

Retail Payments Policy and Developments

The Reserve Bank implements retail payments policy and undertakes research under its remit to maintain a safe, competitive and efficient payments system. Recent policy work has included the completion of a major review of the regulatory framework for card payments.

Review of Card Payments Regulation

Over the past year and a half, the Board oversaw the Bank's conduct of the Review of Card Payments Regulation (the review), which culminated in the release of a conclusions paper and a set of revised standards in May 2016. The review was a comprehensive examination of the regulatory framework, guided by the Board's mandate to promote competition and efficiency in the payments system.

Background to the review

In the early 2000s, the Board implemented a series of reforms to card systems aimed at improving competition and efficiency in the payments system. The reforms included measures that changed the relative prices cardholders faced when using debit and credit cards, reducing the incentives to use higher-cost payment methods. The reforms also required changes to certain restrictive rules in card systems. This included allowing merchants to apply surcharges on card transactions so that cardholders were more likely to face prices that reflected the cost of the card they were using. The Board also took steps that reduced the

barriers to entry for entities wishing to issue cards or provide card payment services to merchants.

In 2007–08, the Board conducted its first review of its reforms. The review concluded that the reforms had improved access, increased transparency and had led to more appropriate price signals to consumers. The review also explored a number of options for possible changes to the regulatory framework, including stepping back from formal regulation and relying on industry undertakings. However, the industry was unable to arrive at suitable undertakings, so, in August 2009, the Board decided against stepping back from interchange regulation but noted that the regulatory framework would remain under review.

The recent review was the first comprehensive examination of card payments regulation since 2007–08. Since then, the retail payments market has evolved considerably: card payments have continued to grow in importance; new products and channels have been developed; and current and would-be participants have continued to innovate. Part of this evolution has reflected the actions of payment systems, participants and end users in response to the regulatory framework. Accordingly, the review

set out to ensure that reforms that were intended to promote competition and efficiency in the payments system, by improving price signals and encouraging efficient payment choices, continue to do so.

The review was also informed by the Murray Financial System Inquiry (FSI), which endorsed the Board's approach to card regulation and which made a number of recommendations and suggestions, including in relation to interchange fees and surcharging. The review incorporated the FSI recommendations amongst the various regulatory options that were consulted on.

The review process

The review commenced in March 2015 with the publication of an Issues Paper that sought the views of stakeholders and interested parties on the regulatory framework, including on issues that the Bank had raised in its March 2014 submission to the FSI and on issues that the FSI had identified in its Interim and Final Reports. The Bank received over 40 written submissions in response to the Issues Paper and also considered submissions on card payments regulation to the FSI. In addition to consulting with stakeholders individually, the Bank held an industry roundtable in June 2015. Thirty-three organisations were represented at the roundtable, including card schemes, consumer representatives, merchants, financial institutions, and government and regulatory agencies.

In November 2015, the Board approved the release of a Consultation Paper, the second key document in the review. The Consultation Paper presented the Board's preliminary conclusions on the future of card payments regulation and included draft standards for consultation. Over 40 organisations and individuals made substantive submissions and the Bank conducted around 50 consultation meetings with interested parties, including with a number of stakeholders that had not provided formal written submissions.

The release of the draft standards in December 2015 coincided with the government introducing legislation to ban excessive surcharges on card payments, which was subsequently passed by parliament on 22 February. Under the new law, the ACCC will have powers to take action in relation to excessive surcharging and will, in the case of payments in designated card systems, rely on the Board's surcharging standard to determine the level of surcharge that is permitted. The Bank worked closely with Treasury and the ACCC to ensure that the surcharging regime would be as clear as possible for the industry, merchants, consumers and regulators.

Designation of card schemes

In August 2015, prior to the Bank's consultation on draft standards, the Board asked Bank staff to liaise with industry participants on the possible designation of the bank-issued American Express companion card system, the Debit MasterCard system and the eftpos, MasterCard and Visa prepaid card systems. The Bank determined that it would be in the public interest to designate these systems and, following a resolution of the Board, did so in October. The Bank considered that there was potential for regulation of prepaid card systems to remove some of the ambiguity that had developed in the treatment of prepaid cards since 2006, when the Board had expressed its expectation that interchange rates in prepaid card systems should be set broadly in compliance with the relevant debit card standard. Similarly, the regulation of the Debit MasterCard system had the potential to provide consistent treatment of debit card systems in Australia, including ensuring that obligations applied in a standard in a debit card system would also apply to participants of the system. The designation of the American Express companion card system reflected the Board's conclusion that the issuer fees and other

incentive payments that are made in companion card arrangements are, in most respects, equivalent to interchange and other incentive payments in traditional four-party schemes, and therefore consultation on equivalent regulation was warranted.

