Regulatory Developments in Retail Payments

Surcharging

Since the Reserve Bank removed the 'no surcharge' rules imposed by the card schemes as part of its payments system reforms starting in 2003, merchants have been able to pass on the cost of credit and debit card acceptance to consumers. The removal of the rules was aimed at improving efficiency and competition in the payments system. In particular, the reforms have better aligned price signals to cardholders about the cost of card acceptance, reduced the cross-subsidisation of card users by all other customers, and increased merchants' ability to use surcharging as a tool in negotiations over merchant service fees.

As discussed in the 2012 Payments System Board Annual Report, the Board decided, after extensive consultation, to change the surcharging Standards to allow the card schemes to limit surcharges to the 'reasonable cost of acceptance'. The decision to vary the Standards reflects the Board's concerns about the increase in cases where surcharges appear to be well in excess of acceptance costs or where surcharges are 'blended' across card schemes or products, even though merchants' acceptance costs may be considerably higher for some cards than others. These practices have the potential to reduce the effectiveness of the Bank's previous surcharging reforms. The Bank intends that its variation will improve price signals by enabling card schemes to address cases where merchants are clearly surcharging at a higher level than is justified for acceptance of their card products, while at the same time continuing to ensure that merchants can fully recover their card acceptance costs.

At the suggestion of a number of parties during the initial consultation process, the Bank held two further rounds of consultation on a guidance note to provide clarification on its view of 'the reasonable cost of acceptance'. The final version of the Guidance Note was published in November 2012.[11] It makes clear that it is the Bank's expectation that merchant service fees and other costs payable to acquirers will typically represent the bulk of the reasonable cost of card acceptance for merchants, and that merchants surcharging only for these costs should not be required to provide any additional verification of their costs. The Guidance Note also states that in a limited number of cases, surcharges may appropriately include other costs, and there is nothing in the Standards which prevents a scheme from seeking verification of these costs. Reflecting the revisions to the Guidance Note and the longer-than-expected period of consultation after the Standards were varied, the Board decided in November to delay the commencement date of the varied Standards from 1 January 2013 to 18 March 2013.

Since the varied Standards took effect, the four-party schemes (MasterCard and Visa) have changed their scheme rules to limit Australian merchants' surcharges on their products to the 'reasonable costs of acceptance'. The three-party schemes (American Express and Diners Club), which have provided updated

11 The Guidance Note is available at <http://www.rba.gov.au/payments-system/reforms/cards/201211-var-surcharging-stnds-guidance/guidance-note.html>.

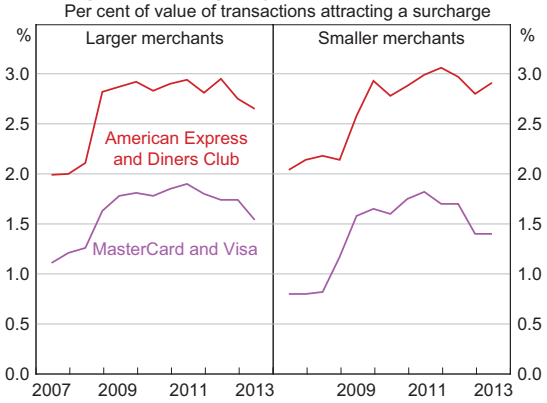
undertakings to the Bank in relation to the varied Standards, have likewise changed their terms and conditions to limit surcharges.

Given the relatively short period since these changes took effect, discussions on surcharge levels are still underway between the schemes and acquirers, and between acquirers and merchants. A major airline has lowered some of the surcharges that apply to its booking process. In addition, there is tentative evidence that the average surcharge level applied to transactions attracting a surcharge has declined from the previous year. Drawing on data from East & Partners' semiannual survey of the merchant acquiring market and the Bank's estimates of each scheme's market share, the average surcharge applied across all card types is 1.70 per cent of transaction value, compared with 2.00 per cent in June 2012. The decline occurred for both larger and smaller merchants, and across three-party and four-party schemes (Graph 13). At the same time, the proportion of merchants that surcharge credit card transactions has continued to rise, with 39 per cent of merchants surveyed applying a surcharge on at least one of the credit cards they accepted. Surcharging continues to be more common among 'very large' merchants (in the survey, those whose annual turnover exceeds $530 million). Surcharges tend to be lower for MasterCard and Visa than in the higher-cost American Express and Diners Club systems.

