RESERVE BANK OF AUSTRALIA

EXPLANATORY STATEMENT

Standard No. 1 of 2016 The Setting of Interchange Fees in the Designated Credit Card Schemes and Net Payments to Issuers Variation 2021

Standard No. 2 of 2016 The Setting of Interchange Fees in the Designated Debit and Prepaid Card Schemes and Net Payments to Issuers Variation 2021

Standard No. 3 of 2016 Scheme Rules Relating to Merchant Pricing for Credit, Debit and Prepaid Card Transactions Variation 2021

Payment Systems (Regulation) Act 1998

This Explanatory Statement relates to the following three instruments (the **Instruments**):

- Standard No. 1 of 2016 The Setting of Interchange Fees in the Designated Credit Card Schemes and Net Payments to Issuers Variation 2021;
- Standard No. 2 of 2016 The Setting of Interchange Fees in the Designated Debit and Prepaid Card Schemes and Net Payments to Issuers Variation 2021; and
- Standard No. 3 of 2016 Scheme Rules Relating to Merchant Pricing for Credit, Debit and Prepaid Card Transactions Variation 2021.

Background

Following a comprehensive review of its regulatory framework, in May 2016 the Reserve Bank of Australia (the **Bank**) determined three standards (the **Standards**):

1. Standard No. 1 of 2016 *The Setting of Interchange Fees in the Designated Credit Card Schemes and Net Payments to Issuers* (**Standard No. 1**). Standard No. 1 came into force on 1 July 2017. A minor technical variation came into effect on 20 November 2017. Further amendments came into effect on 1 July 2019.
2. Standard No. 2 of 2016 *The Setting of Interchange Fees in the Designated Debit and Prepaid Card Schemes and Net Payments to Issuers* (**Standard No. 2**). Standard No. 2 came into force on 1 July 2017. A minor technical variation came into effect on 20 November 2017. Further amendments came into effect on 1 July 2019.
3. Standard No. 3 of 2016 S*cheme Rules Relating to Merchant Pricing for Credit, Debit and Prepaid Card Transactions* (**Standard No. 3**). Standard No. 3 came into force on 1 September 2016.

Standard No.1 sets a benchmark for average interchange fees in the designated *credit* card systems of 0.50 per cent and also a maximum level of any individual interchange rate of 0.80 per cent. It also requires designated credit card schemes to ensure that their weighted-average interchange rates are below the benchmark on a quarterly basis.

Standard No. 2 sets a benchmark for average interchange fees in the designated *debit and prepaid* card systems of 8 cents per transaction and also a maximum level of any individual interchange rate of either 15 cents or 0.20 per cent. It also requires designated debit and prepaid card schemes to ensure that their weighted-average interchange rates are below the benchmark on a quarterly basis.

Standard No. 1 and Standard No. 2 also seek to prevent the circumvention of the interchange benchmarks and caps through non-interchange payments or other incentives being provided by schemes to card issuers. Under clause 5 in both Standard No. 1 and Standard No. 2 (the **Net Compensation Provision**), broadly speaking, benefits received by an issuer (excluding interchange fees and some other payments) that have the purpose or effect of promoting the issuance and use of cards of the scheme cannot exceed the payments made by the issuer to the scheme in relation to core services of a scheme (in a financial year).

Standard No. 3 stipulates that the designated card schemes, and participants in those schemes, shall not prohibit merchants from levying a surcharge on card payments from a scheme to recover the cost to the merchant of accepting those payments. However, surcharges cannot exceed the 'permitted surcharge', which is defined in terms of a merchant's cost of acceptance for a particular scheme. The permitted surcharge is also used to determine excessive surcharges under the *Competition and Consumer Act 2010*. To facilitate greater transparency of permitted surcharges, acquirers are required to provide (either directly or indirectly via a payment facilitator) to merchants in their regular statements details of the average cost to the merchant of accepting card payments from each scheme.

The Bank has conducted comprehensive reviews of its regulatory framework every five years or so. The latest Review of Retail Payments Regulation (the **Review**) began in November 2019 with the publication of the *Review of Retail Payments Regulation: Issues Paper* (the **Issues Paper**). Some of the issues considered in the Review included the shift by some issuers towards issuing single-network debit cards (SNDCs) rather than dual-network debit cards (DNDCs); the level of interchange fees, particularly for low-value transactions and on foreign-issued cards; and the end of the major banks' American Express companion card programs.

Authority

The Standards were made under subsection 18(1) of the *Payment Systems (Regulation) Act 1998* (the **Act**). Pursuant to subsection 33(3) of the *Acts Interpretation Act 1901,* the Bank's power to determine standards under subsection 18(1) of the Act includes a power to vary any standards in a like manner and subject to the same conditions. The Instruments were made pursuant to the Bank's power under subsection 18(1) of the Act to vary the Standards.

Purpose and operation

The objective of the Instruments is to amend the Standards to give effect to certain policy decisions of the Payments System Board following the comprehensive Review, which will contribute to a more efficient and competitive payments system. The relevant policy decisions, and their rationale, are summarised below.

1. Modify Standard No. 2 to introduce a 'sub-benchmark' for SNDCs, such that the weighted-average interchange fee on SNDCs from a given scheme must be no more than 8 cents. This will limit the possibility of schemes using interchange rates to incentivise SNDC issuance, which could accelerate the shift towards SNDCs (away from DNDCs). A significant reduction in DNDC issuance would reduce the benefits of least-cost routing (LCR) for merchants; LCR is functionality that allows DNDC transactions to be processed through whichever network on the card is less costly for the merchant. Over time, this would likely impose significant costs on the payments system and broader economy due to the loss of competitive tension between the debit schemes.
2. Modify Standard No. 2 to reduce the cap on debit (and prepaid) interchange fees that are set in cents terms from 15 cents to 10 cents. This will address the unreasonably high costs faced by smaller merchants for some low-value transactions, due to the increasing tendency for interchange fees on certain debit transactions to be set at the cents-based cap.
3. Modify Standard No. 1 and Standard No. 2 to require schemes to publish interchange fees on transactions on foreign-issued credit and debit cards on their websites, to increase the transparency of these relatively high fees.
4. Modify Standard No. 1 and Standard No. 3 to remove references to the American Express Companion Card system. As a result of the introduction of the Net Compensation Provision, the four major banks

have ceased offering American Express companion cards. In light of this, the Bank will revoke the designation of the American Express Companion Card system.