Conclusions of the review

The key issues for the review fell into three broad, but interrelated, categories. The first were efficiency issues related to interchange fees and the transparency of card payments. In particular, the review considered: whether interchange fee caps were inefficiently high; the implications of the widening of the range of interchange fees for the transparency of payment costs to merchants; whether the coverage of the interchange benchmarks was appropriate; and whether compliance with the current benchmarks could be made more effective. Overall, the Board reaffirmed its long-held view that there is little justification for significant interchange fees in mature card systems. It concluded that there is an ongoing role for regulation in the cards market, in part because of the perverse way in which competition between card schemes can drive up costs in the payments system.

The key decisions taken by the Board in May regarding regulation of interchange fees were:

- The weighted-average interchange fee benchmark for debit cards will be reduced to 8 cents per transaction, and will apply jointly to debit and prepaid cards in each scheme.
- The weighted-average benchmark of 0.50 per cent for credit cards will be maintained.
- The weighted-average benchmarks will be supplemented by ceilings on individual interchange rates: 0.80 per cent for credit; and 15 cents, or 0.20 per cent if the interchange fee is specified in percentage terms, for debit and prepaid.
- To prevent interchange fees drifting upwards in the manner that they have previously, compliance with the benchmark will be observed quarterly, based on transactions in the preceding four quarters, rather than every three years.
- Commercial cards will continue to be included in the benchmark and will be subject to the same ceilings as other credit and debit cards.
- Transactions on foreign-issued cards acquired in Australia will for the present remain outside the benchmark, in light of commitments from schemes to ensure that the Bank's standards are not circumvented. The Board will take careful note of developments in this area.
- The new interchange benchmarks will take effect from 1 July 2017.

The second set of issues related to the application of regulation to some payment systems but not to others with similar characteristics. This had given rise to concerns that the regulatory framework was not fully competitively neutral and might be influencing market developments. A particular focus was on the American Express companion card system; issuance of companion cards had been growing faster than that of four-party schemes' cards and of traditional three-party cards over the preceding decade. The review considered whether interchange-like payments from the scheme to issuers under companion card arrangements should be regulated in the same way as interchange fees in standard four-party business models. The Board decided that they should. To prevent possible circumvention of the debit and credit card interchange standards the Board also introduced limits on any scheme payments to issuers that are not captured within the interchange benchmarks; these limits will apply to all designated card schemes.

The third set of issues related to surcharging. The Board reaffirmed its view that the right of merchants to surcharge for expensive payment methods is important for payments system efficiency and helps to hold down the cost of goods and services to consumers generally. However, the Board acknowledged that practices had emerged in some industries where surcharge levels on some transactions appeared to be well in excess of merchants' likely acceptance costs; the use of fixed-dollar surcharging in the airline industry was of particular concern. The Board also recognised that enforcement of the existing framework, which enabled schemes to limit surcharges to the reasonable cost of acceptance, had not been effective.

As noted, the government legislated to ban excessive surcharges on card payments in February, with the new law relying on the Board's surcharging standard to determine the level of a merchant's permitted surcharge. An important element of the improved enforceability of the new surcharging standard will be the new role for the ACCC in enforcing the ban on excessive surcharging.

The Board's key decisions regarding surcharging were:

- The Bank's standard now defines the 'permitted surcharge' on a card transaction in terms of the merchant's average cost of acceptance for each scheme.
- The breadth of costs included in the permitted surcharge is somewhat narrower than under the Bank's current guidance note.
- The average cost of acceptance is defined in percentage terms, implying that merchants will not be able to levy high fixed-amount surcharges on low-value transactions.
- Acquirers and payment facilitators will be required to provide merchants with easy-to-understand information on the

cost of acceptance for each scheme from 1 June 2017.

- The new framework for surcharging will take effect for large merchants on 1 September 2016 and on 1 September 2017 for other merchants.

