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Michele Bullock
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Mr Jason Lange
Executive Director
Office of Best Practice Regulation
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By Email – helpdesk@obpr.gov.au

Dear Mr Lange

Regulation Impact Statement – Review of Retail Payments Regulation – Second Pass Final Assessment

I am writing in relation to the attached Regulation Impact Statement (RIS) prepared for the Reserve Bank's Review of Retail Payments Regulation.

I consider the RIS meets the requirements set out in the *Australian Government Guide to Regulatory Impact Analysis* and is consistent with the six principles for Australian Government policy makers. I am satisfied that the RIS addresses the comments in your letter of 7 September 2021. In particular, we have quantified all regulatory costs (to the extent possible) and described the underpinning assumptions. We have also explained the status of the RIS at each of the major decision points in the policy development process, including whether the RIS was used to inform each of these major decisions. For your convenience we have attached a marked up version of the RIS with your comments and our amendments highlighted.

The RIS addresses the seven RIS questions:

1. What is the policy problem?

The Bank has identified policy issues in three key areas:

Dual-network debit cards and least-cost routing

The majority of debit cards in Australia are DNDCs, which allow domestic debit payments to be processed via either the domestic scheme or one of the international debit networks. LCR is functionality that allows merchants to process contactless ('tap-and-go') DNDC transactions through whichever network on the card costs them less to accept. This choice can help merchants reduce their payment costs and increase competitive pressure between the debit networks. Given their potential benefits for competition and efficiency in the payments system, the Bank has strongly supported the issuance of DNDCs and the provision of LCR functionality to merchants.

However, despite the benefits of LCR, awareness and take-up of the functionality by merchants has remained low. There are also a number of emerging challenges to the long-run viability of LCR. One key concern is the growing number of small and medium-sized card issuers choosing to issue single-

network debit cards (SNDCs) instead of DNDCs. SNDCs only allow payments to be processed through the one debit network on the card, which prevents LCR. The Bank is concerned that a significant reduction in DNDC issuance would limit the benefits of LCR and make it unattractive for many merchants. Another issue is the rapid growth of transactions made using mobile wallets, because LCR is currently not technically possible for such transactions. Some merchants have also alleged that the international schemes have been dis-incentivising the take-up of LCR by making low 'strategic' interchange rates on credit card transactions conditional on the value or volume of a merchant's debit card transactions ('tying conduct'). Finally, there are risks that the development of LCR for online transactions may be hindered by some participants in the payments system.

Interchange fees

Interchange fees are wholesale fees set by the card schemes that are paid by acquirers to card issuers on each card transaction. They are passed on to merchants and are a significant component of merchants' cost of accepting card payments. Under the Bank's standards, card schemes must comply with weighted-average interchange fee benchmarks, as well as caps on individual interchange rates. The Bank's view is that the current interchange settings are generally working well, and does not see a public policy case for lowering the weighted-average benchmarks or the credit card cap at this time.

However, the Bank has identified two issues that may warrant further policy action. First, there has been an increasing tendency for interchange fees on certain debit transactions at smaller merchants to be set at the cents-based cap of 15 cents, and is concerned that this can result in smaller merchants facing unreasonably high costs for some low-value transactions (for example, a 15-cent interchange fee on a $15 transaction is equivalent to 1 per cent of the total value of the transaction, which is significantly higher than would apply based on the ad valorem cap on debit transactions of 0.2 per cent). The second issue is interchange fees on foreign-issued card transactions, which are significantly higher than those on domestic cards. With foreign-issued cards representing an increasing share of card payments at Australian merchants over the past decade, there may be a public policy case to expand the Bank's interchange standards to include transactions on foreign-issued cards.

Scheme fees

Scheme fees are payable by both acquirers and issuers to the card schemes for the services they provide. They are an important component of the costs faced by merchants in accepting card payments (because they are passed on by acquirers), as well as the costs borne by issuers for providing card services to their customers. The Bank has held concerns for some time about the opacity of scheme fee arrangements to end-users of the payments system, with some indications that this has allowed for scheme fees to increase over recent years. The opacity could also, in principle, make it easier for schemes to implement fees or rules that may be anti-competitive or have the effect of circumventing the Bank's interchange fee regulation. Addressing these concerns through greater transparency of scheme fees could help improve efficiency and promote competition in the payments system.