5. Make a minor amendment to Standard No. 1 and Standard No. 2 to clarify when and how new issuers should begin certifying compliance with the Net Compensation Provision, consistent with earlier guidance issued by the Bank.
6. Make a minor technical revision to the definition of 'Core Service' in Standard No. 2 to cover services relating to prepaid cards, as originally intended by the Bank.

These proposals and their implementation is further explained in the *Review of Retail Payments Regulation: Conclusions Paper* (the **Conclusions Paper**) published by the Bank on 22 October 2021 and available on the Bank's website. The Conclusions Paper also contains a mark-up of the Standards, showing all the differences between the Standards as in effect before the Instruments commence on 1 January 2022 and the Standards as they will operate from 1 January 2022 (apart from some minor changes to the commencement and implementation provisions of Standard No. 2 which were subsequently made by the Bank in response to feedback from acquirers and which provide for the lower cents-based interchange cap to commence on 1 February 2022, rather than 1 January 2022).

Consultation

The Bank consulted extensively about the reform of retail payments regulation, including proposed variations to the Standards. The Issues Paper, published in November 2019, sought the views of industry participants, end users and other interested parties on a wide range of payments issues. The Bank received over 50 written submissions from a range of financial institutions, merchants, card schemes, consumer groups and individuals. Around 25 parties took up the invitation to discuss their submission with the Bank. Over the following year, the Bank conducted a large number of follow-up meetings with a broad range of stakeholders in relation to the key issues being considered as part of the Review.

In May 2021, the Bank published on its website (and announced by media release) the *Review of Retail Payments Regulation: Consultation Paper* (the **Consultation Paper**), which set out proposed variations to the Standards. The Bank received 35 written submissions to the Consultation Paper; these were published on the Bank's website with the exception of those that were submitted in confidence. The Bank subsequently held additional meetings with over 15 interested parties. In response to stakeholder feedback, the Bank amended certain proposed variations to the Standards, including with respect to the cents-based cap on interchange fees for SNDCs under Standard No. 2.

The Payments System Board approved the variations to the Standards made by the Instruments at a meeting in October 2021.

Documents

Reserve Bank of Australia (2019) *Review of Retail Payments Regulation: Issues Paper*, November

Reserve Bank of Australia (2021a) *Review of Retail Payments Regulation: Consultation Paper*, May

Reserve Bank of Australia (2021b) *Review of Retail Payments Regulation: Conclusions Paper*, October

A Regulation Impact Statement (**RIS**) was prepared and submitted to the Office of Best Practice Regulation (ref 43447) and assessed as good practice. The RIS is set out in Attachment 1.

Approved by the Reserve Bank of Australia
15 November 2021

Attachment 1

Review of Retail Payments Regulation

Regulation Impact Statement

October 2021

Contents

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1. Executive Summary

This Regulation Impact Statement (RIS) is part of the Reserve Bank's review of retail payments regulation (the Review). It presents the Bank's assessment of issues currently affecting the retail payments market, options for reform and their costs and benefits. In November 2019, the Bank published the *Review of Retail Payments Regulation: Issues Paper* (the Issues Paper) (RBA 2019). Following extensive consultation with stakeholders, in May 2021 the Bank published the *Review of Retail Payments Regulation: Consultation Paper* (the Consultation Paper) presenting options for reform and the Payments System Board's preliminary conclusions (RBA 2021). The submissions to the Issues and Consultation papers and follow-up discussions with stakeholders have contributed to the analysis and options presented in this paper. The Board will consider this RIS in making its final decisions and the Bank will publish a Conclusions Paper which, together with the two earlier papers, addresses the competition and efficiency mandate of the Bank under the *Reserve Bank Act 1959* and *Payment Systems (Regulation) Act 1998* (PSRA).

This Review has focused on a number of different elements of the retail payments market in Australia. The three key policy areas in which the Bank is proposing reforms are: dual-network debit cards (DNDCs) and least-cost routing (LCR); interchange fees; and scheme fees. While different in nature, all of these issues relate to the Bank's mandate for competition and efficiency in the payments system.

1.1. What is the policy problem?[1]

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-*

1 Another key issue that has been considered by the Review is the no-surcharge rules of 'buy now, pay later' (BNPL) providers (see RBA (2019) and RBA (2021)). However, there is uncertainty about the Bank's powers under the PSRA to impose formal regulation on BNPL providers (which has been raised by a number of BNPL providers). Accordingly, while the Board intends to state its views regarding BNPL providers' no-surcharge rules in the Conclusions Paper to the Review, it is not currently in a position to set formal regulation or a credible expectation to influence BNPL providers' behaviour (and so analysis of this issue has not been included in this RIS). A future regulatory response to BNPL providers' no-surcharge rules will likely depend on the Government's response to the recommendations of the Treasury's Review of the Australian Payments System, particularly on whether the PSRA is amended to broaden or clarify the Bank's ability to regulate entities that play a material role in facilitating payments.

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.[2] 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 the Bank 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

2 In the case of debit cards, a scheme's weighted-average interchange fee (expressed in cents) is the total value of interchange fees paid for transactions made on the scheme's cards, divided by the number of those transactions. For credit cards, a scheme's weighted-average interchange fee (expressed in per cent or basis points) is the total value of interchange fees paid for transactions made on the scheme's cards, divided by the value of those transactions. Under the Bank's standards, if a scheme's weighted-average interchange fee is above the Bank's benchmark in a relevant period, the scheme must reset its interchange fees such that its weighted-average would have been below the benchmark if the revised interchange fees had applied during the relevant period.

transparency of scheme fees could help improve efficiency and promote competition in the payments system.

1.2. 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[3] 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.

3 The 'device-present environment' refers to payments made where the card or payment device (such as a mobile phone) is physically present at the point of sale; they are also called 'in-person' payments. By contrast, 'device-not-present' payments are those made using a card or payment device that is not physically presented to the merchant; these include payments made over the internet or within an 'app'.

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.

1.3. 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. Issuers would continue to make the choice between issuing DNDCs and SNDCs based on commercial considerations (and whether to provision both DNDC networks on different form factors). Likewise acquirers and payment facilitators would be free to choose whether or not to offer and promote LCR functionality.
- **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. Other banks would be free to choose. 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.

1.4. 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 some 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).

1.5. 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.

