John Chaplin – individual submission

1. Payment scheme fees

Policy alternatives

A dilemma for payments regulators around the world is whether and how to regulate scheme fees charged to participants in payment schemes.

The argument for not regulating scheme fees is that they are complex (in some cases deliberately so), change frequently because of changes in the market and are service fees charged by schemes to organisations that have voluntarily elected to join such schemes. Therefore, few of the competition concerns that surround interchange determination appear to apply and regulators avoid becoming embroiled in oversight of an extremely complex area.

The argument for regulation of scheme fees is that they are increasing globally, especially on acquirers, and now form an increasingly significant, non-negotiable element of transaction costs which are baked into merchant service fees. The level of these fees and the lack of transparency in how they are established is causing many regulators to reconsider their historical stance of no oversight especially given that an approach of increasing overall fee levels but then applying selective rebates to favoured participants creates a significant opportunity to distort a level playing field objective.

There is a 'third way' of regulators requiring transparency and applying some aggregate level controls which it is argued ensures that market participants fully understand the scheme fee structures and can therefore make better informed decisions, provides some assurance against market distortions and avoids the perceived regulatory trap of becoming over-involved in the detail of a complex industry. This approach, which has been adopted by European regulators, leaves the door open to more comprehensive regulation in the future.

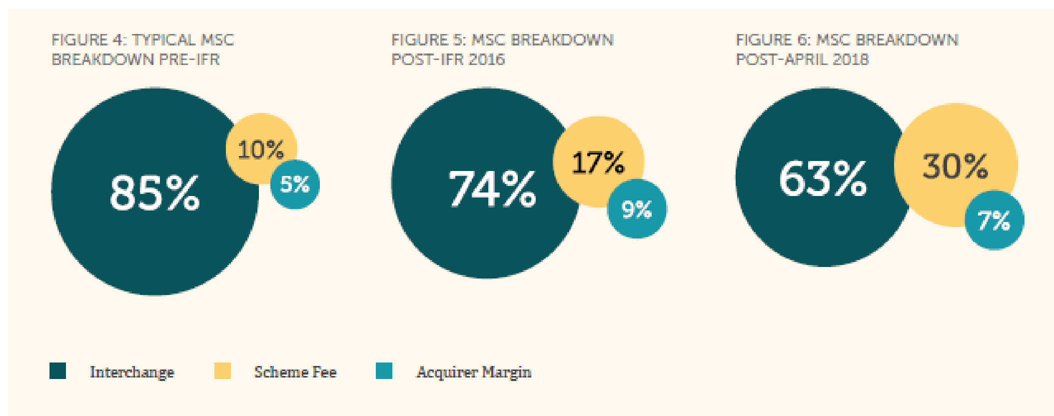
Changes in the market

There is considerable evidence from major markets, notably Europe and USA, that major payment schemes are significantly increasing scheme fees exploiting their unregulated nature. Studies in EU, by organisations such as CSMPI, show annual increases of approximately 30% per annum in fees levied on acquirers, in a market where economies of scale should lead to a recurring decrease.

From USA, there are signs of new forms of schemes charging such as a fee per outlet which have the potential to significantly increase acceptance costs in the medium term.

The data from Europe suggests that scheme fees now account for 30% of merchant service fees and assuming that there are some further increases, it is realistic that scheme fees will account for the same proportion of merchant service fees as

interchange does. At this level, there should be an even higher level of regulatory concern.



Source: CMSPI

The European Commission requires disclosure of scheme fees to merchants that are on interchange++ pricing. In Europe, traditional bank acquirers argued heavily against such transparency whereas newer non-bank acquirers such as Adyen were and are strongly supportive.

However, an opt-out was allowed *"unless payees request the acquirer, in writing, to charge blended merchant service charges"* which in practice allows for widespread circumvention of the rule, especially for smaller merchants.