Graph 13

Average Surcharge by Merchant and Scheme

Per cent of value of transactions attracting a surcharge



Sources: East & Partners' Australian Merchant Acquiring & Cards Market Program; RBA

eftpos Regulatory Framework

Following the Board's announcement in 2011 that it would undertake a review of the regulatory framework for the eftpos system and its decision in May 2012 to put in place a new designation for the eftpos system, the Bank began the second phase of the review in June 2012.[12] Much of the regulatory framework for the eftpos system was put in place when interchange fees and connection agreements in the eftpos system were bilaterally agreed. The regulatory framework therefore did not anticipate the establishment in 2009 of the new management structure for the system under eftpos Payments Australia Limited (ePAL) and its decision to introduce a multilateral interchange fee schedule for the system from 2011. It also predated the establishment of the Community of Interest Network (or COIN), which simplified connections between participants in the system.

The review was aimed at ensuring that the regulatory framework for the eftpos system continues to support competition and efficiency in the payments system as a whole, in light of the significant changes to the governance and architecture of the system. In particular, the consultation paper released in June 2012 sought views on the regulatory options for interchange fees in and access to the eftpos system.

In line with the views expressed during consultation, the Board decided at its November 2012 meeting to move the regulation of bilaterally negotiated eftpos interchange fees to a basis that is consistent with other

12 For more detail on the designation, see RBA (2012), *Review of the Regulatory Framework for the EFTPOS System: Consultation on Options for Reform*, June, available at <http://www.rba.gov.au/publications/consultations/201206-rev-reg-frmwrk-eftpos-sys/index.html>.

eftpos interchange fees and those of the international debit schemes.[13] The regulatory changes in respect of the eftpos system are intended to enhance competition between eftpos and the international debit schemes by placing them on a more consistent regulatory footing. Under current benchmarks, the change means that bilateral interchange fees can now be up to 12 cents paid to the issuer (and any amount paid to the acquirer), compared with the previous requirement for bilateral interchange fees to be between 4 and 5 cents paid to the acquirer. The change took effect on 1 July 2013 through a new standard on eftpos interchange fees.[14]

The Board also made an in-principle decision to revoke the existing *Access Regime for the EFTPOS System*, subject to satisfactory access arrangements being put in place by ePAL. The Access Regime, which was aimed at addressing issues arising from the bilateral nature of the system, contains 'no-discrimination' provisions relating to the bilateral negotiation of interchange fees and a cap on charges that can be levied on a new entrant for the establishment of a connection to an existing eftpos participant. The Board concluded that these provisions are no longer necessary given that new entrants can access the multilateral interchange fees set by ePAL. The Board is also prepared to remove the connection charge cap when it is satisfied that ePAL has suitable access arrangements in place. This has not occurred to date; the Bank continues to liaise with ePAL over potential rule changes and other developments that may have a bearing on access.

Review of Card System Access Regimes

In May 2013, the Reserve Bank released a consultation paper reviewing the access regimes applying to the MasterCard credit, Visa credit and Visa Debit systems. The access regimes were originally introduced by the Bank in the mid 2000s to expand access for prospective issuer and acquirer participants in the card schemes in Australia, to address concerns that the schemes' restrictions on entry had not struck the right balance between competition in the payments system and the financial safety of the schemes. Prior to the reforms, scheme rules stipulated that only card issuers that were prudentially supervised or organised under local banking legislation were eligible to participate. In Australia, this meant that card issuers and acquirers had to be authorised deposit-taking institutions (ADIs) supervised by the Australian Prudential Regulation Authority (APRA). Card acquirers were also required to be issuers to be eligible, and penalties were imposed on institutions that were significant net acquirers. At the same time, it was considered that there are good reasons why card issuers should be required to be of sound financial standing.

To address these concerns, the Bank worked closely with APRA to formulate a new class of ADIs – specialist credit card institutions (SCCIs) – to allow entities that are not deposit-takers to undertake issuing or acquiring activities in the MasterCard and Visa card systems while being subject to prudential supervision. The Bank subsequently imposed access regimes on the card schemes, requiring that any ADI, including SCCIs, be eligible to apply to participate in the schemes without discrimination. The reforms have therefore allowed new entrants that would otherwise have been ineligible for scheme membership to participate in the card schemes without compromising the financial safety of the schemes. They have also facilitated the participation of institutions that specialise only in card issuing or acquiring.