1.6. 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 in the device-present environment 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

1.7. 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 2026, unless there are material developments that suggest a case for moving sooner.

2. Background

2.1 The Review and RIS process

The Reserve Bank's review of retail payments regulation formally started in November 2019, when the Payments System Board approved the publication of an Issues Paper. That paper sought the views of industry stakeholders and other interested parties on a wide range of payments issues. While some of the issues were directly related to the Bank's existing card payments regulation, the paper also asked whether there were any gaps in the payments system or regulatory issues that needed to be addressed outside the narrower topic of card payments. The Bank received over 50 written submissions in response to the Issues Paper, and subsequently consulted with a wide range of interested parties, including card schemes, consumer representatives, merchants, financial institutions and government.

While the Bank originally expected to publish a follow-up paper in mid 2020, the Review was temporarily suspended in March 2020 in response to the COVID-19 pandemic. The Bank recommenced work on the Review in late 2020, and the Board approved the publication of a Consultation Paper in May 2021. That paper was prepared to be broadly consistent with the requirements of an early-stage RIS. It outlined numerous options for regulatory reform to address the policy problems identified in the Issues Paper, discussed their costs and benefits, and set out the Board's preliminary conclusions on those issues. Following this extensive policy development and consultation process the Bank has refined its views and condensed its regulatory proposals into this RIS.

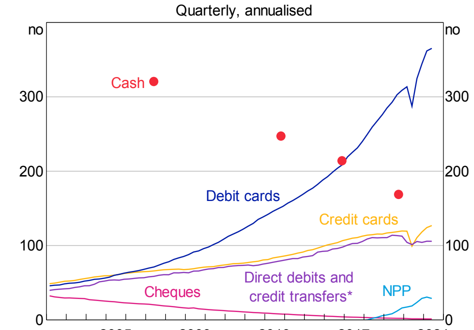
2.2 The changing payments landscape

Over the past two decades, the Australian retail payments system has moved from one where the dominant payment methods were cash and cheques to one where electronic payment methods are near-ubiquitous. In particular, there has been strong growth in the use of card payments (particularly debit cards), as well as in the use of the direct entry system and BPAY (Graph 1). The use of the New Payments Platform (NPP) has also increased markedly since its launch in February 2018 (Graph 2).

Graph 1

Transactions per Capita

Quarterly, annualised



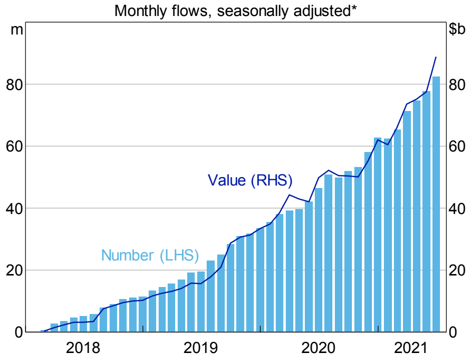
* Includes BPAY

Sources: ABS; AusPayNet; BPAY; Colmar Brunton; Ipsos; RBA; Roy Morgan Research

Graph 2

New Payments Platform

Monthly flows, seasonally adjusted*



* Excludes transactions between accounts held at the RBA for the purposes of intra-government funding transfers

Source: RBA

Innovation and new technologies have had a significant impact on the payments landscape in recent years. In some cases, such as with the NPP, new infrastructure has been developed. In other cases, new entrants have leveraged existing payment channels to widen the range of payment options available to consumers and businesses. For example, the widespread adoption of mobile phones has seen the launch of digital wallets like Apple Pay, Samsung Pay and Google Pay, which allow consumers to store a digital representation of their debit and/or credit cards in their phone or other payments-enabled device. According to the Bank's 2019 Consumer Payments Survey (CPS), contactless tap-and-go payments accounted for around 55 per cent of in-person transactions in 2019, following strong growth in preceding years; while most of these payments were made using a plastic card with contactless functionality, the share of transaction made using mobile wallets had increased notably. 'Buy now, pay later' (BNPL) services have also emerged, with very strong growth in their use over the past few years.[4]

More generally, as part of a longer-term trend, payments are increasingly taking place online or remotely, rather than face-to-face. In part, this reflects the way that purchasing habits have changed, with more shopping taking place online. Another contributing factor is the growth of online subscription services and in-app payments (e.g. where payment details are provided once and then stored – typically in tokenised form – for future use).

The COVID-19 pandemic reinforced many of these long-run trends towards cards and other forms of electronic payment. When the pandemic emerged in Australia in early 2020, businesses tended to encourage people to use cards instead of cash for face-to-face payments and, partly for hygiene reasons, many consumers preferred to tap their card or mobile phone instead of insert a card in a payment terminal. The available evidence indicates that the pandemic has led to a significant further increase in the popularity of tap-and-go payments, particularly via cards stored in mobile wallets. The share of payments being made online also increased notably during the pandemic; ABS data show that the share of retail sales conducted online increased from an average of 6.6 per cent in the second half of 2019 to 11.1 per cent in April 2020 when COVID-related restrictions were first introduced, and it has since remained elevated. While a range of COVID-related restrictions will still be affecting consumers' payment behaviour in Australia, the size of the adjustments seen to date along with international experience suggests that the pandemic has induced a permanent shift in payment behaviour.

In line with the shift towards electronic payment methods, the use of cash for transactions has declined steadily for many years. The Bank's most recent Consumer Payments Survey showed that cash was used for 27 per cent of consumer payments (by number) in late 2019, compared to around 70 per cent in 2007. While a similar survey has not been undertaken post-pandemic, a range of indicators point to a decline in transactional demand for cash since the pandemic began. This partly reflects reluctance by some consumers to use cash because of concerns about contracting the virus. As noted above, merchants also encouraged the use of electronic payments instead of cash for face-to-face transactions, and more transactions were conducted online. Notwithstanding this, the vast majority of retail businesses continue to accept cash and a significant minority of face-to-face payments are still made in cash, with some members of the community continuing to use cash extensively.

