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Open consultation

Interchange fee regulation: a consultation

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1. Introduction

1.1 The subject of this consultation

This consultation invites views on the government's proposed steps to meet the UK's obligation to put in place an adequate and efficient regulatory regime to supervise compliance with the 'Interchange Fee Regulation' (IFR). It also seeks views on exercising the national discretions the IFR affords to member states; namely the way in which member states apply and set caps to interchange fee rates, and, based on an assessment of market shares, the application of a time-limited exemption period of up to 3 years to three-party card systems that use issuers or acquirers.

1.2 Who should read this?

This consultation should be read by those who will be affected by the IFR coming into force. This could be any individual, firm or group that is a stakeholder in the UK payments market including: banks, card schemes, merchant acquirers, business groups, consumer groups, and other interested parties.

1.3 Background to the regulation

On 29 April 2015, the European Parliament and the Council of the European Union adopted the IFR. This was published in the Official Journal of the European Union on 19 May 2015. Provisions within the IFR take effect on different dates. The interchange fee caps come into effect on 9 December 2015 and the majority of provisions relating to business rules on 9 June 2016.

The key objective of the IFR is to cap interchange fees, which are set centrally by the card scheme and which merchants have limited negotiating power over. These fees are paid from the merchant acquirer (the merchant's bank) to the card issuer (the cardholder's bank), as a percentage of each transaction made by the card-holder and form part of the package of fees that merchant acquirers charge to merchants. To prevent circumvention of the regulation through an alternative flow of fees, the IFR treats the 'net compensation' (fees paid or received by the issuer from or to a card scheme, an acquirer or any other intermediary) as an interchange fee.

The intention of the cap on interchange fees is to redistribute revenue from issuing banks to merchants and on to consumers. The European Commission has estimated that interchange fees amount to £1 billion per annum in the UK, although some analysis estimates that the figure could be double this. 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.

The government is clear that merchants are expected to pass these savings onto consumers in the form of lower prices.

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

Although the IFR is directly applicable, it provides national discretions in 3 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 to domestic debit card transactions, such as being able to applying a weighted average for a period of up to of 5 years
- member states can exempt three-party card systems that use issuers and/or acquirers from caps to interchange fees for a period of up to 3 years, provided that the scheme's market share remains below 3% in that member state

1.4 How did the Commission set the cap levels?

In 2013, the European Commission published in its Explanatory Memorandum its rationale for recommending that interchange fees should be capped at 0.2% for debit card transactions and 0.3% for credit card transactions across the EU. These cap levels were set using the so-called 'Merchant Indifference Test' (MIT). The test is passed if interchange fees are set at a rate which renders a merchant indifferent to whether it is accepting a card or cash payment. This model was introduced because, in certain circumstances, accepting cash is cheaper than accepting cards, which dissuades merchants from accepting cards. Using the MIT methodology to set interchange fee rates should, therefore, help to set a rate which encourages greater card use.

The European Commission also argued that that the 0.2% and 0.3% levels are proportionate as they provide benefits for merchants (in the form of lower fees passed on from acquirers) and consumers (in the form of lower prices, which should be passed on from merchants). Yet, they do not "call into question the operation of international card schemes and payment service providers"¹.

1.5 UK approach to negotiations on the 'Interchange Fee Regulation'

A key part of the government's long term economic plan is to build a more competitive banking sector to ensure consumers and businesses can gain access to the high quality banking services and products they need.

This was taken into account by the Prime Minister's EU Business Taskforce, which published a report in 2013 on reducing red tape. This report drew on evidence from 90 UK businesses and business organisations, and over 20 business organisations across Europe. It sets out a range of proposals to ensure that the EU single market makes it easy for businesses in Europe to trade across borders, and to ensure that the EU regulatory framework is, and remains, competitive in the global market place.

One of the key recommendations was the capping of interchange fees. The taskforce noted that smaller businesses often pay higher rates than larger companies as they lack the financial power to negotiate better terms. Retailers can be unaware of the exact cost of interchange fees until after they are billed, which significantly increases risk and uncertainty, particularly for SMEs.

In order to avoid these potential negative outcomes for businesses, the UK was a key supporter of the IFR during negotiations and supported swift implementation and flexibility on interchange fee caps so that the UK could choose caps to suit its own market.

2. The regulatory regime

2.1 UK proposed approach to implementing the regulatory regime

The terms of the IFR require member states to designate a competent authority that is empowered to supervise the IFR and grant the competent authority appropriate investigation and enforcement powers in order to do so.

It is the government's intention to designate the Payment Systems Regulator (PSR) as the overarching regulator for this purpose. The PSR launched on 1 April 2015 and is the economic regulator of payments systems in the UK. Its 3 objectives are to:

1. ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them
2. promote effective competition in the markets for payment systems and services – between operators, payment service providers and infrastructure providers
3. promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems

The PSR is the entity best-placed to supervise compliance with the IFR, given its expertise and oversight of the UK payments market. It also has statutory powers to request information from the operators, infrastructure providers and participants of any UK payment system in relation to its work. However, there are modifications and additions required to the PSR's existing powers to ensure that it can fulfil this role adequately.

