HM Treasury

Interchange fee regulation:

consultation response

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Contents

1 Introduction

1.1 This document sets out the government's final approach to implementing the Interchange Fee Regulation, following a consultation published on 27 July 2015.

Background

1.2 In July 2015, the government published a consultation document, *The Interchange Fee Regulation: a Consultation*, setting out its proposed approach to implementing the Interchange Fee Regulation (IFR). This followed the publication of the IFR in the Official Journal of the European Union on 19 May 2015.

1.3 The key objective of the IFR is to cap interchange fees, which, as the European Commission set out, are "fees set by banks and payment card schemes, which are hidden from the consumer and neither retailers nor consumers can influence"[1]. These fees are paid by the merchant acquirer (the merchant's bank) to the card issuer (the cardholder's bank), as a percentage of each transaction made by the cardholder and form part of the package of fees that merchant acquirers charge to merchants. To prevent circumvention of the IFR through an alternative flow of fees, the IFR treats the 'net compensation' (fees received by a card issuer from a payment card scheme, an acquirer or any other intermediary) as an interchange fee.

1.4 The European Commission has estimated that interchange fees amount to £1 billion per annum in the UK. Figures from the British Retail Consortium have also estimated that an interchange fee cap of 0.2% for debit cards and 0.3% for credit cards could save merchants in the UK £480 million each year. In its response to the consultation, the UK Cards Association suggested that the government's approach to implementing interchange fee caps, as set out in the consultation document, could save businesses across all sectors in the region of £700 million each year.

1.5 As well as capping interchange fees, the IFR also aims to improve transparency and competition in the card market by removing barriers to entry through various business rules.

1.6 Although the IFR is directly applicable, it offers national discretions in three key areas:

- Member States can decide to implement **lower interchange fee caps for domestic credit card transactions** than the caps set out in the IFR;
- Member States can decide to implement **lower caps on interchange fees for domestic debit card transactions** than the caps set out in the IFR. There are also other flexibilities in the way Member States can apply interchange fee caps for domestic debit card transactions, such as applying a weighted average for a period of up to 5 years; and
- Member States can **exempt three party card schemes that use issuers or acquirers** from caps to interchange fees for a period of up to three years, provided that the scheme's market share remains below 3% in that Member State.

[1] http://europa.eu/rapid/press-release_IP-15-4585_en.htm

2 The Regulatory Regime

2.1 The terms of the IFR require Member States to designate a competent authority to supervise and enforce the IFR and grant the competent authority appropriate investigation and enforcement powers in order to adequately carry out this role.

2.2 All respondents to the consultation agreed that the Payment Systems Regulator (PSR) is the entity best placed to be the overarching regulator for the IFR, given its expertise and oversight of the UK payments market. Many respondents noted that the PSR already has statutory powers under the Financial Services (Banking Reform) Act 2013 (FSBRA). As such, there are only some minor modifications and additions required to the PSR's existing powers to ensure that it can fulfil this role adequately and exercise its powers in relation to all persons regulated under the IFR.

Penalties

2.3 Similarly, all respondents agreed that the PSR's penalties regime should be based on the penalties regime set out in FSBRA, which states that the PSR can require a regulated person or body to pay a penalty in respect of a compliance failure. Some respondents called for a fixed upper limit to be set for penalties. In its policy statement, PSR PS15/1 published in March 2015, the PSR explained that it did not intend to set an upper limit for penalties so that it had "the discretion to set penalties at levels that are appropriate and proportionate to the specific circumstances of each case"[2]. However, the PSR will be required to publish a statement of the principles which it will apply in determining the level of a penalty. Additionally, regulated persons or bodies will be able to appeal any PSR decision to issue a penalty.

Appeals

2.4 All respondents agreed with the government's approach of designating the Competition and Appeal Tribunal (CAT) for this purpose. Respondents acknowledged that the CAT is already the appellate body in relation to many of the PSR's decisions under FSBRA. Regulated persons or bodies will also be able to appeal to the CAT against PSR directions, for example a request for information, and against the publication of compliance failures.

Other regulators

2.5 The majority of respondents agreed with the government's suggestion that the Financial Conduct Authority (FCA) should also have a role alongside the PSR, specifically for articles 8(2), (5), (6), 9, 10(1) and (5) and 12 of the IFR where it crosses over with the FCA's role as supervisor of institutions regulated under the UK Payment Services Regulations 2009. Respondents also, however, commented that it was important that this was done it a way that was not complex.

2.6 In response to these comments and to mitigate the risk of any complexity, the government will make clear in legislation that the PSR is the overarching regulator for the IFR. To provide clarity on how the regulators work with one another, there is an existing, four-way Memorandum of Understanding between the PSR, FCA, Bank of England and Prudential Regulation Authority under FSBRA.[3] This covers:

- information exchange;

[2] https://www.psr.org.uk/sites/default/files/media/PDF/psr-publications-consultations-psr-ps-15.1.pdf

[3] www.gov.uk/government/publications/memorandum-of-understanding-on-the-relationship-between-the-payment-systems-regulator-and-the-uks-other-financial-regulators

- co-operation in respect of regulated entities; and
- co-ordinated exercise of functions and policy.