However, recent developments suggest that the access regimes in their current form may no longer be fulfilling their original objective, and may indeed be preventing some prospective scheme participants to entry. The Bank is aware of a number of entities, particularly foreign corporations focusing on non-traditional products, with an interest in undertaking credit card issuing or acquiring activities (and not other banking business) in

13 See RBA (2012), *The Regulatory Framework for the EFTPOS System: Final Reforms and Regulation Impact Statement*, November, available at <http://www.rba.gov.au/payments-system/reforms/debit-card-systems/201211-reg-frmwrk-eftpos-sys/index.html>.

14 The Standard, *Interchange Fees in the EFTPOS System*, is available at <http://www.rba.gov.au/payments-system/legal-framework/standards/interchg-fees-in-the-eftpos-system-29112012.pdf>.

Australia. These prospective participants may be discouraged from entry because the access regimes impose a regulatory burden – prudential supervision by APRA – that may be more onerous than necessary given the nature of their operations. To an extent, the current regulatory framework also transfers the cost of screening the soundness of current and prospective members of the card schemes to APRA.

Additionally, the access regimes' requirement that participants must be ADIs means that the Reserve Bank, in its capacity as a provider of banking services to various government departments, is not eligible to apply to become a participant in the MasterCard and Visa systems; the Bank is able to undertake banking business but is not an ADI. The Bank is nonetheless eligible to become a participant in the eftpos scheme. It is appropriate for the Board to consider whether it is in the public interest for regulatory arrangements to allow the Bank to participate in one scheme, but not other competing systems.

In light of these issues, the Bank outlined three policy options in its May 2013 consultation paper, *Review of Card System Access Regimes*: to vary the access regimes to widen the eligibility for participation; to revoke the access regimes; or to maintain the status quo. Submissions closed in July 2013.

ATM Access Regime

As reported in the 2012 Payments System Board Annual Report, the Bank began a consultation on varying the Access Regime for the ATM System in May 2012. The catalyst for the consultation was the ATM industry's response to a joint Treasury/Reserve Bank ATM Taskforce report on Indigenous ATM issues. The report found that residents in very remote Indigenous communities are generally more reliant on ATMs than other Australians because of a lack of alternatives to withdraw cash or make balance enquiries. These residents are also more likely to have no alternative to paying a direct charge for ATM transactions because their communities typically only have access to an independently owned ATM, resulting in high expenditure on ATM fees by these communities. In light of these findings, the Taskforce and the Australian Government facilitated negotiations among ATM industry participants which resulted in an arrangement to help reduce the sizeable expenditure on ATM fees in the communities.

Related to this work, the Bank consulted on varying the ATM Access Regime to provide greater flexibility to grant exemptions from the prohibition of certain interchange fee arrangements in the ATM system. The Board decided at its August 2012 meeting to vary the Access Regime to extend the Bank's exemption power. At the same meeting, the Board decided to use its expanded powers to grant an exemption to the industry's arrangement for very remote Indigenous communities.[15]

Dual-network Debit Cards

A longstanding practice in Australia is the issue by banks and other financial institutions of cards for ATM use and with debit functionality from more than one payment network. The Board has previously indicated it supports the issue of such cards in Australia, because they are convenient for cardholders and allow stronger competition between networks at the point of sale, facilitating both consumer and merchant choice. In August 2012, the Board considered a range of issues relating to these cards, including scheme rules that require the provision of commercially sensitive data about one network to a competitor network; the imposition of fees by one network on another network's transactions; and disputes over the placement of network brands on cards. The Board also noted issues that had arisen between networks in the context of contactless debit cards,

15 More detail on the variation can be found in RBA (2012), *A Variation to the Access Regime for the ATM System: Conclusions,* August, available at <http://www.rba.gov.au/payments-system/reforms/atm/var-access-regime/index.html>. The exemption is available at <http://www.rba.gov.au/payments-system/reforms/atm/rem-indigenous-com-290812.pdf>.

which had the potential, in the Board's view, to inhibit competition, limit choice to consumers and increase costs. The Board noted that authorities in other jurisdictions had taken measures to address similar issues, and authorised a consultation on the case for regulatory action. However, rather than proceed immediately to a consultation, the Board encouraged the parties involved to see if voluntary agreements could be reached that were acceptable to all parties and also in the public interest.