Overall, the Board considers that its changes to the regulatory framework will improve competition and efficiency in the card payments market and in the broader payments system. The interchange reforms will reduce the dispersion in interchange fees across products, and are expected to benefit small merchants that do not qualify for strategic interchange rates. The quarterly requirement to observe the interchange benchmarks will ensure that average interchange fees do not drift well above benchmark levels over time. The regulation of fees paid by three-party schemes to issuers of companion cards is expected to improve competitive neutrality of interchange regulation. Instances of excessive surcharging are likely to be reduced by a stricter definition of payment costs and stronger enforcement by the ACCC.

Technology

The Bank monitors developments in technology relevant to the payments system. Staff periodically brief the Board on these developments and on implications for the safety and efficiency of the payments system and potential competition issues.

Digital currencies and distributed ledger technology

A notable development in recent years has been the emergence of digital currencies and distributed ledger technology more broadly.¹⁰

¹⁰ Distributed ledger technology and its potential application in the Australian market is also discussed in 'Supervision of Clearing and Settlement Facilities' and 'Regulatory Developments in Financial Market Infrastructures'.

The emergence of Bitcoin and its 'blockchain' as a means of maintaining a distributed database of ownership of a digital asset has generated considerable interest and investment in the technology, particularly in payments and other parts of the financial services industry. More recent focus in this area has been in relation to 'permissioned' blockchain implementations rather than the 'open-to-all' model of Bitcoin.

Essentially, a distributed ledger is a database that is not administered or controlled by a central party; instead, the ledger is replicated in real-time across many different nodes in a network. Cryptography is typically used to enable the participants in the network to agree on a single version of the ledger. A blockchain – an implementation of a distributed ledger – is made of blocks of information linked together in chronological order (a 'chain'). Each 'block' is the information set at a particular period of time. Changes to the information set are processed and verified through a peer-to-peer network that links each user with all other users. After being verified, a new block is added to the end of the chain, with cryptography used to ensure the integrity of the ledger. Among the potential benefits cited are the scope for the technology to lower transactions costs, the ability to shorten settlement times, the capacity to more efficiently and reliably manage digital identity, and the potential for automation of certain types of transactions (including via so-called 'smart contracts').

The Bank has liaised with a wide range of participants in the 'fintech' sector over the course of the year. These include companies focusing on Bitcoin and other alternative digital assets, as well as financial institutions that have been experimenting with the technology, and representatives of the various fintech hubs that provide facilities for small start-up companies.

The Bank has also engaged with other regulators interested in the technology, both informally and also through formal channels. Domestically, in December 2015, the CFR established a working group (with participants from all CFR agencies plus AUSTRAC) to consider the implications of distributed ledger technology for the financial system and regulation. Bank staff participated in the working group, which reported to the Council in June. The Bank is also an observer on the Australian Securities and Investments Commission's (ASIC) Digital Finance Advisory Committee (DFAC), which has members drawn from fintech firms, academia and consumer backgrounds. The DFAC aims to provide ASIC with feedback on its engagement with the fintech sector. As discussed in the chapter on 'Accountability and Communication', Bank staff also participate in international work on the topic, including the CPMI's Working Group on Digital Innovations and the FSB's Financial Innovation Network.

The final report of the FSI suggested that regulatory frameworks for the Bank and ASIC be clarified to ensure that they can accommodate new mediums of exchange, including digital currencies. The government's response undertook to ensure that ASIC and the Bank 'have the power to regulate new payment systems in a graduated way'. The Bank will work with ASIC and the Treasury to assess any changes that may be needed in this area.

In March 2016, the government announced its intention to introduce legislation to address the 'double taxation' of digital currency transactions in Australia. Currently, digital currency transactions are charged GST when the digital currency is purchased domestically, and again when it is used to purchase taxable goods and services. In early May 2016, Treasury released a discussion paper with options to address this.

The paper explores the implications of treating digital currencies as money for GST purposes, or, alternatively, as input taxed (as in the United Kingdom (UK) and European Union (EU)), and in line with the treatment of financial instruments such as securities and derivatives). Treasury considers that, in the majority of cases, the two options would deliver similar outcomes.