Recommendations

1. In view of the policy objectives of lower cost payments and open competition, it seems clear that at a minimum, scheme fees should be the subject of ongoing regulatory oversight and visible to those that eventually pay them (i.e. merchants). There is no reason why payment schemes that possess market power should not be transparent about their scheme fees; if a result of greater openness is that complex scheme fees are simplified, that would also be a benefit to the industry. As a key policy objective is to lower the cost of electronic payments, all merchants should be aware of the difference in acceptance costs between low cost scheme and high cost schemes. Global research indicates that the difference between the scheme fees of low and high operators is often in excess of 100%
2. However, I would argue that some level of aggregate control should be applied because the European experience has already shown that transparency requirements are not sufficient to prevent abuse by a scheme of a dominant position. Therefore, the RBA should consider aggregate level control options such as capping the level of aggregate fees as a percentage of total mandated acquirer payments (i.e. interchange + scheme fees) at a level that was historically considered to be reasonable before the recent surge in scheme fees. Using the data from Europe, a scheme fee cap of 20%

would be justified and in fact would be substantially more generous than long-term data suggests is necessary for the viability of a payment scheme.

2. Real-time payments – providers and governance

A number of countries, including Australia, have invested in a real-time payments infrastructure which is in effect a "fast ACH". The country that has made the greatest progress in volume terms with real-time account to account transactions is Nigeria where currently >40% of low value electronic payments are made through a national system operated by NIBSS. And in other geographies, including Europe, South Africa and USA there is great interest with hopes that the real-time payments infrastructure can encourage a wave of payments innovation and build viable alternatives to (foreign owned) card-based systems.

I believe that this optimistic view is unrealistic for 4 principal reasons:

- real-time account to account payment is a processing model and not a system. There is no reason why card-based systems cannot operate in real-time mode. The messaging is already normally real-time so adding a real-time settlement capability is not a major problem. If more organisations develop real-time capabilities in a country such as Australia, that should be seen as a benefit to the economy.
- real-time account to account payments can introduce problems as well as deliver benefits so they are not a panacea. The UK has already experienced a rising level of fraud arising from situations where "the money has already gone". It is clear that there will have to be an increased level of fraud checking (which will mean some slowing down of transactions and incremental cost) and consumer redress rights introduced. It is to be noted that the expertise for controlling fraud and allowing consumer redress tends to reside in card organisations and not ACH's.
- the concept of a neutral infrastructure on which a variety of schemes and services can be built by market actors will inevitably be very stretched by the market reality. There is evidence from Europe and Africa that the infrastructure gets drawn further and further into commercial activities – this can be in the area of fraud prevention but also into app and service development. However, the scope of the neutral infrastructure is initially defined, it will be impossible to prevent the organisation from becoming more commercially involved in the market and therefore competing with existing providers instead of remaining as a technical layer only.
- the governance model for a real-time payment infrastructure is critical. It seems extremely unwise for a central bank that is a regulator to have any role in the ownership or governance of such an infrastructure. It is highly likely that competitive real-time infrastructures will be developed (this has already happened in Nigeria where a private company has built a service to compete

with the NIBSS service), so the regulator must avoid any moral hazard of being involved with the governance of a real-time payments operator.

Recommendations

In order to preserve the reputation as an independent regulator my recommendations are:

1. RBA should have no future involvement in NPP governance
2. RBA should be supportive of other initiatives that provide real-time payment capability.

3. **Interchange levels**

There is a clear disparity between the relativity of debit and credit card interchange rates in the Australian market when compared to major markets such as Europe where interchange has also been the subject of rigorous regulatory scrutiny.

In Europe, 4-party consumer credit card programmes are evaluated as justifying an interchange premium of 10bps compared to consumer debit card programmes. The EU justified their rate structure by reference to the "merchant indifference test". There has been considerable academic debate about the theoretical underpinnings of the merchant indifference approach but less argument that the additional issuer costs of credit card programmes that should be borne by merchants must not exceed 10bps.