While they have not been widely used to make payments, the emergence of crypto-tokens has also attracted the attention of policymakers. These include 'stablecoins', which aim to maintain a stable

4 For further discussion of developments in the BNPL market, see Fisher, Holland and West (2021).

value relative to a specified unit of account or store of value, such as a national currency, commodity or other asset. Globally, stablecoin activity is currently concentrated in a small number of asset-backed stablecoins which are used for transactions involving tokenised assets or cryptocurrencies rather than for everyday household purchases, and the Australian market for stablecoin issuance is very small at this time. However, the potential for stablecoins to quickly gain traction was highlighted when a consortium of high-profile technology-focused companies proposed in mid 2019 to launch a stablecoin for use in consumer digital wallets. Central banks, including the Reserve Bank, are actively studying issues relating to the possible introduction of central bank digital currencies (CBDCs).

2.3 The card payments market

Payment cards are the most commonly used retail payment method in Australia, accounting for three-quarters of the total number of non-cash retail payments. Much of the rapid growth in card payments over the past two decades has been attributable to increasing use of debit cards, a trend further reinforced during the COVID-19 pandemic.

The majority of debit cards in Australia are dual-network debit cards (DNDCs), which allow domestic debit payments to be processed via either the domestic scheme (eftpos) or one of the international debit networks (Debit Mastercard or Visa Debit). The remainder are single-network debit cards (SNDCs), which only allow transactions to be processed through one network; these cards are more likely to be issued by new entrants (typically with one of the international debit schemes on the card) or be a legacy product (typically eftpos-only cards).

In the credit card market, around 85 per cent of the value of transactions is processed through the international 'four-party' schemes (Mastercard and Visa), with the remainder processed through the 'three-party' schemes (American Express and Diners Club). The market shares of three-party credit card schemes have declined over the past few years. This was largely driven by the closure of the major banks' companion card programs following reforms introduced in the Bank's 2015– 16 Review of Card Payments Regulation, which resulted in the American Express companion card system being regulated in a similar way to the traditional four-party schemes. However, part of this decline has been offset recently by increased issuance of American Express proprietary cards.

Contactless technology and online functionality are available for most debit and credit cards issued in Australia. However, eftpos has only recently introduced its online functionality, and this is still being rolled out. Many issuers have also enabled their debit and credit cards to be used in digital wallets, such as Apple Pay, Samsung Pay and Google Pay.

The four major banks are the main issuers of debit and credit cards, although there is also issuance by around 90 mid-sized and smaller financial institutions, both Australian and foreign-owned. The major banks are also the main acquirers of card transactions in Australia, allowing merchants to accept card payments. Acquiring services are also provided by larger regional banks and a number of specialist payment providers. Two major Australian retailers have payment switching arrangements which allow them to 'self-acquire' transactions. The three-party card schemes act as acquirers for cards issued under their respective networks.

2.4 Card payments regulation and Bank reforms

The *Reserve Bank Act 1959* requires that the Bank's payments system policy is to be directed towards controlling risk in the financial system, promoting the efficiency of the payments system and promoting competition in the market for payment services, consistent with the overall stability of the financial system. The Bank's broad approach to payments system regulation has been to seek to encourage industry to undertake reform, using its powers only when a self- or co-regulatory solution has been unlikely to emerge to address public interest concerns. The Bank introduced a range of reforms to credit and debit card systems in the early 2000s. These reforms have subsequently been reviewed every five years or so to ensure that the Bank's regulatory settings remain appropriate; the previous comprehensive review of the regulatory framework for card payments took place over 2015–16.

Under the *Payment Systems (Regulation) Act 1998* (PSRA), the Bank can designate payment systems, and establish standards and access regimes for designated systems. To date, the Bank has designated nine card payment systems:

- the Mastercard and Visa credit card systems and the American Express companion card system
- the eftpos, Debit Mastercard and Visa Debit systems
- the eftpos, Mastercard and Visa prepaid card systems.

The Bank has determined three standards under the PSRA. Two of these regulate interchange fees and net payments to card issuers (one relating to credit card systems, the other relating to debit and prepaid card systems). Some background on interchange fees is set out in 'Box A: Interchange Fees: Key Concepts'. A third standard applies to all nine designated systems and regulates certain aspects of merchant pricing, precluding card schemes from applying 'no-surcharge' rules.

The Bank has also established access regimes under the PSRA applying to the designated Mastercard and Visa credit card systems. These require those systems to have in place transparent eligibility and assessment criteria for scheme membership and to report information about membership and applications to the Bank. These criteria should not discriminate between entities or classes of entity, except to the extent reasonably required to assess and address the risks arising to the scheme or its participants, merchants or cardholders.

The 2015–16 Review concluded in May 2016 with the release of a conclusions paper and the publication of new surcharging and interchange standards. The revised surcharging standard, which sought to address issues around excessive surcharging, took effect for large merchants in September 2016 and for small merchants in September 2017.[5] The standard preserves the right of merchants to surcharge but ensures that consumers using payment cards from designated systems cannot be surcharged in excess of a merchant's cost of acceptance for that card system. Additionally, from June 2017, acquirers and payment facilitators have been required to provide merchants with easy-to-understand information on the cost of acceptance for each designated scheme that would help them make decisions about surcharging. These reforms work in conjunction with legislation passed by the Government in 2016 that banned excessive surcharges and provided the ACCC with enforcement powers.

Following discussions with the Bank, several schemes that were not formally captured by the Bank's new standard modified their surcharging rules in line with the Bank's standard. American Express and Diners Club updated their undertakings to the Bank in relation to 'no-surcharge' rules, while UnionPay International provided new undertakings to the Bank. PayPal has also removed its 'no-surcharge' rule

5 A merchant was considered large if it had at least 2 of the following: (i) more than $25 million in revenue; (ii) more than $12.5 million in assets; (iii) 50 or more employees.

in Australia and introduced provisions in its merchant terms and conditions aimed at preventing merchants from surcharging above their costs of acceptance.

The revised interchange standards came into effect in July 2017. Under these standards, the weighted-average benchmark for interchange fees on transactions using debit cards was reduced from 12 cents to 8 cents, and applies jointly to debit and prepaid cards in each designated scheme. The weighted-average benchmark for credit cards was maintained at 0.50 per cent. These weighted-average benchmarks are now supplemented by ceilings on individual interchange rates: 0.80 per cent for credit; and 15 cents, or 0.20 per cent if the interchange fee is specified in percentage terms, for debit and prepaid. To prevent interchange fees drifting upwards in the manner that they had previously, compliance with the benchmark is now assessed quarterly, based on transactions in the preceding four quarters, rather than every three years.