2. Why is government action needed?

Dual-network debit cards and least-cost routing

Given the competition and efficiency benefits that flow from DNDCs and LCR, the Bank considers that policy action might be warranted to address the emerging threats to their viability. In particular:

- **DNDC issuance.** The Bank understands that for any individual issuer, supporting two debit networks imposes additional costs that may not always be fully offset by the benefits to that issuer. The trend for some issuers to make the commercial decision to move from DNDCs to SNDCs is therefore likely to continue under the status quo. Since a widespread shift towards SNDCs could threaten the viability of LCR, reduce competition between the debit schemes, and

impose significant efficiency costs on the system as a whole, the Bank considers that policy action to limit the shift to SNDCs is necessary.

- **Tying conduct.** The Australian Competition and Consumer Commission (ACCC) has recently carried out some investigations into alleged 'tying conduct' by the international schemes, which has resulted in a short-term court-enforceable undertaking from Visa that it would not engage in such conduct. While the ACCC would obviously retain the ability to take ex post enforcement action after anti-competitive conduct has occurred, there may be some merit in the Bank putting in place an ongoing regulatory requirement that would make it clear that all schemes should not engage in tying conduct.
- **Provision of LCR.** The payments industry has made considerable progress in developing LCR for the device-present environment without any explicit regulatory requirements. However, the low take-up of LCR by merchants, combined with the growth of (non-routable) mobile-wallet transactions, suggests that policy action to promote the provision and merchant awareness of LCR may be required to increase the cost savings for merchants and the competitive tension between the debit schemes. Given the risk of some market participants hindering the development of LCR for online transactions, there may also be a case for policy action to encourage and support the provision of LCR functionality online.

Interchange fees

The Bank regulates interchange fees because competitive forces in the card payments market do not have the usual effect of bringing costs down. The interchange standards are working well, and have contributed to a significant decline in merchants' average cost of accepting card payments over the past two decades. However, the setting of debit interchange rates at the cents-based cap results in unreasonably high costs for some low-value debit transactions at smaller merchants. The Bank's assessment is that this practice is likely to persist in the absence of regulatory action, so a change to the Bank's card regulations is necessary to address this issue.

The impact of foreign-issued cards on system-wide payment costs does not appear to be significant at this point in time, as these cards still account for a low share of total card payments in Australia. However, given the significantly higher cost of foreign card transactions, there is a public interest case for low-cost regulatory intervention to increase the competitive pressure on such fees.

Scheme fees

The Bank generally views transparency as an important mechanism for improving efficiency and promoting competition in the payments system. In the absence of greater transparency, scheme fees could continue to increase and lead to higher payment costs for merchants, particularly if the competitive pressure arising from DNDCs and LCR were to lessen. Schemes may also find it easier to implement changes to scheme fee schedules or related rules that may be anti-competitive or have the effect of circumventing the interchange fee regulations. There is also a case for greater transparency of scheme fees to end-users to improve price signals in the payments market. For example, it could improve merchants' understanding of the costs of accepting different card schemes, helping them make more informed routing decisions. However, greater transparency of scheme fees is unlikely to materialise without policy action.

3. What are the policy options being considered?

In the Consultation Paper published in May 2021, the Bank proposed a number of options for regulatory reform across the key policy issues outlined above. These proposals were informed by the extensive consultation with stakeholders that the Bank had undertaken during the preceding 18 months. For most of the policy issues, the Bank has proposed three broad options, which represent varying degrees of regulatory response. These options are listed below.

Dual-network debit cards and least-cost routing

- **Option 1 (status quo)**: No change – business as usual.
- **Option 2**: The Bank would state an explicit expectation that the major banks would continue to issue DNDCs, with the two card schemes to be provisioned in all form factors. The interchange cap for SNDC transactions would also be set lower than for DNDC transactions, to prevent schemes from providing issuers with interchange-based incentives to issue SNDC. The Bank would seek voluntary undertakings from card schemes that they will not engage in tying conduct. The Bank would also state an explicit expectation that all acquirers and payment facilitators would offer and promote LCR functionality to merchants in the device-present environment, and periodically report to the Bank on their LCR offerings and on merchant take-up. The Bank would set out a list of principles that it expects the industry to follow to prevent the erection of barriers to the development and adoption of LCR online.
- **Option 3**: The Bank would formally require all issuers above a certain size threshold to issue only DNDCs, with two card schemes to be provisioned in all form factors. The Bank would also formally require acquirers and payment facilitators to offer LCR functionality for both device-present and online DNDC payments. The proposals regarding tying conduct in Option 2 would also apply.