The government intends to include a legislative requirement to amend this document so that it covers oversight of the IFR.

2.7 Respondents agreed that a specific role for Trading Standards in relation to article 10 (4) would be appropriate. This provision obliges merchants to display clearly to their customers which cards they do and do not accept, be it in a shop or online. However, there were also comments about the appropriateness of an enforcement role for Trading Standards, given capacity issues. As such, the government will add article 10 (4) of the IFR to the list of Part 2 in Schedule 13 of the Enterprise Act 2002. This will allow for a complaints-led regime, overseen by both Trading Standards and the Competition and Markets Authority, with the PSR retaining overarching responsibility for compliance.

Out-of-Court redress procedure

2.8 An out-of-court redress procedure is required by the IFR under article 15. Respondents acknowledged that this would be achieved most efficiently by extending the PSR's existing dispute resolution procedures. The PSR currently has powers to vary agreements between businesses and their payment service providers in the event of a dispute. The government will provide a similar ability for relevant bodies to apply to the PSR, after which the PSR can exercise its powers to resolve disputes, including powers to direct redress to be paid where appropriate.

Fees and savings

2.9 Several respondents were concerned that merchants might see a rise in fees elsewhere in an attempt by banks to recoup costs lost from interchange fee caps. The IFR mandates that acquirers must provide a breakdown of the merchant service charge for its merchant customers (unless a merchant requests otherwise). This will ensure that fees are transparent.

2.10 Furthermore, under article 5, the IFR contains a 'prohibition of circumvention' provision, which considers interchange fees to be:

> "any agreed remuneration, including net compensation, with an equivalent object or effect of the interchange fee, received by an issuer from the payment cards scheme, acquirer or any other intermediary in relation to payment transaction or related activities."[4]

In practice, this provision will prevent acquirers substituting interchange fees with an alternative fee. The PSR will set out in a consultation how it intends to monitor compliance with the IFR, which also covers prohibiting circumvention.

2.11 Some respondents also asked how the government can be assured that savings gained by merchants will be passed onto consumers. In its impact assessment, the European Commission looks at international comparisons to demonstrate how customers have benefited from reduced interchange fees in other countries following the introduction of caps.[5] The IFR also requires the European Commission to review the IFR by 2019, which includes looking at "the levels of merchant pass-through of the reduction in interchange fee levels".[6]

[4] IFR, article 5

[5] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0550&from=EN

[6] IFR, article 17 (d)

3 National Discretions

3.1 As set out in the consultation document, the IFR offers national discretions in three key areas. Member States can:

- decide to implement lower interchange fee caps for domestic credit card transactions than the caps set out in the IFR;
- decide to implement lower caps on interchange fees for domestic debit card transactions than the caps set out in the IFR. There are also other flexibilities in the way Member States can apply interchange fee caps for domestic debit card transactions, such as being able to apply a weighted average for a period of up to of 5 years; and
- Member States can exempt three party card systems that use issuers or acquirers from caps to interchange fees for a period of up to three years, provided that the scheme's market share remains below 3% in that Member State.

3.2 This section sets out the government's final approach to each of these national discretions.

Credit card transactions

3.3 In the consultation document, the government set out that it proposed to cap the interchange fee for domestic credit card transactions at 0.3%, in line with the default caps set out in the IFR. The vast majority of respondents agreed with this approach, noting that a rate of 0.3% in the UK would reduce credit card interchange fees by a considerable amount, representing a significant saving to merchants.

3.4 Some respondents commented that the government should monitor the effects of the reduction in fees on the credit card market. A number of respondents also commented that the government should monitor the impact of this reduction in credit cards fees to ensure that benefits of the reduction are being passed on to merchants from acquirers, and in turn to customers. The government notes that the European Commission is required to review the impact of the IFR on the European market and publish a report by 9 June 2019. This report will look at the impact of the IFR, including factors such as competition, effect on merchants and consumers and will take account of new technology and business models. The UK government, working with the PSR and the FCA, will ensure it gathers evidence to feed into this review.

3.5 The FCA is also undertaking a thorough review of the credit card market to assess whether competition is effective and whether consumers have access to credit cards that are affordable and deliver value for money. This review will also take into account the impact of the IFR. The FCA has published its terms of reference for the study and will produce an interim report in the autumn.

3.6 On this basis, the government's position remains that interchange fees for domestic credit card transactions should be capped at 0.3% per transaction.

