

# Regulatory Developments in Retail Payments

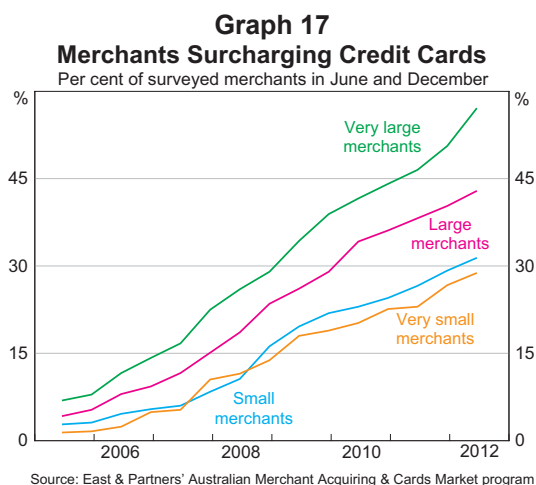
Regulatory developments in Australia during 2011/12 included the Payments System Board's decision to vary the surcharging Standards to allow scheme rules to limit surcharges to the reasonable cost of card acceptance, and its decision to undertake a review of the regulatory framework for the eftpos system. More recently, the Payments System Board decided at its August 2012 meeting to vary the ATM Access Regime to expand its power to grant exemptions to arrangements that would otherwise be counter to the interchange fee provisions. This chapter also discusses a number of regulatory reviews related to retail payment systems that are being undertaken in other jurisdictions.

## Surcharging

The removal of 'no-surcharge' rules by the Reserve Bank as part of the reforms starting in 2003 allowed merchants to pass on the cost of credit and debit card transactions, with merchants having previously been prevented from doing so by rules of the international card schemes. These rules had masked price signals to cardholders about the relative costs of different payment methods. They had also contributed to the cross-subsidisation of credit card users by all other customers, as merchants could recover the costs of accepting card payments only by incorporating them into the overall prices of their goods and services. Finally, by preventing the possibility of surcharging, these rules limited the ability of merchants to put downward pressure on their merchant service fees.

Following the removal of these rules, the proportion of merchants that surcharge credit card transactions has risen substantially. According to the latest data from East & Partners' semi-annual survey of the merchant acquiring market for June 2012, around 36 per cent of merchants surveyed applied a surcharge on at least one of the credit cards they accepted (Graph 17). Surcharging is more common among very large merchants, with over half now surcharging credit cards.<sup>11</sup>

As reported in the 2011 Payments System Board Annual Report, the Reserve Bank issued an initial consultation paper on surcharging practices in June



<sup>11</sup> Very large merchants are classified in these data as those with annual turnover of more than \$530 million.

2011.<sup>12</sup> The catalyst for this review was the Bank's concerns that several types of surcharging practices that have the potential to reduce the effectiveness of previous surcharging reforms were becoming increasingly commonplace. These practices included excessive surcharging (where surcharges are set well above the cost of acceptance) and blended surcharging (where cards from multiple schemes are surcharged at the same rate despite significant differences in acceptance costs). This initial consultation paper sought feedback on several possible modifications to the Standards, including various ways in which the Standards could allow for card schemes' rules to impose caps on surcharges; the need to provide clarification on the ability of merchants to differentially surcharge across card types; and the scope for greater disclosure of merchant service fees.

After considering the views put forward in the initial consultation, the Board decided at its November 2011 meeting to undertake a public consultation on a draft variation to the surcharging Standards that would allow scheme rules to impose a limit on surcharges based on the 'reasonable cost of acceptance'. The draft Standards made clear that merchants would have the ability to differentially surcharge across card schemes and card types, though the Board noted that it would not require merchants to disclose their merchant service fees after a large number of submissions raised concerns about commercial confidentiality issues.

Accordingly, the Reserve Bank released a second consultation paper in December 2011, setting out the issues raised from the previous consultation, and seeking comment on the specific form of the proposed variation to the Standards.<sup>13</sup> There was general support for the Bank's proposed approach to varying the Standards, though a number of submissions sought further clarification around the definition of the 'reasonable cost of acceptance' and raised some concerns about implementation and compliance.