At its August 2013 meeting the Board was briefed on discussions between the networks and the Bank in which the three networks had agreed to address the Board's concerns. The outcome will safeguard the rights of Australian card-issuing banks and institutions to maintain existing dual-network arrangements in the contactless environment. Where an issuer wishes to include applications from two networks on the same card and chip, the networks have agreed to work constructively with issuers to allow this. The networks have also agreed not to take steps preventing merchants from exercising choice in the networks they accept, in both the contact and contactless environments. In addition, to the extent that merchants are able to and wish to exercise their own priorities with respect to two contactless debit applications on one card, the networks will not prevent this choice. The Board considers that this agreement on 'rules of the game' is a positive development and, as a consequence, a consultation on a possible regulatory intervention appears to be unnecessary at present. The Board has asked the Bank to maintain liaison with the industry on dual-network card issues and to monitor market developments and technological changes in the industry. While market forces are likely to lead to competition for the payment flows of very large merchants, the Board will be particularly interested in seeing that there is also downward pressure on payments costs faced by smaller merchants.

Operational Incidents in Retail Payments Systems

Given the growing importance of retail payments and the potential system-wide implications of any incident, the Bank has been considering how best to strengthen its oversight of significant disruptions and contribute to the ongoing integrity of retail payment systems. In addressing the resilience of retail payment systems, the Bank is conscious of the need to coordinate with APRA and APCA so as to avoid duplication.

To inform its consideration of this issue, the Bank informally consulted with industry participants in 2012 on issues including sources of vulnerability; existing controls; safeguards and contingencies; change management; and plans for upgrade and enhancement of supporting technology. In general, the Bank observed an encouraging level of industry attention on operational resilience, with a number of payments system participants citing commercial pressures as a driver of increased investment in payments infrastructure. Moreover, payments operations are increasingly perceived as a strategic priority within financial institutions.

As a result of the informal consultation, in November 2012 the Board published its findings, in which it concluded that at present there is no need for a regulatory response.[16] In the Board's view, senior management of individual institutions are primarily responsible for improving the operational resilience of their organisations. Accordingly, the Bank plans, at least for the time being, to limit its role to monitoring retail operational incidents and working with industry on initiatives around the disclosure of data on incidents.

Consistent with this, the Bank has implemented an incident reporting protocol, and is in the process of implementing a framework for routine statistical reporting on retail payments incidents. It has also collected additional information on the system architecture supporting retail payments activities. The data collected under the reporting framework will be used to identify trends and, as appropriate, follow up with any payments system participant that was persistently underperforming. The data could also form the basis for industry

16 RBA (2013), *Operational Incidents in Retail Payments Systems: Conclusions*, November. Available at <http://www.rba.gov.au/payments-system/resources/publications/payments-au/201211-operational-incidents-in-retail-payments-systems-conclusions/index.html>.

initiatives to disclose aggregate data on operational incidents to facilitate performance benchmarking by payments system participants.

International Developments

International regulators have continued with work on a variety of regulatory reforms aimed at improving competition, enhancing governance and restricting excessive surcharging. There remains a considerable focus internationally on the level of interchange fees in card payment systems.

United Kingdom

In March 2013, the UK Government began consulting on the establishment of a new payments system regulator. The Government argued that self-regulation was no longer sufficient to promote the best interests of all stakeholders in the payments system given recent experiences in banking industry self-regulation and the conflicts created by the concentrated ownership of payment systems by their member banks. This followed an initial consultation in July 2012, which outlined options for changes to the way in which payments system strategy is set.

The regulator would be responsible for:

- implementing a licensing regime for payment systems
- promoting access to and competition in the payments system
- ensuring any payments system decisions take into account the views of all stakeholders, including end users.

The Government has also raised the possibility of the regulator having powers to seek divestment by banks of their ownership of payment systems, if deemed necessary. The Government is consulting on whether the Financial Conduct Authority or one of the existing economic regulators (e.g. the Office of Communications, or Ofcom) should be the regulatory authority.

Under the proposal, the Government does not envisage a formal role for the UK Payments Council in the new regulatory structure. The strategy-setting role the Council currently plays would instead be performed by the individual payment schemes, with approval given by the regulator. It is up to the industry to decide if the Payments Council will continue to perform its industry coordination and representation functions.

Separately, ban on excess surcharging came into effect in April. This follows the consultation initiated in September 2012 and the subsequent passage of the *Consumer Rights (Payment Surcharges) Regulations 2012*. The legislation prohibits merchants from levying 'fees that exceed the cost borne by the trader' for the use of a payment method. Similar to the approach taken here by the Board, the UK Government released, in March, non-legally binding guidance to merchants on the costs that could be passed on to consumers.