Debit card transactions

3.7 In the consultation document, the government proposed to exercise the national discretion to allow card schemes to set a weighted average rate for domestic debit transactions. This means that interchange fees cannot exceed more than the equivalent of 0.2% of the annual overall transaction value of all domestic debit card transactions within each payment card

scheme. Following consultation, the government confirms that it will allow card schemes the flexibility to implement a weighted average approach for domestic debit card transactions.

3.8 The rationale behind this decision is to provide industry with flexibility with regards to the application of interchange fees. Under this approach, card schemes will be able to choose to implement a weighted average approach, implement the default 0.2% per transaction option, or in fact choose a lower rate than 0.2% as either a flat rate or weighted average.

3.9 The current predominant UK model for applying interchange fees sees a system where lower fees are applied to new, innovative payment methods, such as contactless, to encourage greater uptake. Maximum rate caps are in place for the vast majority of transactions (50p for secure transactions and £1 for unsecure transactions). Therefore, banks can continue to apply interchange fees in the same way as they do currently in the vast majority of cases.

3.10 Overall, there were mixed views on the weighted average approach, although more consultation respondents were in support of this approach than against it. Respondents commented that allowing schemes the flexibility to apply a weighted average means that banks could choose to introduce maximum rate caps. These caps prevent high fees being incurred for higher value transactions, and would therefore provide more security to those businesses and retailers which offer products and services of a higher monetary value.

3.11 Other respondents noted that there was a clear benefit in allowing an approach which meant that the rate for many transactions will remain as it is. Given there is little time for industry to cater for changes before the implementation date, a short-term, interim solution which allows the status quo to remain for the majority of transactions will be the least disruptive approach. Another benefit noted was that the government's approach allows for the possibility of differentiation by card schemes, which could have a positive impact on competition in the market.

3.12 A number of respondents did not agree with the government's proposed approach on the basis that the weighted average system is too complicated for the various parties to understand. The government recognises this concern and as such, the PSR is considering how it proposes to regulate and monitor the weighted average approach. It will provide greater clarity to the market in due course.

3.13 Respondents also commented that for some transactions, UK domestic interchange fees would be higher than the cross-border rate and the rate in some other Member States. Therefore, some merchants may be incentivised to acquire on a cross-border basis. The government notes that UK merchants, in some cases, already acquire on a cross-border basis to benefit from lower interchange fees, and it remains their choice to do so in a competitive European market.

3.14 It is important to note that this is an interim measure that can only be applied for a maximum period of 5 years. The PSR launched a programme of work in April 2015, part of which looks at the impact of the IFR, as well as other trends and issues within the card payments sector. This programme of work is expected to last for around 12 months. The government may reconsider this position once the impact of the IFR becomes clear. Three party schemes that use issuers or acquirers

3.15 In the consultation, the government proposed to exercise the exemption for three party schemes that license with other payment service providers which issue payment cards or acquire payment transactions on their behalf. Overall, respondents who replied to this question were in favour of this approach.

3.16 Those in favour of exercising the exemption agreed that a transitional period is crucial to allow for changes to the specific arrangements which make up the business models of those

three party schemes which license. This will allow these schemes time, for example, to renegotiate the fees that underpin the licensing agreements they hold with issuers and acquirers. One respondent commented that without time for these smaller schemes to develop a viable business model, the IFR would make it difficult for them to operate in the UK and therefore damage the potential for competition in the payments card market.

3.17 Other respondents were also concerned about the impact on the market if the exemption was not exercised. One respondent commented that without exercising the exemption, there would be different regulatory treatment between 'pure' three party schemes (which acquire and issue as a single entity without licensees and are automatically exempt from interchange fee caps) and licensee three party scheme models. The respondent thought that this would cause confusion for both customers and merchants, and therefore supported the government exercising the exemption.

3.18 Some respondents thought that an exemption would allow three party schemes which license with payment service providers to charge higher fees to merchants. However, there is no obligation on merchants to accept these cards given that they are not considered to be 'must take'. Rather, merchants have a choice on whether they accept three party scheme cards or not, given they are not ubiquitous in the same way as other dominant market brands, and must fall beneath a 3% market share in order to qualify for the exemption. Additionally, one respondent commented that higher fees charged by three party schemes would, in any case, come under downward pressure in the UK market due to competition once the IFR caps on debit and credit cards come into force

3.19 Other respondents argued that these schemes should be treated as four party card schemes so not to give them a competitive advantage. However, it is important to note that this exemption can only be applied to schemes which have less than a 3% market share, and so are smaller players in the market. The PSR will gather the information and undertake an assessment of whether a three party scheme operating with licensees exceeds a 3% share of the market. If a three party scheme which licenses moves over this threshold, they will be subject to the interchange fee caps.

3.20 On balance, the government's position remains that it will exercise the exemption for three party schemes which use issuers and acquirers. However, the government will be able to revisit the decision to exercise this exemption within the maximum three year period should it deem it appropriate to do so.

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