Interchange fees

- **Option 1 (status quo)**: The current debit interchange caps would remain, and there would be no regulation of interchange fees on foreign-issued cards.
- **Option 2**: The Bank would reduce the cents-based debit interchange cap from 15 cents to 10 cents for DNDC transactions and 6 cents for transactions on SNDCs, and require the publication of interchange fees on foreign-issued cards (but no regulation regarding fee levels).
- **Option 3**: The Bank would require all debit interchange fees to be set in ad valorem terms, and would extend interchange regulation to include caps on foreign-issued card transactions.

Scheme fees

- **Option 1 (status quo)**: No scheme fee disclosure requirements.
- **Option 2**: Schemes would be required to publish all scheme fee rates and rules on their websites.
- **Option 3**: Schemes would be required to disclose to the Bank all scheme fee rates and rules, as well as aggregate data on scheme fees paid by Australian scheme participants, with the Bank to consider publication of some aggregate data. Larger scheme participants would also be required to report total scheme fees paid and rebates received to the Bank annually.

4. What is the likely net benefit of each option?

Dual-network debit cards and least-cost routing

Under **Option 1**, the trend for some issuers to make the commercial decision to move from DNDCs to SNDCs is likely to continue. Also, if regulators continued to rely only on ex post investigation and enforcement action, the international schemes may continue to engage in tying conduct when negotiating contracts with large merchants. Schemes or other market participants may also impose rules or behave in ways that would deter the development of LCR for online DNDC transactions. All of these developments could threaten the viability of LCR, reduce competition between the debit schemes and impose significant efficiency costs on the system as a whole. Even if LCR were to remain viable, merchant awareness – and therefore take-up – of LCR functionality would likely remain low as the major acquirers may have little incentive to promote it.

Option 2 would ensure reasonably broad-based issuance and usability of DNDCs in all form factors (including mobile wallets), while allowing smaller issuers to make their own commercial decisions about their debit card issuance. However, changes to the interchange regulations would limit the capacity of schemes to encourage SNDC issuance through interchange-based incentives. It is therefore likely that many small issuers would continue to issue DNDCs, so a large majority of debit cards would remain dual-network. The commercial case for merchants to adopt LCR would be greater than under Option 1 but less than under Option 3. Since only the major banks would be expected to issue DNDCs, the regulatory burden of this policy approach would be minimal. Obtaining open-ended voluntary undertakings from the international card schemes regarding tying conduct would likely be more effective than the status quo at preventing such conduct from taking place, ensuring that merchants would be better placed to take advantage of LCR for debit transactions (and thereby lowering their payment costs). An explicit expectation on acquirers and payment facilitators to offer and promote LCR functionality would help increase awareness and take-up of LCR by merchants, increasing the cost savings for merchants. The benefits of LCR will diminish as (non-routable) mobile wallet transactions continue to grow, but enabling LCR for mobile wallets would be very expensive and time-consuming. Setting out guidance on how LCR for online transactions should work would ensure that schemes and other market participants cannot set up unreasonable barriers to its implementation. This would help support the industry-led development of online LCR, which is expected to generate material competition and efficiency benefits in the online payments environment. However, there are concerns that the major acquirers may not prioritise the development of LCR online without regulatory pressure, which could limit or delay the potential cost savings for merchants. Although acquirers and schemes would have some periodic reporting requirements under Option 2, the compliance costs would be relatively low.