Europe

In July 2012, the European Commission (EC) expressed concerns about potential violations of antitrust legislation of Visa Europe's consumer credit card multilateral interchange fees, foreshadowing a formal investigation to follow. The multilateral interchange fees, which ranged from 0.50 to 0.70 per cent, applied to cross-border Visa credit card transactions where the issuer and acquirer are both in the European Economic Area (EEA), and to the domestic Visa credit card transactions of eight European Union (EU) member states. Visa Europe responded in May 2013 by agreeing to cap its credit card multilateral interchange fees at 0.30 per cent

of transaction value and make its cross-border scheme rules more competitive. The EC has put the offer to a market test by inviting public comments on Visa Europe's offer. This development follows a May 2012 decision of the EU General Court to uphold the 2007 EC ruling requiring MasterCard to roughly halve its cross-border multilateral interchange fees for debit and credit card transactions to 0.20 per cent and 0.30 per cent of the transaction value, respectively.

In other developments, the EC announced in April 2013 that it was conducting an investigation into MasterCard, focusing on three aspects:

- international interchange fees that are paid by acquirers in the EEA to issuers outside the EEA
- scheme rules related to cross-border acquiring which restrict the ability of merchants to obtain acquiring services from banks located in another country within the EU
- other scheme rules or business practices that may be anti-competitive in nature (e.g. the 'honour all cards' rule, which obliges merchants to accept all types of MasterCard cards).

Subsequent to the end of the financial year, the EC released two very wideranging regulatory proposals. The first is to regulate interchange fees and business rules for card payments (including honour all cards and no-steering rules, unblending of merchant service fees, multi-network cards and separating scheme and processing entities). The second proposal is for the Payment Services Directive to be updated to help further develop an EU-wide market for electronic payments through harmonisation of payment services and regulations.

United States

In July 2012, a settlement agreement was proposed in a lawsuit between MasterCard, Visa, a number of card-issuing banks and US merchants. The lawsuit concerns alleged collusion in setting of credit card interchange fees by the credit card schemes and card-issuing banks. The key conditions of the settlement are:

- a modification to MasterCard and Visa scheme rules to allow 'brand level' and 'product level' surcharging for credit cards up to a predetermined cap, and to allow merchants to form 'buying groups' for the purpose of negotiations – the scheme rules were amended in January 2013
- a US$6 billion payment from MasterCard, Visa and the card-issuing banks to the merchants that agree to the settlement
- further payments totalling an estimated US$1.2 billion to merchants agreeing to the settlement; these payments are intended to represent a 10 basis point reduction in interchange fees for MasterCard and Visa credit card transactions at the relevant merchants for eight months, and will be funded by the schemes withholding part of the interchange income of all issuers.

Following the 28 May 2013 deadline for opting out of and objecting to the settlement, a number of related lawsuits have been filed by merchants objecting to the settlement condition that merchants involved in the suit will be unable to litigate in future to contest MasterCard's and Visa's credit card interchange fee setting or other merchant rules. MasterCard and Visa, on the other hand, have filed retaliatory complaints seeking that the interchange fees be declared legal and competitive, in an attempt to limit the scope for future lawsuits.

A fairness hearing was scheduled for 12 September 2013, where the judge was expected to announce whether the settlement has been agreed to by merchants representing at least 75 per cent of the value of all MasterCard and Visa credit card transactions. After taking into consideration the objection filings from merchants, a ruling on whether the settlement offer has been granted approval by the court was also expected.

Other international

In the second half of 2012, China and India both introduced new regulatory regimes relating to payment card fees. In June 2012, the Reserve Bank of India issued a directive requiring merchant service fees on debit cards to be capped at 0.75 per cent of the transaction value for transactions up to 2 000 rupees (around A$34) and 1 per cent for transactions above 2 000 rupees, effective in September. In November, China's State Council put in place a new interchange fee regime for UnionPay cards for domestic transactions.[17] Effective February 2013, interchange fees on UnionPay debit and credit card transactions in China – which previously ranged from 0.35 per cent to 1.40 per cent – fell to 0.26 per cent for transactions at merchants in the essential goods category, 0.55 per cent for the general merchandise category, and 0.90 per cent for the dining and entertainment category.

In July 2012, the World Trade Organization ruled that certain requirements imposed on payment service providers operating in China discriminated against foreign electronic payment providers by allowing UnionPay to monopolise the clearing of certain types of renminbi-denominated card-based transactions. In June 2013 the Chinese central bank ruled that no domestic payment institution would be allowed to cooperate with foreign card companies in renminbi-denominated cross-border transactions.

17 UnionPay is the dominant national card scheme in China and was established by the People's Bank of China and the State Council in 2002.