Taking into account the views expressed in both consultation rounds, the Board decided to vary the Standards relating to merchant surcharging on credit and scheme debit cards.<sup>14</sup> The variation, which will come into effect in January 2013, will allow card scheme rules to limit surcharges to the reasonable cost of acceptance, but will continue to ensure that merchants cannot be prevented from fully recovering their costs. The Board also noted that it would investigate ways to enhance transparency around costs – for instance, through the publication of more detailed data on merchant service fees by the Reserve Bank. To provide some further clarification of the meaning of the 'reasonable cost of acceptance', the Bank issued a draft guidance note to assist in interpreting the Standards. The Bank is currently consulting on the form of the guidance note and intends to publish the final version in early October.

## eftpos Developments

In September 2011, the Board announced that it would undertake a review of the regulatory framework for the eftpos system. A review has become necessary because of industry developments in the system in recent years, most notably the establishment of a new governing body for the eftpos system – ePAL – in 2009 and its recent decision to introduce a multilateral interchange fee schedule for the system (see the section on 'Interchange fees' in the previous chapter). Alongside these changes to the governance framework, the underlying architecture of the eftpos system has also undergone significant change: the industry, with encouragement by the Reserve Bank, has migrated to simpler connection arrangements under the Community of Interest

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12 See RBA (2011), *Review of Card Surcharging: A Consultation Document*, June. Available at <<http://www.rba.gov.au/publications/consultations/201106-review-card-surcharging/index.html>>.

13 See RBA (2011), *A Variation to the Surcharging Standards: A Consultation Document*, December. Available at <<http://www.rba.gov.au/publications/consultations/201112-variation-surcharging-standards/index.html>>.

14 See RBA (2012), *A Variation to the Surcharging Standards: Final Reforms and Regulation Impact Statement*, June. Available at <<http://www.rba.gov.au/payments-system/reforms/cards/201206-var-surcharging-stdns-fin-ref-ris/index.html>>.

Network (COIN). Given these significant developments, the aim of the review is to ensure that regulation for the eftpos system continues to support competition and efficiency in the payments system as a whole, and provides fair access to new participants.

As the first public element of the review, the Reserve Bank released a consultation paper in March 2012, seeking views on the appropriate form of designation for the eftpos system.<sup>15</sup> The Board had formed the view that the existing designation, put in place in 2004, no longer clearly or accurately defined the eftpos system. Specifically, the 2004 eftpos designation relied on a description of the eftpos system as set out in the Australian Payments Clearing Association's (APCA) Consumer Electronic Clearing System (CECS) Manual and Regulations. With the establishment of ePAL, the CECS Manual and Regulations were modified, with the description of the eftpos system removed and replaced by a reference to ePAL's Scheme Rules.

The consultation paper sought views on two options for defining the eftpos system for the purpose of designation: a narrow definition based on ePAL membership and Scheme Rules, or a broader definition to capture those parts of the eftpos system that lie outside the scope of ePAL's membership and Scheme Rules. Nearly all submissions were of the view that the 2004 designation was no longer appropriate and should be revoked. The views, however, were more divergent on the form of a new designation.

Taking into account the various views, at its meeting in May 2012, the Board decided that it was in the public interest to put a new designation in place and to adopt a narrow definition of the eftpos system based on ePAL's Scheme Rules. A key consideration in the Board's decision was a desire to remove any uncertainty regarding the participants subject to the Bank's regulatory framework. The new designation was put in place in June 2012; the 2004 designation will be revoked once the broader regulatory framework has been put in place.

With the new designation in place, the Reserve Bank began the second phase of its review – a consultation on the future regulatory framework for the eftpos system – releasing a paper in June 2012.<sup>16</sup>

This consultation sought views on options for the Reserve Bank's future regulation of:

- eftpos interchange fees – such as whether regulation of bilateral and multilateral interchange fees should be brought under a common benchmark
- access to the eftpos system – such as whether 'no discrimination' provisions regarding interchange fees are required to ensure existing participants are entitled to interchange fees that are in line with existing arrangements and whether a cap on connection charges is required if industry were able to put in place acceptable and appropriate access arrangements.