Under **Option 3**, all mid-sized and potentially some smaller issuers would be required to issue DNDCs. This would provide greater competition and efficiency benefits, including more assurance that LCR would remain viable, although the size threshold for DNDC issuance might have to be set at a very low level if the intent was to ensure that LCR would be attractive for most large merchants. However, this option would impose additional costs on the mid-sized and smaller issuers that would have otherwise switched (or have already switched) to issuing SNDCs. Formal regulation requiring LCR to be offered in the device-present environment is judged to be unnecessary to drive improvements in the availability or functionality of LCR, given the progress made by the industry to date and the likely impact of further competition between acquirers. Formally requiring LCR to be offered for online transactions would be expected to help lower payment costs for merchants, though formal regulation would be complex and may impose additional costs on industry participants. An alternative option of stating an expectation that industry participants would develop online LCR functionality within a defined period would help ensure the broad-based availability of online LCR for merchants (and hence the associated benefits) within a reasonable timeframe, while giving greater flexibility to industry participants and therefore reducing the regulatory costs.

Interchange fees

Under **Option 1**, schemes are likely to continue setting interchange rates for some non-routable debit transactions at the cents-based cap of 15 cents, resulting in smaller merchants facing unreasonably high costs for some low-value debit transactions. The international schemes will also be able to continue setting high interchange fees on foreign-issued card transactions without any competitive pressure. If the share of card payments in Australia made using foreign-issued cards continues to grow, this would likely put upward pressure on system-wide payment costs.

Option 2 would directly reduce the interchange fees paid by acquirers on a range of transactions, which would be expected to flow through to lower payment costs for smaller merchants (and subsequently lower prices for their customers). This would also affect the distribution of payment costs across merchants, reducing the disparity between the cost to small and large merchants for accepting similar transactions. Since the weighted-average benchmark for debit interchange fees

would not change, card schemes would be free to adjust their interchange schedules to maintain issuers' interchange revenue. However, smaller issuers of SNDCs may be particularly penalised by the lower interchange cap for SNDCs, adversely affecting their ability to compete. Requiring schemes to publish their interchange fees on foreign-issued card transactions acquired in Australia would give all participants in the Australian payments industry visibility of such fees, which could potentially contribute some modest downward pressure on these fees. Overall, this option would not impose material additional compliance costs on the industry.

Requiring all debit interchange fees to be set on an ad valorem basis under **Option 3**, would also achieve the policy objective of lowering the unreasonably high cost of accepting many low-value transactions for smaller merchants. A new ad valorem weighted-average benchmark could be set at a level that kept issuers' interchange revenues, and so average payment costs for merchants, broadly unchanged. However, this would be a reasonably significant change to the interchange framework, implying greater adjustment costs for industry participants and the potential for unintended consequences.

Applying the domestic interchange caps to foreign-issued card transactions in Australia would directly reduce the interchange fees paid by acquirers (reducing the interchange revenue of foreign card issuers). This would be expected to flow through to lower merchant payment costs and thereby lower prices for consumers. The compliance costs borne by the schemes would be very small. However, schemes and regulators in other jurisdictions could react in ways that offset the potential benefits. This option could also have some marginal adverse effect on the international schemes' ability to compete for issuers' business in some foreign markets.

Scheme fees

Under **Option 1**, the card schemes could continue to increase scheme fees on both issuers and acquirers, which could in turn put upward pressure on merchant payment costs. Schemes would also have greater ability to make changes to their scheme fees and rules that might be anti-competitive or have the effect of undermining the Bank's interchange regulations, as the Bank would have to rely on market participants to notify it of any such changes.

Option 2 would be a low-cost way of increasing the transparency of scheme fees. The compliance burden would be minimal as the Bank would only require schemes to publish the same information that is already provided to scheme participants. However, the complexity and length of scheme fee schedules means that simply publishing the schedules online is unlikely to be particularly useful to end-users (including merchants and the Bank). This option is therefore unlikely to have a significant impact on the issues identified above.

Option 3 would impose some regulatory burden on the industry, as the schemes and larger scheme participants would be required to periodically report new data to the Bank; however, stakeholder feedback suggests that the compliance burden would not be significant over the medium term. The disclosure requirements under Option 3 would also provide significant benefits. For example, they would allow the Bank to promptly identify any changes in scheme fee arrangements that might be anti-competitive or have the effect of undermining the interchange regulations. By collecting aggregated data on scheme fees and rebates, the Bank could also monitor the level and growth of scheme fees over time, and thereby the impact of scheme fees on merchant payment costs. Publishing summary data on scheme fees would also be expected to assist merchants in their negotiations with acquirers and better inform routing decisions. By increasing the competitive tension between the card schemes and between acquirers, greater visibility of scheme fees could help reduce costs for both smaller issuers and merchants (and consequently, consumers).