The interchange standards also included new provisions relating to 'net compensation'. To prevent circumvention of the interchange fee caps and benchmarks, the standards contain a requirement that issuers may not receive 'net compensation' from a scheme in relation to card transactions. This requirement is intended to limit the possibility that schemes may use payments and other incentives to issuers (funded by higher scheme fees on acquirers) to effectively replicate interchange fee payments. In 2018–19, the Bank conducted a consultation on the operation of the net compensation provisions and made some changes aimed at clarifying and improving their operation.

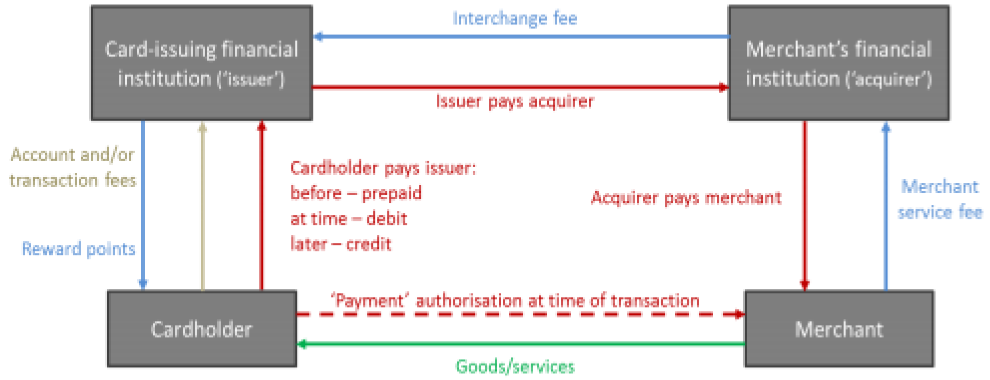
Since the 2015–16 Review, the Bank has undertaken a public consultation in response to concerns about possible restrictions on the ability of card issuers and mobile-wallet providers to provision both networks on dual-network debit cards (DNDCs) for use by cardholders. Such restrictions could have the effect of reducing competition and efficiency in the payments system. Following discussion with industry participants through the consultation process, the Bank received commitments from relevant participants addressing its concerns.

Box A: Interchange Fees

An interchange fee is a fee charged by the financial institution on one side of a payment transaction to the financial institution on the other side of the transaction. They are most commonly seen in card transactions, although can arise in other payment methods.

A typical card transaction, as shown in Figure 1, involves four parties – the cardholder, the cardholder's financial institution (the issuer), the merchant and the merchant's financial institution (the acquirer). For most card transactions, the interchange fee is paid by the acquirer to the issuer. Interchange fees can have important implications for the prevalence and acceptance of different cards as well as the relative costs faced by consumers and merchants. In contrast to normal markets for goods and services, competition in payment card networks can actually drive fees higher.

Figure 1: Stylised Flows in a Card Transaction



Financial institutions typically charge fees to their customers for payment services. Cardholders are charged by their financial institution in a variety of ways. This typically includes monthly account-keeping fees for debit cards and annual fees for credit cards plus interest on borrowings that are not repaid by a specified due date.

Merchants receiving payments are also typically charged by their financial institutions. The fees paid by merchants usually depend on the payment method. For card payments, merchants are usually charged a 'merchant service fee' for every card payment they accept. Some merchants are also charged a fee by their financial institution to rent a terminal to accept cards.

In contrast, interchange fees are paid between financial institutions and are present in many, but not all, card systems. Interchange fees are often not transparent; cardholders and merchants do not typically see them. But they have an impact on the fees that cardholders and merchants pay.

When a card payment is made, interchange fees are paid by the merchant's financial institution to the cardholder's financial institution. This has two effects. First, the merchant's financial institution will charge the merchant for the cost of providing it with the acceptance service plus the fee that it must pay to the card issuer (the interchange fee). The higher the interchange fee the merchant's financial institution must pay, the more the merchant will have to pay to accept a card payment. Second, since the card issuer is receiving a fee from the merchant's financial institution every time its card is used, it does not need to charge its customer – the cardholder – as much. The higher the interchange fee, therefore, the less the cardholder has to pay. In effect, the merchant is meeting some of the card issuer's costs which can then be used to subsidise the cardholder. Indeed, with rewards programs, the cardholder may actually be paid to use his/her card for transactions and competition tends to involve offering incentives for a consumer to hold and use a particular network's cards. A network that increases the interchange fee paid by the merchant's financial institution to the cardholder's financial institution enables the latter to pay more generous incentives, and can increase use of its cards.

However, the competitive response from other networks is typically to increase interchange rates. That is, competition in well-established payment card networks can lead to the counterintuitive result of increasing the price of payment services to merchants (and thereby leading to higher retail prices for consumers). This phenomenon has been most clearly observed in the US credit card market, which has not been subject to any regulation. Prior to the Bank's reforms this had also occurred to an extent in the Australian credit card market, with Mastercard and Visa's average interchange rates tending to rise.

When one compares the incentives for cardholders and merchants and for their financial institutions the implications of the interchange flows described above are clear. Other things equal – in particular assuming no regulatory intervention and no surcharging by merchants to offset the differences in their costs – cardholders will have a preference to use a card from a network where larger interchange payments flow to the card-issuing financial institution, while merchants will prefer to receive cards from a network with lower interchange fees (or fees flowing in the opposite direction).

In circumstances where multiple card networks are widely accepted by merchants (as in Australia and many other developed countries), the consumer typically decides which means of payment is tendered and used in a transaction. Given this, financial institutions will have an incentive to issue cards from networks where interchange fees flow from the merchant's financial institution to the cardholder's financial institution, and competition may lead networks to increase the size of such fees. The generosity of cardholder rewards programs will rise, as will the cost of payments to merchants.