The Reserve Bank also sought views on the form of any transitional arrangements that might be appropriate, acknowledging that there have been large shifts in the governance and regulatory framework and that the decision by ePAL to reverse the direction of interchange fee flows has potentially affected some business models more than others.

The Reserve Bank is reviewing submissions and considering the possible policy options. At this stage, the Bank anticipates that a final decision on the regulatory framework for the eftpos system will be made towards the end of 2012.

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<sup>15</sup> See RBA (2012), *Review of the Regulatory Framework for the eftpos System: Consultation on Designation*, March. Available at <<http://www.rba.gov.au/publications/consultations/201203-replacing-efpos-designation/index.html>>.

<sup>16</sup> See RBA (2012), *Review of the Regulatory Framework for the EFTPOS System: Consultation on Options for Reforms*, June. Available at <<http://www.rba.gov.au/publications/consultations/201206-rev-reg-frmwrk-efpos-sys/index.html>>.

## ATM Taskforce

In December 2010, the Australian Government established a joint Treasury/Reserve Bank ATM Taskforce, which submitted two reports to the Government:

- *Report on Transparency and Competition*
- *Report on Indigenous ATM Issues.*

The Government released both of these reports in May 2012.<sup>17</sup>

For the report on transparency and competition, the Taskforce found that in most regions of Australia there appears to be a reasonable amount of competition in the market for the services provided by ATMs, and most Australians have access to a range of free or low-cost options for accessing cash and making balance enquiries (with the notable exception of very remote Indigenous communities). Accordingly, for most Australians the payment of a direct charge to use a 'foreign ATM' (an ATM not owned by the account holder's institution) is generally a matter of convenience rather than necessity. The Taskforce concluded that the industry-led ATM reforms in 2009 have been positive for both the ATM market and for consumers:

- On the demand side, consumers have responded to the increased transparency of fees by shifting away from transactions at foreign ATMs, saving an estimated \$270 million on cash withdrawal fees in the two years following the reforms.
- On the supply side, there has been a continued increase in the number of ATMs deployed (including to non-metropolitan regions), with much of the expansion attributable to independent deployers, which have benefited from the shift to direct charging.

Nonetheless, the Taskforce recommended two further measures to enhance transparency and competition: improved disclosure of direct charges through upfront advertising of prices on ATMs – that is, without the need to insert a card in the machine – and increased collection and dissemination by the Reserve Bank of more comprehensive data from ATM deployers.

For the report on Indigenous ATM issues, the Taskforce found that residents in very remote Indigenous communities are generally more reliant on ATMs than other Australians because of their lack of access to alternative means to withdraw cash and make balance enquiries. Moreover, these residents typically only have access to an independently owned ATM and have no alternative to paying a direct charge for cash withdrawals and balance enquiries. Although the level of direct charges for ATMs in very remote Indigenous communities was found to be generally similar to those in metropolitan areas, a range of social and economic factors means that residents in the communities tend to access ATMs for withdrawals and balance enquiries much more frequently than their urban counterparts – this results in sizeable expenditure on ATM fees by these communities. To reduce the impact of ATM fees on these residents, the Taskforce recommended examining the scope for foreign-ATM fees to be reduced in very remote Indigenous communities – including through voluntary action by the industry – together with complementary measures to address the high usage of ATMs in these communities. The Taskforce and the Government have since been facilitating negotiations among industry participants on a scheme to help reduce the sizeable expenditure on ATM fees by residents of very remote Indigenous communities.<sup>18</sup>

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<sup>17</sup> The Treasury and RBA (2011), *ATM Taskforce – Report on Indigenous ATM Issues*, released on 25 May 2012; The Treasury and RBA (2011), *ATM Taskforce – Report on Transparency and Competition*, released on 25 May 2012. Available at <<http://archive.treasury.gov.au/banking/content/reports.asp>>.

<sup>18</sup> See The Treasury (2012), *Very Remote Indigenous Communities Benefiting from ATM Initiative*, May. Available at <<http://archive.treasury.gov.au/banking/content/atms.asp>>.