There have been some consequences of the credit card interchange reduction in Europe:

- Some consumer benefits programmes attached to credit cards (especially cash back) have been withdrawn because issuers have found that in the absence of merchants being forced to fund such benefits, the benefits are unsustainable given that consumers are generally unwilling to pay higher fees.
- Some consumer benefits programmes such as British Airways Amex have continued to flourish because consumers are willing to pay high fees of approximately £200/annum.
- There has been an uptick in merchant loyalty programmes where the merchants that benefit directly from the programmes pay directly for their costs thus avoiding the forced cross-subsidisation resulting from issuer loyalty programmes.
- There has been a growth of fintechs such as Klarna/Sofort that provide alternative and lower cost credit than that of traditional credit cards.

The European regulator has also introduced regulations to cap the interchange on transactions generated by non-European cards in European merchants. The reason for this regulation was that international interchange, which is totally unregulated by any national authority, has been raised to egregious levels for some card products, especially

those originating from USA issuers. The European regulator considered two options which it discussed with market participants:

1. Prohibiting a scheme requirement that merchants must take all cards from all geographies (i.e. giving the merchants the right to reject expensive payment products)
2. Capping interchange for transactions from non-European cardholders at the same level as transactions from European cardholders.

The market participants reached a voluntary agreement with the EU to adopt the second option. A number of other markets, especially those with high proportions of incoming international transactions, are now believed to be considering similar approaches.

Recommendations

1. The RBA should seek to narrow the differential between debit and credit card interchange rates potentially by adopting some of the European regulatory model. To have a credit card interchange of a maximum of 0.4% would represent a move in the right direction.
2. The RBA should invite international payment schemes to cap interchange on transactions by non-Australians at Australian merchants at the same level as domestic transactions. If agreement cannot be reached voluntarily, regulatory enforcement should be implemented.

4. **Dual network cards**

The market experience of Australia in relation to the introduction of contactless and mobile technology to dual network debit cards is markedly different from the experience of other markets. I believe that the RBA should question why this difference has arisen and whether it is likely to impact achievement of the payments policy objectives for the country.

As a general principle, consumers are indifferent as to which of the applications on a dual network card are used to effect a transaction given that the payment is made from the same account and to the same merchant. And merchants generally prefer the payment application that provides the best commercial terms (generally taken as the lowest cost given that settlement times are now relatively uniform).

In Europe, there has been little market share shift between international and national card schemes during the introduction of contactless and mobile technology. The regulatory framework which has been a significant factor in this stability comprises:

- No payment scheme or payment service provider (principally banks) is allowed to mandate the use of their application

- Merchants should be able to select the payment application but, in some circumstances, the consumer should be given the opportunity to over-ride the merchant selection
- Equality of interchange between all payment schemes

Therefore, a form of least cost routing is in operation with the merchants tending to favour the domestic schemes that have lower scheme fees for acquirers. There is a flaw in the European regulatory framework in that the desired controls on payment schemes incentives to issuers and acquirers which are seen as an unwelcome market distortion can be circumvented by payment schemes paying incentives directly to merchants to influence application selection. The regulations only imagined incentives being paid by payment schemes to their members, so this practice is within the letter of the law but contrary to the intent.

There are two scenarios where acquirers or issuers take actions which have the effect of denying merchants access to lower cost payment applications.

1. There is an obvious apparent difference between the European and Australian situations with Australian bank-owned acquirers seemingly opting to protect their issuing profitability but not supporting new technology such as contactless. This could be due to differential interchange or to satisfy scheme incentive contractual requirements. Whatever the reason, it is clearly undesirable from a payments policy perspective that merchants should be prevented from having access to the lower cost payment applications. There are alternative regulatory approaches to address this issue (see below)
2. A second aspect to consider is whether regulators should be concerned if issuers of dual network cards elect to remove the application with the lowest cost to merchants in order to maximise their issuing profitability. In markets such as Saudi Arabia, the central bank mandates the placement of the local, low-cost debit application on all cards and requires its usage for domestic transactions. In USA, the Federal Reserve Board requires that all debit cards offer two unaffiliated debit networks (i.e. schemes) so that the merchant can select the lowest cost routing if they so wish. Clearly the practice of some issuers in Australia of converting dual network debit cards to single network cards, which has to be seen as a move to increase their profitability at the expense of merchants, would not be permissible in markets such as USA or Saudi Arabia.