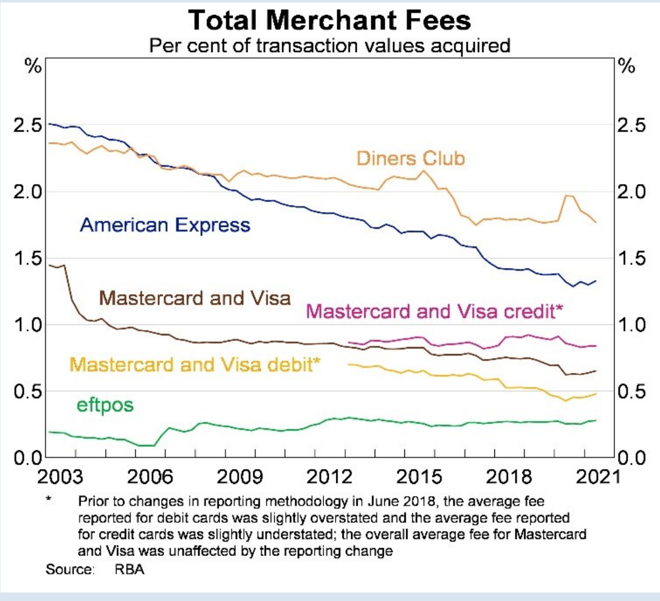
Interchange fees may be appropriate in some circumstances, particularly in the establishment of new systems where they may be necessary to rebalance costs between the sides of the market and ensure that both sides of a market have an incentive to participate. However, the major card schemes are mature systems, and regulators in many countries have reached the judgement that their cards are 'must take' methods of payments – that is, that merchants have little choice but to accept their cards. In practice, with interchange fees being used to incentivise issuers to issue cards from a particular scheme and cardholders to use that card, the tendency has been for competition between mature card schemes to drive up interchange fees and costs to merchants, with adverse effects on payments system efficiency.

Since the early 2000s, the Bank has had in place weighted-average interchange fee benchmarks to constrain the potential for interchange fees to distort efficient payment choices and to underpin a fall in the overall resource cost of payments. Further reforms following the 2015-16 Review imposed maximum caps on interchange fees, as a way of addressing some large differences that had emerged between interchange fees that were being paid by small merchants and the lower 'strategic' rates applying to larger merchants.

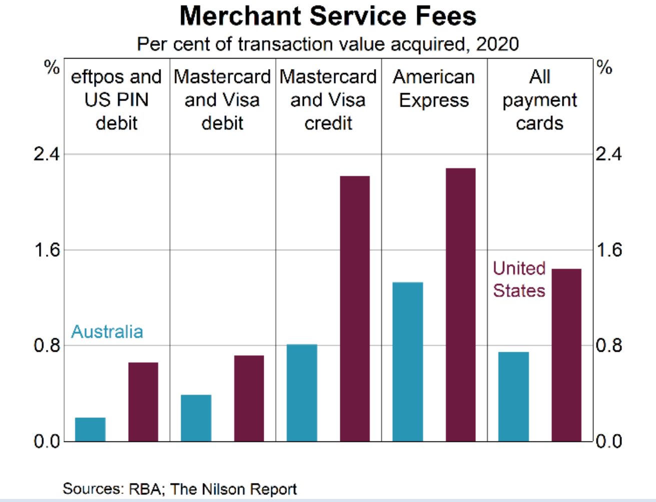
The effects of reform in Australia

Card payments have continued to grow strongly in Australia since the initial implementation of the Bank's reforms in 2003 (Graph 1). Furthermore, data on merchant service fees indicate that interchange fee regulation has led to overall lower costs for merchants in accepting card payments (**Graph 3**). Australia now has a relatively low-cost payments system by international standards, most notably compared with the United States (**Graph 4**).

Graph 3



Graph 4


Merchant Service Fees
Per cent of transaction value acquired, 2020
%
eftpos and US PIN debit
Mastercard and Visa debit
Mastercard and Visa credit
American Express
All payment cards
%
2.4
1.6
0.8
0.0
Australia
United States
Sources: RBA; The Nilson Report

3. Policy Issues and the Need for Government Action

3.1 Dual-network debit cards and least-cost routing

Debit cards are now the most frequently used payment method in Australia. Over recent years, the Board has considered a number of issues relating to competition in the debit card market, most notably around DNDCs. Around 90 per cent of debit cards issued in Australia are DNDCs, which allow domestic payments to be processed via either eftpos or one of the international debit schemes (Debit Mastercard or Visa Debit). For customers, DNDCs typically draw from the same deposit account and offer broadly similar protections to the cardholder in relation to fraudulent and disputed transactions regardless of which debit scheme processes the transaction. For many merchants, however, payments via eftpos can be significantly cheaper to accept than payments via the international schemes.

If a cardholder inserts their DNDC into a terminal to make a payment, they are able to select the debit card scheme to process the transaction. By contrast, if the cardholder makes a contactless ('tap-and-go') payment, the transaction is usually routed through the network that has been programmed as the default on the card (typically the international scheme). In recent years, however, financial institutions have begun providing merchants with LCR or 'merchant-choice routing' functionality. LCR gives merchants the ability to route contactless DNDC transactions via whichever of the two networks on the card costs them less to accept. This can help merchants reduce their payment costs and increase competitive pressure between the debit schemes, incentivising the schemes to lower the fees that are ultimately incurred by merchants. The Board has strongly supported the issuance of DNDCs and the provision of LCR because of this contribution to efficiency and competition in the payments system.

As LCR functionality has been gradually rolled out, schemes have responded to the increase in competitive pressure with lower interchange rates and scheme fees on routable transactions. The weighted-average interchange rates for Visa and Mastercard debit have declined and since late 2019 have been comfortably below the 8 cents benchmark. Industry participants have also reported that the international schemes have decreased scheme fees on some routable debit transactions significantly since mid 2019. This has translated into a reduction in the average cost of accepting debit card transactions through the international schemes over the past few years (**Graph 3**). At the same time, however, there have been increases in interchange fees and scheme fees for some non-routable debit transactions, which are making up a growing share of total debit transactions (see below).

Given the benefits to date from LCR, a key issue raised in the Issues Paper was whether policy action was warranted to promote the availability and wider take-up of this functionality. Following pressure from the Bank, most acquirers had implemented some form of LCR functionality by mid 2019. However, there remain some key differences in the LCR capabilities offered by different acquirers, with most not yet offering a version that maximises merchant savings by enabling 'dynamic' routing for each individual transaction. Furthermore, take-up among merchants remains relatively low, which may reflect a lack of awareness or understanding of the potential benefits. One major bank has automatically switched on LCR for eligible small merchants where it determined that they would benefit from the functionality. Another [two] major banks have implemented single-rate plans for smaller merchants with LCR implemented in the background. However, for many merchants the onus remains on them to understand the benefits of LCR and request it from their acquirer.