Related to this work, in May 2012, the Reserve Bank released a consultation paper setting out a proposal to vary the ATM Access Regime.<sup>19</sup> The variation would provide the Bank with greater flexibility to grant exemptions for ATM arrangements that would otherwise be prohibited by the interchange fee provisions of the Access Regime. Taking into account views expressed during the consultation process, the Board decided at its August 2012 meeting to proceed with the variation to the ATM Access Regime. The Board also decided to use the expanded exemption power to grant an exemption to the ATM scheme for very remote Indigenous communities, discussed above.<sup>20</sup>

## Operational Incidents in Retail Payments Systems

Over the past few years, there have been a number of prominent operational incidents causing considerable disruption and denting public confidence in retail payments systems. Meanwhile, the value of payments settled in these systems has continued to grow rapidly and, as a consequence, the importance of retail payments systems in the Australian economy continues to grow. Accordingly, given the Reserve Bank's responsibility for promoting an efficient and stable payments system, the Bank is considering possible approaches to strengthening the handling of any future disruptions. In doing so, the Bank is conscious of the need to coordinate with the Australia Prudential Regulation Authority and industry bodies to avoid duplication.

In February 2012, the Reserve Bank began an informal consultation with industry participants to deepen its understanding of authorised deposit-taking institutions' retail payments operations.<sup>21</sup> This consultation, in which all four major banks have participated, spans a number of areas, including: sources of vulnerability; existing controls; safeguards and contingencies; change management; and plans for upgrade and enhancement of supporting technology. The Board will consider the information gathered in this consultation and establish whether the incident reporting should be supplemented with additional measures.

In addition, as of April 2012, the Reserve Bank has formalised its requirements of Reserve Bank Information and Transfer System (RITS) Members that operate an Exchange Settlement Account (ESA) for reporting of major retail payments system incidents. Providers of retail payments services that operate ESAs are required to report significant incidents in their retail payments operations to the Bank. The Bank is in the process of eliciting feedback on the scope of this reporting requirement and plans to supplement the detailed reporting on major incidents with periodic statistical reporting.

## International Developments

Work on existing and forthcoming regulatory reform – intended to improve competition, enhance governance, and restrict excessive surcharging – has continued internationally. Regulators in the United States, Canada and the European Union (EU) have continued to examine competition at all levels of the payments system – between issuers, acquirers, payment card networks, processors and clearing and settlement systems. Relatedly, governance in payment systems has also been an important issue, with Canada, the United Kingdom and the EU each in the process of examining the efficacy and representativeness of governance structures of their respective industry organisations. Additionally, as has just been undertaken in Australia, authorities in

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19 RBA (2012), *A Variation to the Access Regime for the ATM System: Consultation Document*, May. Available at <<http://www.rba.gov.au/publications/consultations/201205-acc-reg-atm-sys-cons-doc/pdf/201205-acc-reg-atm-sys-cons-doc.pdf>>.

20 RBA (2012), 'Payments System Issues: Variation to the Access Regime for the ATM System', Media Release 2012-24, 29 August. Available at <<http://www.rba.gov.au/media-releases/2012/mr-12-24.html>>.

21 For more information, see RBA (2012), 'Payment System Issues: Retail Operational Incidents', Media Release 2012-03, 20 February. Available at <<http://www.rba.gov.au/media-releases/2012/mr-12-03.html>>.

the United Kingdom have commenced consultation on the matter of excessive surcharging by merchants, with an intention to restrict the practice. The same issue is also being considered by the EU as part of a wider consultation on card payment issues in the Single European Payments Area (SEPA).

## United States

During the course of the year, the debit card interchange fee restrictions and network exclusivity provision of section 1075 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010* (the Durbin Amendment), as implemented by the Federal Reserve Board, came into effect. Effective from October 2011, debit card interchange fees have been capped at US\$0.21 plus 0.05 per cent of the transaction value (plus US\$0.01 if the issuer undertakes steps to limit fraud). The Federal Reserve has since published a report examining debit card interchange fees pre- and post-Durbin Amendment. It found that interchange fees for non-exempt issuers have fallen from an average of US\$0.50 in the March to September quarters 2011 to US\$0.24 in the December quarter 2011, in line with the regulated level of interchange fees.<sup>22</sup> The exclusivity provisions require issuers and networks to have at least two non-affiliated networks enabled on a debit card; these became effective from October 2011 for networks and from April 2012 for issuers. Under these provisions, merchants must also not be restricted from routing a transaction over any of the networks enabled on a debit card or from promoting the use of a particular network.