Tokenisation and mobile wallet developments

Tokenisation is the process of anonymising data; replacing sensitive information with a substitute value containing randomly generated elements – a ‘token’. In the payments context, tokenisation primarily refers to replacing a cardholder’s primary account number (or PAN) where details are held either ‘on file’ by a merchant or on a device, such as a mobile phone. When tokenisation is used, fewer parties in the payment process have access to the cardholder’s details. If, for example, cardholders’ details are not available in merchants’ systems, the data held by merchants are rendered unusable by fraudsters and the potential financial impact of a data breach or unintended disclosure is reduced.

Tokenisation is used to facilitate payment options in the mobile payments space. Mobile payment applications such as Apple Pay, Samsung Pay and Android Pay have all recently been launched in the Australian market. All of these applications rely on tokenisation and any scheme that wishes to be a payment option on a mobile payment application must have an accessible tokenisation solution – from a Token Service Provider (TSP) – in place. The international card schemes have established or are establishing their own TSPs, and ePAL announced in July 2016 that it had established a domestic TSP.

Over 2015/16 there were a number of announcements regarding mobile wallets. Initially launched in the United States (US) in

October 2014 and subsequently released in other markets, including the UK, Canada, China, and Singapore, Apple Pay was launched in Australia in November 2015 for proprietary American Express cards and in April 2016 for ANZ-issued American Express companion cards and Visa cards. In June 2016, Samsung Pay launched its mobile wallet application in Australia, in partnership with American Express and Citibank. Android Pay announced early in December that it had partnered with a range of financial institutions to launch in Australia in 2016, and in July launched with ANZ, American Express, Macquarie and a wide range of credit unions and mutual banks using service provider Cuscal.

The Board notes that innovation in mobile wallets can provide benefits in terms of consumer choice and convenience, with cardholders potentially able to consolidate a range of payment cards into a single ‘app’ on their mobile device. It is also cognisant of the potential for competition issues to arise as new and existing players seek a competitive advantage in new methods for customers to access their accounts. Accordingly, the Board will continue to monitor developments in this area.

Operational Incidents in Retail Payment Systems

In November 2012, the Bank published a report setting out the Board’s conclusions from an informal consultation on operational incidents in retail payment systems. The report concluded that, at least for the time being, the Bank’s role should be limited to monitoring retail operational incidents and collecting related data. In support of this role, the Bank collects information from Exchange Settlement Account (ESA) holders on significant operational retail payment systems incidents as well as other incidents resulting in less severe disruptions to participants’ retail payment systems.

Over 2015/16, the Board was kept informed of trends in the occurrence of retail payments incidents along with any significant incidents, both within and between institutions. There was an increase in the number of significant incidents in 2015/16 compared with 2014/15, though the total duration of incidents fell in the year. A large proportion of significant incidents over the past year were caused by software/application failures. Changes and upgrades to existing systems also caused a number of significant incidents. As was the case in previous years, online banking and card services were the channels most affected by such incidents. In recent quarters, disruptions have been increasingly reported to mobile banking and other new payment channels, such as mobile payments, tablet banking and cardless ATM withdrawal services.

Since reporting began, the Bank has provided aggregate statistics to APCA for review by the APCA Board. The Bank and APCA have continued to be in discussion about how aggregate information could be made available to industry participants for the purpose of benchmarking.

International Developments

Over the past 12 months, a number of jurisdictions adopted and applied regulations focused on improving the efficiency, competitiveness and security of payments systems. The trend towards faster payments systems continued to gain momentum, while central banks and regulators showed an increasing interest in digital currencies and the technology that underpins them.

Card interchange fees

The EU's Interchange Fee Regulation (IFR) came into force this year, with interchange fee caps and some business rules coming into effect in December. Generally, a 0.3 per cent cap applies

to domestic and intra-European credit card transactions, and a 0.2 per cent cap applies to debit card transactions. However, member states may set lower per-transaction caps for domestic credit and debit card transactions, and may choose to apply a fixed per-transaction cap, or a weighted average cap, to domestic debit card transactions. In addition, member states may exempt three-party schemes with licensing or co-branding arrangements from fee caps, subject to a market share condition. For instance, the UK Government has provided schemes with the option to apply a weighted average fee of 0.2 per cent to domestic debit card transactions, and has chosen to exercise the temporary exemption for three-party schemes with licensing or co-branding arrangements; the only scheme that was eligible for this exemption did not satisfy the market share condition. In June, the remaining IFR provisions came into force; these include regulations relating to card identification at the point of sale, co-branded cards, the 'honour all cards' rule and the separation of card schemes and processing entities.