In addition, there are a number of emerging challenges to the viability of LCR. First, several smaller and mid-sized issuers have begun moving away from DNDCs towards single-network debit cards (SNDCs), which allow payments to be processed through only one (international) debit network. The switch to SNDCs reflects two factors. First, the international schemes have been keen to facilitate the issuance of these cards for some time and at least one scheme is offering higher interchange rates on transactions on SNDCs. In making the case for issuance of SNDCs, the international schemes have noted that some issuers still have single-network, eftpos-only 'proprietary' cards on issue (which may also attract higher interchange rates than equivalent transactions on DNDCs), and LCR is not possible on these cards. Second, issuers and international schemes have pointed in consultation to the additional cost of issuing debit cards with two networks instead of one. Given the largely overlapping functionality provided by the three debit schemes, smaller issuers in particular felt that supporting a second debit network yielded little benefit to their customers but generated significant costs, absorbing funds and resources that could be used elsewhere in their businesses.

SNDCs reduce both customer and merchant choice, and so lessen competition between schemes at the point-of-sale. A particular concern is that a shift towards SNDC issuance could have the effect of making LCR unattractive for large merchants. When larger merchants adopt LCR and their DNDC transactions are routed via eftpos, they lose access to strategic interchange rates on other debit card transactions that continue to be processed through the international networks; the latter transactions would include transactions on DNDCs where the customer actively selects the international network or where routing is not possible because they are online or due to some problem with the chip or the issuer, as well as transactions on SNDCs. An increase in the prevalence of (international scheme) SNDCs would increase the pool of non-routable transactions that must be processed through the international schemes, while decreasing the pool of routable DNDC transactions. This would raise the cost of losing strategic interchange rates – lowering the net savings from LCR – to the point where LCR might not be commercially attractive for large merchants.

Smaller merchants, which do not have access to strategic rates, might continue to benefit from LCR even with a shift occurring to SNDCs. However, if ePAL – the company that runs the eftpos network – cannot compete for the volume of large merchants, its ability to compete for smaller merchants would also be weakened. In the extreme, as the lowest-cost network, its potential exit from the market would result in a significant lessening of competitive pressure in the debit market and would likely result in an increase in both interchange rates and scheme fees, impacting all merchants.

A second challenge to LCR is that technological changes have driven a significant shift away from the use of physical (plastic) cards at the point-of-sale to the use of new 'form factors', such as mobile wallets, through which LCR may not be possible. For mobile wallets, LCR is currently not possible because each network is separately provisioned and the wallet presents the credentials of only one network during payment; this network is typically the international debit network, which is set as the default, but it can be overridden by the cardholder. Nevertheless, DNDCs can still facilitate competition between schemes in the mobile context, as merchants can incentivise the customer to choose a particular network in their mobile wallet during the checkout process. However, not all mobile wallets and issuers currently support the provisioning of both networks of a DNDC; in some cases, only the international scheme is provisioned. Stakeholders have highlighted that the ongoing shift towards mobile payments is increasing the pool of non-routable transactions processed through the international schemes. Accordingly, the financial case for large merchants to use LCR has already become marginal, with the Bank aware of two large retailers that were early adopters of LCR having recently decided to stop using it.

Relatedly, eftpos has recently enabled its online payments functionality, which raises the possibility of LCR in the online (or 'device-not-present') environment. Indeed, the Bank is aware of several payments service providers already offering LCR online. The Board supports the provision of LCR online, given the clear benefits that LCR has had in the card-present or 'device-present' environment, in terms of stronger competition and lower payment costs.[6] However, the online payment process is distinct from the device-present environment, which raises additional policy questions. A key issue is whether customers should be notified when merchants choose to route online transactions and whether customers should be given a choice to override merchants' routing decisions. Some stakeholders are concerned about the comparability of the debit schemes' online payment offerings, particularly in regard to security, and stress the importance of customer choice and notification. In line with this view, one of the international schemes has already imposed a rule requiring acquirers and merchants to notify customers of LCR in the online context and to provide them with an override option. Other stakeholders are concerned about the frictions that these rules would introduce into the checkout process, in part due to customers' poor understanding of payments, which could significantly deter the development and/or merchant take-up of LCR online. Indeed, some acquirers and payment facilitators have noted that they would not implement LCR online if they had to abide by such rules. Accordingly, these stakeholders argue for greater merchant choice of debit network in the online environment.

Another challenge to the viability of LCR is the potential for the international schemes to link strategic interchange rates on credit card transactions to the value or volume of merchants' debit card transactions (or their decision to adopt LCR). Such 'tying conduct' penalises merchants that route debit card transactions to eftpos through higher interchange rates on their credit transactions, which could offset merchants' savings from LCR. In effect, the international schemes could leverage their market power in the credit card market to dis-incentivise the take-up of LCR. In early 2018, the Bank sought and received assurances from the international schemes that they would not respond to LCR in ways that would limit the competitive pressure in the debit card market. Despite these assurances, several merchants have alleged that both Visa and Mastercard have engaged in such anti-competitive tying conduct, which the Board is particularly concerned about. The ACCC has investigated Visa's conduct, due to its concerns that Visa may have limited competition by engaging in tying conduct, resulting in a court-enforceable undertaking from Visa in March 2021.[7]

3.1.1 Need for government action

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.

Dual-network debit card issuance

6 From now on, this paper will use the terms device-present and device-not-present, rather than card-present and card-not-present, to acknowledge the growing tendency of card payments to move away from the traditional physical card form factor (towards form factors like mobile phones). For example, payments made using mobile wallets at the point of sale – where mobile phones are physically presented to a card terminal – are considered 'device-present' transactions.

7 See ACCC (2021).

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 reduce competition between the debit schemes, threaten the viability of LCR 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. This could involve imposing requirements on issuers above a certain size to continue issuing DNDCs, with both networks provisioned in all relevant form factors (particularly mobile wallets).

Also, since switching to SNDCs would reduce the cost burden faced by an issuer, there is little justification for schemes to provide higher interchange revenue to such issuers at the same time (as is currently the case). A change to the Bank's interchange standards would be required to prevent schemes from providing issuers with interchange-based incentives to issue SNDCs.

Tying conduct

Allegations that the international schemes have linked strategic rates on credit card transactions to merchants' decisions on debit card routing are both concerning and contrary to the assurances that the schemes gave the Bank in early 2018 (as noted above). The ACCC's investigation into alleged anti-competitive behaviour has resulted in a short-term court-enforceable undertaking from Visa that it would not engage in tying conduct, which suggests that the Bank could continue to rely on the relevant provisions of the CCA and the ACCC's enforcement powers to address such conduct. However, there may be some merit in the Bank taking further regulatory action in this space to put in place a more permanent solution that would prevent all schemes from engaging in tying conduct, rather than relying on regulators to take *ex post* enforcement action to address such conduct.