In November 2011, merchant groups filed a lawsuit against the Federal Reserve, alleging that its implementation of the Durbin Amendment was against the wording and intent of the legislation. Specifically, they contended that the current debit card interchange cap is too high due to the inclusion of extraneous costs in the calculation of the cap. The merchant groups also argue that the current implementation of the network exclusivity provision requiring at least two unaffiliated networks to be enabled on each debit card do not provide sufficient choice of routing. They believe the provision should be applied with respect to each authorisation method; that is, each debit card should have at least two PIN and two signature networks – a proposal that was initially considered. The case is ongoing.

## Canada

In March 2012, the 'Task Force for the Payments System Review' released a series of discussion and policy papers recommending reforms to the Canadian retail payments system. Convened by the Minister of Finance, the taskforce had a mandate to review and assess issues of safety, soundness, competition and innovation in the payments system; identify public policy objectives with respect to these issues; and formulate and assess regulatory and institutional structures best suited to achieving the policy objectives identified.

The key recommendations of the taskforce include:

- *Governance.* The establishment of a public oversight body (POB) and self-governing organisation (SGO). Reporting directly to the Minister of Finance, the POB would be responsible for broad monitoring of risk, competition and developments in the payments industry. It would also have statutory authority to regulate the payments system and its participants, and would serve as an arbiter of disputes that the SGO could not resolve. The SGO would be an industry-chaired organisation with delegated powers (from the POB) to develop and enforce standards, codes and policies. All payment service providers would be required to become members of the SGO.

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<sup>22</sup> Exemptions apply to issuers with assets under US\$10 billion, three-party networks, transactions made using cards issued under government-administered programs, and certain reloadable prepaid cards. Interchange fees for exempt issuers were found to have been essentially unchanged over the period examined.

- *Legislative framework and Code of Conduct.* Legislation should be drafted to provide the powers necessary for the establishment and functioning of the POB and SGO, and to bring all relevant institutions under the new governance framework. Furthermore, the existing *Code of Conduct for the Credit and Debit Card Industry in Canada* should be amended to allow merchants and cardholders to identify premium cards; require disclosure of minimum spending and income limits for premium cards; allow merchants to provide differential discounting for different card categories; and clarify steering rules.<sup>23</sup> Under the proposed governance framework, enforcement of the Code of Conduct would be the responsibility of the SGO.
- *System architecture.* The Canadian Payments Association, a not-for-profit entity that currently manages the low- and high-value clearing and settlement systems, should be restructured into a 'core infrastructure entity' that will also manage the cheque system (processing is currently handled by over 30 separate financial institutions) and the Interac debit card network. Additionally, the taskforce recommends that the industry write an implementation plan to replace the low-value clearing and settlement system with a multilateral (hub and spoke) Small Value Transaction System, and upgrade the high-value Large Value Transfer System clearing and settlement system.
- *Other recommendations.* The taskforce advised against direct regulation of interchange fees, considering it administratively complex and difficult to enforce, particularly in an evolving payments environment. Additionally, the industry and SGO should be tasked with establishing an e-invoicing system, utilising a Canadian-specific schema for the ISO 20022 standard; a framework for (Near field communication-focused) mobile payments; and a system to allow verification of electronic identities in payments.

Separate from the work of the taskforce, a Competition Tribunal case seeking the removal of Visa's and MasterCard's honour-all-cards, no-surcharging and no-steering rules, which was launched in December 2010, commenced hearings in May 2012. The case remains in progress.

## Europe

In December 2011, the European Parliament passed legislation regarding direct entry systems within SEPA. First proposed by the European Commission (EC) in December 2010, the key provisions of the legislation require that euro-denominated direct entry systems which are not compliant with SEPA rules be shut down by February 2014; euro-denominated direct entry systems use International Bank Account Number (IBAN) and ISO 20022 messaging standards from February 2014; and multilateral interchange fees for direct debits be abolished from February 2017.

