds, chargebacks and procedures when a package travel voyage is cancelled.
- EU authorities should develop a **common approach that clarifies the treatment of insolvency risk** in a manner that does not transfer liability solely onto EU acquirers/PSPs. Member States should ensure that the domestic package travel security providers they have statutory responsibility for remain solvent.

3. Address potential competitive distortions among PSPs arising from COVID-19

EU authorities should investigate potential distortions of the level playing field in the EU payments ecosystem resulting from COVID-19, including in the PSP space and whether independent EU PSPs may be at an economic competitive disadvantage versus other PSPs (e.g. bank owned), given the lack of access to public measures granted to banks to ensure financial stability and economic recovery.

4. Consider extension of SCA implementation deadline of 1 January 2021

EDPIA members are ready for and strongly support the implementation of SCA under PSD2 as it will strengthen the security of the payments system and consumers in particular. We understand the reluctance of the European Commission and EU consumer organisations to further delay SCA implementation; however, our experience and anecdotal evidence from speaking to our merchant customers suggest that some limited extra time for implementation would benefit the majority of merchants as well as a non-negligible portion of the consumer population.

The millions of **EU merchants** hit by COVID-19 restrictions are wholly focused on safeguarding their business. Their ability to spend resources on enhancing systems to enable SCA is temporarily severely restricted. While there are currently no available figures indicating when merchants (particularly in the travel and hospitality sector) will recover, our conversations with them indicate that many are unlikely to be SCA compliant by 1 January 2021. **Non SCA-compatible merchants will no longer be able to receive card-based payments, and thus will have to abandon the acceptance of cards as a means of payments**. This could further damage their commercial

[2] See Commissioner Breton at https://ec.europa.eu/commission/commissioners/2019-2024/breton/announcements/speech-commissioner-breton-marshall-plan-european-tourism_en)

[3] See Commission President VDL at https://ec.europa.eu/commission/presscorner/detail/en/speech_20_877) announcing the establishment of a "*new Solvency Instrument",* which *"will help match the recapitalisation needs of healthy companies who have been put at risk as a result of the lockdown – wherever they are located in Europe."*

situation given that card-based payments cannot easily be substituted by other means of payments. Economic recovery could be additionally negatively impacted as a result.

On the EU consumer side, many have started to use e-commerce for their daily needs due to lockdown measures. However, many have not, in particular the elderly and financially poor. While COVID-19 has undoubtedly increased levels of consumer digital savviness, it has also exposed digital inequalities. While our interest is for continued increased take-up of digital payments, we are concerned that bringing significant change at a time of over-dependency on online payments without the alternative for in-person interaction or advice could both be detrimental to the consumer experience and further deepen the digital skills gap.

This short extension of the migration period for SCA on remote card payments **should not put into question another strategic intent of PSD2, especially regarding Access to Account (XS2A) or Open Banking account-based payment solutions.** Indeed, the expectations on the introduction of new 'payment initiation' and 'account information services' operated by Third Party Providers have not been fulfilled yet and the necessary investments by the so-called 'account servicing payment service providers' (ASPSPs - typically banks) to comply with the regulation should not be reduced due to economic constraints caused by COVID-19.

5. Establish a COVID-19 payments stability group

EU authorities should consider establishing a COVID-19 payments stability group that addresses the above issues as well as the long-term plan to maintain Europe’s payment system capability and infrastructure for the duration of the crisis and subsequent recovery period.

EDPIA
The European Digital Payments Industry Alliance

Case study: EEA Package and Linked travel company insolvency protection actions passes undue liability to payment companies

Situation:

- With Covid-19 the **package travel industry in the EEA faces a collapse in revenue coupled with a demand for refunds for cancelled holiday packages** – the industry, not just individual companies, risks insolvency
- EU Package Travel Directive **requires EU member states to provide security** that enables EEA consumers to claim refunds from package travel companies (PTC) domiciled in their markets in the event of a company becoming insolvent, e.g. via **a Domestic Insolvency Fund (DIF)** or through insurance.
- **Instead of refunds, many PTC's in the EU-are now issuing long-term vouchers** in an effort to remain solvent and survive beyond the COVID-19 crisis - in some cases backed by domestic legislation, but the approach of the EU Member States is fragmented and may only defer the insolvency problem.