To ensure the government implements an efficient and effective regulatory regime, it plans to assign a role to other regulatory bodies where IFR provisions fall under the scope of existing regulatory bodies. Although the PSR will be the overarching regulator, other bodies can act in conjunction with the PSR to address issues which span multiple remits.

The government's intended approach to the regulatory regime is as follows:

- monitoring and enforcement powers. The government's proposal is that a regime based closely on the enforcement regime that currently exists under the Financial Services Banking Reform Act 2013 would be appropriate. Some modifications and additions will need to be made to ensure that the PSR is fully equipped to supervise compliance with the IFR. This includes minor amendments to its powers to:
 1. make general directions
 2. enable the PSR to take action to correct compliance failures
 3. act on compliance failures and complaints
 4. conduct investigations and make requests for information
 5. raise fees and statutory immunity
- penalties regime: The government's proposal is that a penalty regime based closely on the existing regime under the Financial Services Banking Reform Act 2013 would be appropriate. Some modifications and additions will need to be made to ensure that the PSR is fully equipped with the necessary powers to apply penalties to enforce compliance with the IFR
- assign a role to the Financial Conduct Authority (FCA). The government intends to assign a role to the FCA where certain provisions of the IFR overlap with the FCA's existing remit, specifically where it crosses over with the FCA's role as supervisor under the UK Payment Services Regulations 2009. This applies to the following articles of the IFR: 8(2), 8(5), 8(6), 9(1), 9(2), 10(1), 10(5), 11(1), 11(2), 12(1) and 12(2). This will prevent unnecessary additional costs being incurred by the PSR, given that it would need to equip itself for a role already conducted by the FCA
- assign a role to Trading Standards. The government intends to assign a role to the relevant Trading Standard bodies for a provision which falls under the Honour All Card Rule under article 10 of the IFR. This provision obliges merchants to display clearly to their customers which cards they accept, be it in a shop or online. The PSR or FCA are not best placed to monitor compliance with this obligation as they do not have existing channels through which they interact with these types of

businesses. The supervision of compliance of this kind is closer to the enforcement activity currently undertaken by Local Authority Trading Standards bodies. The government envisages that oversight of this provision will be monitored through complaints made to local Trading Standards offices; this will ensure that there is sufficient yet proportionate regulatory oversight. Any disciplinary action will be taken in conjunction with the PSR

- an appellate body is required to hear appeals against decisions taken by regulators in relation to the IFR. The government intends to assign a role to the Competition Appeals Tribunal (CAT) to hear appeals against penalties imposed and other decisions made by the PSR. The CAT is already the appellate body for some of the PSR's activity. The type of appeal we expect to be in relation to the IFR would be very similar to those already made to the CAT and will be dealt with in a similar way
- out-of-court-redress procedures. The government intends to provide powers to the PSR to establish an out of court redress procedure allow them to adjudicate on business-to-business disputes beyond its enforcement role for breaches of the IFR, including powers to order redress to be paid, for example, where resolution cannot be agreed

Question 1

Do you agree with the government's approach with respect to the design of the regulatory regime for the supervision of IFR?

3. National discretions

The IFR provides for 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 transaction, such as being able to apply a weighted average for a period of up to of 5 years
- member states can exempt three-party card systems that use issuers and/or acquirers from caps to interchange fees for a period of up to 3 years, provided that the scheme's market share remains below 3% in that member state

This section sets out the government's intended approach to each of these discretions.

3.1 UK proposed approach to setting interchange fee caps for credit cards

The final text of the IFR reflects the European Commission's original proposal for credit cards, and caps interchange fees at 0.3%. Therefore, a maximum of 0.3% will be charged per credit card transaction for both cross-border and domestic transactions. This rate is based on the MIT (see section 1.4 for more details), and is consistent with previous commitments made by card schemes and in negotiations between French competition authorities and Groupement des Cartes Bancaires.

The IFR allows member states to define a lower interchange fee cap than 0.3% for domestic credit card transactions. This is to account for differences in national payment markets across the EU. The current rate of credit card interchange fees in the UK is approximately 0.85% per transaction on average; therefore merchants will see significant savings. However, this rate will still allow banks to recoup costs incurred for processing credit card transactions, and it also recognises the credit risk banks take on in offering credit cards.

The government does not intend to implement a lower cap for domestic credit card interchange fees than the default 0.3% cap provided for in the IFR at this stage. A rate of 0.3% will align cross-border and domestic interchange fee rates, meaning greater coherence and consistency across the EU.

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 the appropriateness for the UK market of introducing a lower cap on credit interchange fees following the completion

of this work.

Question 2

Do you agree with the government's suggested approach with regards to the interchange fee caps for credit card transactions?