In January 2012, the EC released a consultation paper, 'Towards an Integrated European Market for Card, Internet and Mobile Payments'. The consultation was motivated by what the EC perceives to be slow implementation of the SEPA framework for card-based payments. The key issues considered in the paper include:

- *Governance.* In addition to expressing concern over the European Payments Council's (EPC) progress in implementing the SEPA Cards Framework, the EC sought comments on a potential change to the EPC's governance model as a way of addressing the EPC's lack of enforcement powers and bank-centric representation.
- *Market fragmentation, access and entry.* The paper raised concerns about the effect of interchange fees on competition, as well as distortions caused by cross-border differences in multilateral interchange fees. The

<sup>23</sup> The Code of Conduct is a voluntary set of standards enforced by the Consumer Financial Agency of Canada, which is currently adopted by all card networks in Canada. It currently provides for, among other things, enhanced disclosure of merchant service fees, differential discounting for different payment card networks and merchant choice in accepting or declining different payment methods from the same payment card network.

EC viewed co-badged cards (multi-network cards) as generally beneficial to competition, provided that issuers are not permitted to choose the network-routing priority.

- *Transparency and cost-effective pricing.* The EC sought views on the harmonisation of steering practices (e.g. surcharges, discounts and rebates) across European countries, along with whether surcharges should be limited to the 'real cost of using a payment instrument'. Additionally, the EC is consulting on ways to improve the transparency of pricing to merchants, including by allowing merchants to report their cost of accepting a payment method to consumers.
- *Security.* The EC also sought comments on additional security requirements for remote transactions, in the context of concerns about fraud moving from physical to remote transactions as the migration from magnetic-stripe cards with signature authorisation to chip-based cards with PIN authorisation nears completion.

The consultation closed on 11 April 2012; the EC has indicated that further reports are likely to be forthcoming in late 2012 and early 2013.

In April 2012, the European Central Bank released for consultation its paper 'Recommendations for the Security of Internet Payments'. The recommendations cover internet payments issues with respect to governance; risk identification, monitoring and reporting; authentication procedures; transaction monitoring; data protection; consumer education; and transaction limits and notifications. Notable recommendations include the requirement for payment service providers to use 'two-factor' authentication for internet payments, and a shift in liability to any party failing to comply with this requirement. If implemented, the recommendations – which are applicable to all payment service providers that process internet payments – would be expected to come into effect by mid 2014.

## United Kingdom

In December 2011, the UK Government announced an intention to ban excessive surcharging, following the release of an Office of Fair Trading (OFT) report on surcharging in the travel industry.<sup>24</sup> The ban will apply to all payment instruments and across most sectors, and is intended to be put in place by the end of 2012.<sup>25</sup> In this context, the UK Government has recently released a consultation paper seeking views on the proposed ban.

In April 2012, the UK Payments Council released the results of, and their response to, an independent governance review conducted by an independent director of the Council's board. The self-assessment was recommended as part of the OFT's review of the Council in 2009. Seven recommendations were made in the self-assessment, namely to improve transparency of decision processes; communication with stakeholders; engagement with small and medium enterprises; the role and powers of independent directors; clarity regarding the boundaries of the Council's role in competitive markets; staff resources and competencies; and the relationship with Visa and MasterCard. The Council has accepted the self-assessment's findings and outlined the steps it is currently undertaking to implement the recommendations.

Separately, the UK Government has signalled the possibility of bringing the UK Payments Council under the regulatory regime, following recommendations from the House of Commons Treasury Select Committee. To this effect, a consultation on reforms to the process of setting strategic direction for the payments system was

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<sup>24</sup> Subsequent to the OFT's investigation into surcharging, it announced in July 2012 that it had reached an agreement with the airline industry to cease surcharging of debit cards, and to incorporate the debit card cost of acceptance into headline prices. Surcharging of credit card transactions in the airline industry will continue to be permitted, but will be subject to transparency and disclosure requirements.

<sup>25</sup> This essentially fast-tracks the implementation of a provision in the EU Consumer Rights Directive, that must be implemented by all EU countries by 2014.



announced in July 2012. The consultation gives consideration to three options: enhancing the governance of the UK Payments Council and retaining the self-regulatory approach; setting up a Payments Strategy Board to guide strategic decisions in the payments system; or establishing a new payments system regulatory body with a similar model to utilities regulation.