Recommendations

To address the issue of acquirers not supporting standard technology solutions, there are two approaches that the RBA could consider:

1. Make provision of support by acquirers for all major card brands a requirement and have an appropriate enforcement mechanism
2. Require payment service providers with both issuing and acquiring business to separate them in terms of governance, management and finance so that each unit acts independently and without the current mixing of agendas.

To address the issuance of single network debit cards and on the assumption that a Saudi Arabia model would be a step too far for the Australian market, RBA should consider the development of a rule with a similar purpose to the USA Federal Reserve Rule.

5. **Barriers to innovation and competition**

It a reasonable assumption from the behaviour of other payments markets around the world that it is the co-existence of a number of competitors in scheme and infrastructure that makes a market competitive, and with an incentive to innovate. Too many small competitors tend to lead to insufficient innovation because low volumes leave most players with profitability concerns. In general, the need to have economies of scale drives consolidation through market forces and the problem of fragmentation is avoided. Too few competitors tend to lead to oligopolistic behaviour which also restricts innovation and often higher prices. Therefore, behaviour or commercial practices that lead to oligopolies need to be controlled through regulation.

Formal exclusivity deals for card issuers are against most national competition policies and therefore are rare. However, similar results can be achieved by various forms of de facto exclusivity, such as card scheme x and issuers agreeing minimum volumes that can only be achieved if the overwhelming majority of issued cards carry the brand of scheme x; such deals are normally accompanied by significant incentives linked to meeting the targets. In this situation, it is irrelevant how much another scheme innovates or introduces better pricing because there is no volume available for them to win. The problems are compounded if the minimum volume contracts are for a lengthy period. In some regions, payment schemes are signing such contracts with a 10-year duration. Given that the time in post of most senior executives and board directors is now usually less than 5 years, this is clearly a case of the market being locked up long-term for shorter term gain.

The practice of technical lockout through mandatory use of a specified captive provider for processing a scheme's transactions also has the effect of reducing competition. The European Commission partly addressed the question of switches and processors from being locked out of competing for a scheme's volume by enforcing a degree of separation between a payment scheme and its captive processor. This regulation which enforced such measures as separation of management also prohibited bundling of scheme and interbank processing. However, the regulation has only achieved partial success as evidenced by:

- The market reality that domestic schemes in Europe have fully complied with the regulation whereas international schemes have not, thus distorting the competitive market
- The regulation which was first drafted in 2012 envisaged the market split into two sectors – scheme and interbank processing. However, new services notably tokenisation have been developed which are classified as "scheme value added services"; these services are mandated by the scheme despite being widely considered to be processing.

Recommendations

1. RBA should consider introducing a regulation that prohibits a card issuer agreeing to volume commitments with any scheme that account for >40% of total cards in issue (accounts with card number rather than physical cards). Over time, it may become necessary to adopt a similar approach for account to account payments if a competitive market develops but the initial focus should be on cards.
2. RBA should consult with the industry on areas of potential technical lockout and if there is an adverse impact on innovation and/or competition, regulate to eliminate the practice.

6. Regulatory powers needed

Given the pace of change in payments, the increasing technical complexity and the potential long-term gains in market position from short-term anti-competitive practices, it seems clear that the success of regulators such as RBA will be determined by three factors:

- Greater and more immediate access to the operating rules and practices of all significant payment schemes which may currently be configured as "private clubs" but are in fact quasi utilities
- A willingness to take corrective action at an early stage of market distorting behaviour before such practices become engrained and requiring more significant corrective action.
- An effective enforcement regime which sends a clear message to market participants that compliance with both the spirit and letter of regulation is the appropriate behaviour

Recommendations

In my view, RBA should:

1. Require all major scheme regulations and fees to be made available on an ongoing basis
2. Conduct an annual review of regulations and fees to assess the impact on the market of any significant changes and take action where necessary
3. Establish a programme of enforcement measures including but not limited to financial penalties

John Chaplin, London January 2020