Complication:

- **Domestic implementation of the EU Package Travel Directive is heterogeneous and response to the COVID-19 crisis (re: Exhibit 1)** across member states is inconsistent, resulting in **differential**:
  - **Coverage by domestic insolvency protection depending upon payment instrument** when the law does not make this distinction – espec. card chargeback rights
  - Possibilities for PTCs in **offering a voucher as reimbursement** for cancelled package travel
  - **Consumer rights and protections** across member states
  - **Financial and operational risk to payment companies** across Member States related to the differences in implementing voucher systems and insolvency protection. **Card scheme rules are inconsistent with respect to chargebacks for insolvent PTCs and with vouchers as reimbursement** and can pass risk that should be covered under DIF requirements or by the issuing a voucher onto PSP's which creates uncertainty for PSP's in identifying risk, liabilities and managing business processes - (re: Exhibit 2)
- **Non-bank PSP's do not have the range of business activities, credit protections or access to public measures that bank based PSP's have** but often this is not recognised in the policy and regulatory process, consequently non-bank PSP's face greater financial and operational risk if unanticipated liability or policy shifts take place.

Resolution:

- European authorities **establish a common approach to addressing the risk of insolvency in the EU** to ensure a common level of consumer protection across markets
- European authorities **enact the right for PTCs to offer vouchers as reimbursement in cases of systemic crisis** to ensure a common level of consumer protection across markets
- European authorities **ensure card payment scheme rules and domestic package travel security provider rules with respect to refunds, chargebacks and procedures when a package travel company becomes insolvent do not transfer liability from the domestic package travel security provider to the Payment Service Provider**
- Member States ensure that the **domestic package travel security providers have a statutory obligation to have sufficient solvency or other financial guarantees to cover a systemic crisis**

Exhibit 1: Member state actions to avoid PTC insolvencies are heterogeneous and have not addressed potential insolvency risk being passed from travel to payments sector

Jurisdiction	feb-20	mar-20	apr-20	maj-20	jun-20	jul-20	aug-20	sep-20	okt-20	nov-20	dec-20	jan-21	feb-21	mar-21	apr-21
AUSTRIA															
BELGIUM		Mandatory vouchers for 12 months if Covid 19 driven with refund after 12 months with 6 months to pay - no specific protection period defined													
BULGARIA															
CROATIA															
CZECH REPUBLIC	Voucher for protection period - 14d refund right after period														
CYPRUS															
DENMARK	EURO 200m loan to Travel Security Fund														
ESTONIA															
FINLAND															
FRANCE		Voucher for 18 months then can ask for refund													
GERMANY		Gov't proposing refund right suspended with vouchers to end of year - want EU level solution. Travel association asking for national Covid-19 fund to support													
GREAT BRITAIN			Industry & government in discussions												
GREECE	Voucher for 18 months then can ask for refund														
HUNGARY															
ICELAND															
IRELAND															
ITALY		Mandatory vouchers for 12 months if Covid 19 driven - no specific protection period defined													
LATVIA															
LICHENSTEIN															
LITHUANIA															
LUXEMBOURG															
MALTA															
NETHERLANDS		Vouchers issued as industry practice with no legal sanction - refund rights maintained													
NORWAY															
POLAND															
PORTUGAL	Voucher for bookings to 30 Sept 2021 - voucher active to 31-12-21 then can refund														
SLOVAKIA			Voucher legislation in discussion												
SLOVENIA															
SPAIN			Voucher for 12 months if related to Covid-19												
SWEDEN															
SWITZERLAND															

Source: Bird & Bird Update; ABTA website summarising interventions in EU

- Member states **policies for PTC's are changing daily** and vouchers effectively a deferral mechanism
- Differential policies could result in **differential consumer rights and PSP liabilities between member states - this means the insolvency risk for PSP's is partially dependent upon their country of domicile**
- **Note**: diagram from May 2020 and current situation may differ in detail, but uncertainty remains

EDPIA
The European Digital Payments Industry Alliance

Exhibit 2: Individual DIF’s and card scheme rules are resulting in shift of liability to acquirer via dispute process to fund consumer refunds for Covid 19 impact