5. What consultation has been done?

The Bank has consulted extensively on potential options for reform of retail payments regulation. In November 2019, the Bank published an Issues Paper seeking feedback from stakeholders on a wide range of payments issues. The Bank received over 50 written submissions from financial institutions, merchants, card schemes, consumer groups and individuals. Around 25 parties took up the invitation to discuss their submissions with the Bank. In late 2020 and early 2021, the Bank conducted a large number of follow-up meetings with stakeholders about the key issues being considered as part of the Review, including those covered in this RIS.

In May 2021, the Bank published a Consultation Paper outlining proposed options for regulatory reform to address the policy problems identified in the Issues Paper. The Consultation Paper also set out the Board's preliminary conclusions on those issues and draft variations to the standards for card payment systems. In early July, the Bank received submissions to the Consultation Paper from 35 stakeholders, and subsequently held over 15 additional meetings with interested parties to discuss their submissions. The Bank also received estimates of the regulatory compliance costs that would arise under each of the potential policy options from a broad range of stakeholders.

6. What is the best option from those considered?

After wide-ranging consultation with industry and other stakeholders, and balancing the different costs and benefits, the Bank believes that the following options would best address the issues highlighted above and promote competition and efficiency in the card payments market.

- **DNDCs and LCR**: Option 2, albeit modified in three ways:
  - (a) The expectation for issuers to issue DNDCs would apply not only to the major banks, but all issuers with more than 1 per cent of the debit market (by transaction value)
  - (b) Instead of a lower cents-based interchange cap for SNDCs (than for DNDCs), the weighted-average interchange fee on SNDC transactions from a given scheme would be limited to 8 cents
  - (c) The expectation that all acquirers and payment facilitators should offer and promote LCR functionality to merchants would be extended to also include the online environment
- **Interchange fees**: Option 2, albeit modified such that the 10-cent debit interchange cap would apply to both SNDCs and DNDCs (in line with modification (b) above).
- **Scheme fees**: Option 3

7. How will you implement and evaluate your chosen option?

The Reserve Bank will publish the updated interchange standards and statements about the Bank's expectations soon after the Board makes a decision. The regulatory expectations related to DNDC issuance and device-present LCR would be effective immediately, although issuers that do not currently issue DNDCs and acquirers that have not yet developed LCR functionality would be allowed an appropriate transition period. The Bank's current expectation is that online LCR functionality would be developed by end 2022. Acquirers and payment facilitators would start reporting to the Bank on their LCR offering and on merchant take-up in early 2022. The interchange standards would be effective from January 2022 for compliance with the new cents-based debit interchange caps and the publication of interchange fees on foreign-issued card transactions. The first compliance period for the new weighted-average benchmark for SNDCs would be the four quarters to 31 December 2022. Schemes would be required to start notifying the Bank of any changes to their scheme fee schedules and rules from the beginning of 2022. Schemes and large scheme participants would be required to start providing summary data on scheme fees and rebates in August 2022.

The Bank will continue monitoring developments in the retail payments market through liaison with industry and collecting data on key indicators (including interchange fees, scheme fees and merchant payment costs). The Bank expects to conduct its next holistic review of the regulatory framework for retail payments around 2025, unless there are material developments that suggest a case for moving sooner.

The RBA has not been able to identify significant offsetting regulatory savings. In large part this reflects the relatively narrow focus of the Bank's retail payments regulation, combined with the growing complexity of the payments ecosystem, which is raising a range of new policy issues. However, throughout the Review process the RBA has considered, and actively sought feedback on, whether aspects of the existing regulations could be streamlined or abolished; this has led to some minor savings, such as the likely removal of the designation of the American Express Companion Card system, in line with feedback from stakeholders received during the Review consultation process. As set out in the RIS, the RBA has also carefully considered the additional regulatory burden on stakeholders when assessing the various policy options.

I submit the RIS to the Office of Best Practice Regulation for formal Second Pass Assessment.

If you have any further queries, please do not hesitate to contact me

Yours sincerely

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Reserve Bank of Australia