The setting of interchange fees in many jurisdictions remains subject to legal actions by merchants or competition authorities. In June, a federal appeals court in the US rejected the 2013 settlement between MasterCard, Visa and a number of card-issuing banks, and US merchants. The lawsuit concerns alleged collusion in the setting of interchange fees by the card schemes and issuing banks. The court noted a conflict between the two classes of merchants defined in the settlement terms; some merchants wanted to maximise their payout, while others wished to place restraints on network rules. The case will now return to a lower court. The European Commission has actions outstanding against MasterCard and Visa in relation to their setting of interchange fees on inter-regional transactions (i.e. transactions involving a European bank and

a bank outside the EU). In the UK, a number of retailers have outstanding claims against MasterCard and Visa for anti-competitive practices and setting excessive interchange fees, with a July decision by the Competition Appeal Tribunal finding in favour of Sainsbury's and ordering MasterCard to pay £69 million in damages, plus interest.

Other regulatory developments

The EU's revised Directive on Payment Services (PSD2) came into effect in January. Member states have two years to transpose the directive's provisions into national law. The original directive sought to harmonise payment services regulations across member states, and to enhance competition by opening the EU payments market to non-banks. PSD2 extends the scope of the original directive to encompass third-party providers, such as 'payment initiation services' that facilitate payments between consumer and merchant accounts. Under PSD2, member states must ensure that third-party providers are given access to information from a customer's bank account, such as the availability of funds, if the customer provides consent. More broadly, these providers now fall under the same regulatory framework as other payment institutions, and are subject to authorisation and regulation by competent authorities in member states. The revised directive also extends information and transparency obligations under the original directive to payments that are made between member states and countries outside the EU, introduces new security requirements to protect consumers against fraud and bans card surcharging on transactions where IFR interchange fee caps apply.

In the UK, the Payment Systems Regulator (PSR) published a report on the competitiveness of the country's payments system infrastructure. The report noted that the same group of banks

owned both the UK's major interbank payments systems, and the infrastructure provider that services these systems. The PSR found that these ownership arrangements limited innovation and competition, and proposed that the banks sell their stake in the infrastructure provider. The PSR also published a report that identified a number of concerns around indirect access arrangements. Subsequently, the Bank of England announced that it intended to provide non-bank payment service providers with direct access to its RTGS system.

Payments innovation

Progress continues to be made towards real-time payments in a number of jurisdictions. In the US, the Federal Reserve approved changes to its automated clearing house service, which will allow it to facilitate same-day payments. In addition, several payments industry participants announced that they had submitted real-time payments proposals to the Federal Reserve-sponsored Faster Payments Taskforce. In Europe, the European Payments Council launched a consultation on the technical and business rules for the Single Euro Payments Area (SEPA) Instant Credit Transfer scheme. In its current form, the scheme will facilitate instant transfers between SEPA countries of up to €15 000; it is set to launch in late 2017.

India's national mobile payments platform, the Unified Payments Interface, was formally launched in April. The platform is designed to leverage the high rate of mobile phone adoption in India; it facilitates 'push' and 'pull' transactions using a phone number, national identification number or virtual payment address.

Digital currencies

A number of central banks indicated that they were examining the conceptual benefits of digital currencies. The Bank of England and Bank

of Canada have included central bank-issued digital currencies on their research agendas, while staff from De Nederlandsche Bank have developed and undertaken internal tests on a prototype digital currency.

Governments and regulators continue to monitor digital currencies and the distributed ledger technology that underpins them. In the US, the Commodity Futures Trading Commission (CFTC) defined Bitcoin and other virtual currencies as commodities. As a result, businesses that offer derivatives linked to the underlying Bitcoin price are required to comply with commodity exchange regulations enforced by the CFTC. In Japan, the parliament approved a law that will require digital currency exchanges to register

with the country's financial regulator; the law is intended to address money laundering concerns, while also improving user protections.

Similarly, as part of a package of amendments to the Anti-Money Laundering Directive (AML), the European Commission announced measures intended to reduce the anonymity associated with digital currency transactions. The proposed amendments would extend the provisions of the AML to include digital currency exchanges, bringing them under the supervision of national anti-money laundering and counter-terrorist financing legislation. The European Commission will also consider whether digital currency exchanges should be subject to licensing and supervision rules.