3.2 UK proposed approach for setting interchange fee caps for debit cards

The IFR sets a maximum interchange fee of 0.2% that can be charged per debit card transaction for both cross-border and domestic transactions. As with the credit card rate, this rate was based on the MIT (see section 1.4 for more details). However, the IFR also allows for other flexibilities for domestic debit card transactions, including an option for member states to implement a cap lower than 0.2% (as is the case for credit card rates), or apply a weighted average for a period of 5 years.

The government could choose to harmonise rates for cross-border and domestic transactions by implementing the 0.2% cap for domestic transactions, and therefore ensure greater consistency (as is the intended approach for credit card rates). However, adopting this approach would mean that a large number of merchants would end up paying higher interchange fees than they do today under the current predominant UK model. This is because the rates set by the card scheme which processes the vast majority of debit card payments in the UK (97%) caps the maximum amount a merchant can pay in interchange fees for a given transaction². These maximum rate caps mean that merchants do not currently face higher fees than 50p or £1, even for very high value transactions.

As such, the government intends to allow payment service providers to apply a weighted average. This means that interchange fees cannot exceed more than the equivalent of 0.2% of the annual average transaction value of all domestic debit card transactions within each payment card scheme. This will allow the status quo to be maintained for the vast majority of transactions and will help to provide an easier transition when the IFR caps come into effect on 9 December 2015.

Given that the weighted average can only be applied for a maximum period of 5 years, the government will take a further decision on rates by 2020. This will be informed by the PSR's programme of work launched 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 and is expected to last for around 12 months. The government may reconsider the appropriateness for the UK market of introducing a lower cap on debit interchange fees following the completion of this work.

Question 3

Do you agree with the government's suggested approach with regards to interchange fee caps for debit card transactions?

3.3 UK proposed approach to three-party card schemes with licensees

The predominant card scheme model in the UK is the so-called 'four-party card scheme'. This consists of an issuing bank, an acquiring bank, a merchant retailer and a cardholder. Most four-party card schemes require the acquirer to pay an interchange fee to the issuer every time a transaction is made. In the case of 'three-party card schemes', there are no banks involved in the issuing and acquiring of cards and the card scheme plays the role of both issuer and acquirer. Given there is no explicit interchange fee in this model (rather, fees are negotiated bilaterally between the card scheme and merchants) three-party cards schemes are exempted from the interchange fee caps.

In some instances, three-party cards schemes may choose to use payment service providers to issue its cards, rather than the card scheme issuing these cards directly to consumer, which improves coverage of that particular card type. Similarly, a three-party scheme may choose to use a payment service provider to acquire cards on its behalf. These licensing agreements are underpinned by bilaterally negotiated fees.

The IFR states that where a three-party payment card scheme uses a payment service provider for issuing or acquiring cards (or both), it is considered to be a four-party payment card scheme, and therefore the bilaterally negotiated fee is subject to the same caps.

However, member states can exempt three-party schemes which use issuers and acquirers from the interchange fee caps

provided that the card scheme's payment transactions made in a member state do not exceed a 3% market share across all card products. This is a time-limited exemption which can be exercised for a maximum of 3 years, after which three-party schemes which use issuers and acquirers will be subject to the IFR fee caps.

The government intends to exercise this time-limited exemption to provide a transitional period in which three-party schemes which use issuers and acquirers can adjust their business models. The government understands that this transitional period is necessary due to changes that need to be made to the specific arrangements which make up this model. This will allow three-party schemes which use issuers and acquirers time, for example, to renegotiate the fees that underpin the licensing agreements they hold with issuers and acquirers.

The PSR conducts regular horizon-scanning of the UK payments market to see whether payment systems which are unregulated might be eligible for designation under the Financial Services (Banking Reform) Act 2013. To carry out this activity, the PSR has powers to request information from any UK payment system. The PSR is therefore well-placed to monitor the market share of UK card schemes, and to assess whether any three-party scheme exceeds a 3% share of the market. If any three-party scheme moves over this threshold, they will be subject to the interchange fee caps.

Question 4

Do you agree with the government's position with respect to exercising the time-limited exemption for three-party schemes which use issuers and acquirers?

4. Consultation questions

Question 1

Do you agree with the government's approach with respect to the design of the regulatory regime for the supervision of IFR?

Question 2

Do you agree with the government's suggested approach with regards to the interchange fee caps for credit card transactions?

Question 3

Do you agree with the government's suggested approach with regards to interchange fee caps for debit card transactions?

Question 4

Do you agree with the government's position with respect to exercising the time-limited exemption for three-party schemes which use issuers and acquirers?

5. How to respond

The Treasury invites responses on the questions raised. The questions can be found throughout the document and are also listed in section 4. This consultation will run from 27 July 2015 to 28 August 2015.

Responses can be sent by email to ifrconsultation@hmtreasury.gsi.gov.uk

Alternatively they can be posted to:

Interchange fee regulation consultation
Banking and credit team
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When responding please say if you are a business, individual or representative body. In the case of representative bodies, please provide information on the number and nature of people you represent.

1. <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0550&from=EN> (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0550&from=EN>) ←
2. 50p for secure transactions and £1 for unsecure transactions ←