Least-cost routing

The payments industry has made considerable progress in developing LCR for the device-present environment without any explicit regulatory requirements. However, many acquirers still provide somewhat limited functionality and the take-up of LCR by merchants remains quite low. The pool of routable device-present transactions is also declining due to the growth of mobile-wallet transactions. This suggests that policy action to promote the provision and merchant awareness of LCR may be required to further lift the availability and take-up of LCR, and so increase the cost savings for merchants and the competitive tension between the debit schemes.

It is also reasonable to expect that LCR could generate material competition and efficiency benefits in the online environment, just as it has done in the device-present environment. While online LCR is in its infancy, given that ePAL is still in the process of building out the functionality for eftpos transactions online, a number of payments service providers are already building the functionality. However, there is a real risk that the provision of online LCR may be hindered, or even prevented, by schemes or other market participants taking divergent, and in some cases restrictive, approaches to its implementation. Some stakeholders have also expressed concerns that the major banks could stall the roll-out of LCR online, as occurred in the device-present environment. Accordingly, there is a case for policy action to support the provision of LCR functionality online. There might also be a case for ensuring that the Bank is informed in a more timely fashion of changes to scheme rules that could raise policy concerns.

3.2 Interchange fees

Interchange fees may be appropriate in some circumstances, for example in the establishment of new systems where they may be necessary to rebalance costs between each side of the market and ensure that both sides of a market have an incentive to participate. However, the major card schemes are mature systems, and regulators in many countries have reached the judgement that their cards are 'must take' methods of payment – that is, that merchants have little choice but to accept their cards. In practice, with interchange fees being used to incentivise issuers to issue cards from a particular scheme and cardholders to use that card, the tendency has been for competition between mature card schemes to drive up interchange fees and costs to merchants, with adverse effects on the efficiency of the payments system.

Since the early 2000s, the Bank has had in place weighted-average interchange fee benchmarks to constrain the potential for interchange fees to distort efficient payment choices and to reduce the overall resource cost of payments. Further reforms following the Bank's 2015–16 Review imposed maximum caps on interchange fees, as a way of addressing some large differences that had emerged between interchange fees that were being paid by small merchants and the lower 'strategic' rates applying to larger merchants. While the earlier reforms have improved the efficiency of the payments system, the Bank has considered several issues relating to interchange fees which may warrant further regulatory action.

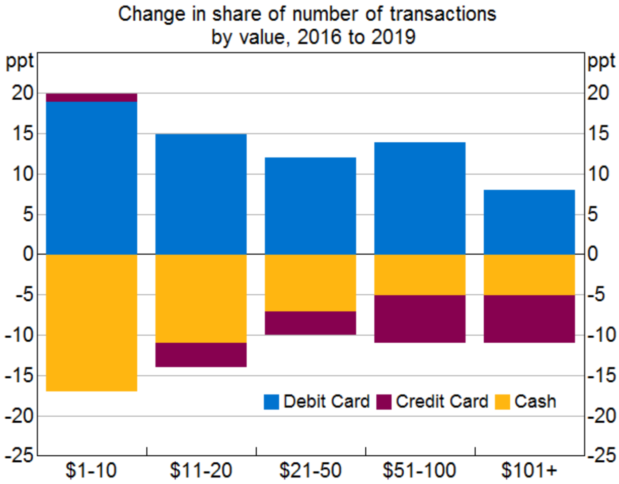
The first key issue is whether the levels of the card scheme interchange benchmarks and caps remain appropriate, particularly in light of the following:

- recommendations by the Black Economy Taskforce (2017) and the Productivity Commission (2018) that interchange fees should be reduced or even eliminated, on the grounds that there is little justification for such fees in mature card systems such as in Australia.
- the continuing decline in the average value of card transactions, particularly for debit cards. The average value of debit card transactions is now $50, down from $56 in 2016 when the Bank lowered the weighted-average benchmark for debit and prepaid transactions from 12 cents to 8 cents. This trend is largely attributable to a migration of lower-value payments from cash to debit cards, amid the widespread adoption of contactless 'tap-and-go' technology (**Graph 5**). In 2019, 40 per cent of in-person payments of $10 or less were made on debit cards, compared with 21 per cent in 2016;[8] this share has likely increased further since the emergence of COVID-19.

8 See Caddy et al (2020) p18.

Graph 5

Payment methods



Sources: RBA Calculations; using Ipsos and Roy Morgan Research

- the increased tendency for schemes to set debit interchange fees for non-routable transactions at smaller (non-strategic) merchants at the cents-based debit interchange cap of 15 cents (**Table 1**). The Bank's regulatory framework, which is based around weighted-average benchmarks, provides schemes with considerable flexibility in setting their interchange schedules, including to incentivise behaviours that support innovation and benefit the payments system. In the case of debit cards, the schemes have increasingly been using this flexibility to set low rates on some categories of transactions that are at risk of being routed to another scheme, while – to maintain interchange revenues for their issuers – increasing rates on other transactions that are less at risk of being routed. The result has been increasingly complex interchange fee schedules, which offer lower rates for routable transactions at larger 'strategic' merchants, accompanied by rates at the cap for many non-routable transactions (for example, card-not-present and tokenised card-present transactions) at smaller (non-strategic) merchants.

Table 1: Selected Debit Card Interchange Fees

Excluding GST; cents unless otherwise indicated; non-routable categories are in bold

<table>
<tr><th rowspan="2">Category</th><th colspan="2">Mastercard</th><th colspan="2">Visa</th><th colspan="2">eftpos proprietary</th><th colspan="2">eftpos dual-network</th></tr>
<tr><th>July 2017</th><th>Sept 2021</th><th>July 2017</th><th>Sept 2021</th><th>July 2017</th><th>Sept 2021</th><th>July 2017</th><th>Sept 2021</th></tr>
<tr><td>Strategic Merchant 1*</td><td>2.82</td><td>1.0</td><td>2.0</td><td>1.0</td><td>0.0</td><td>1.5</td><td>0.0</td><td>1.0</td></tr>
<tr><td>Strategic Merchant 2*</td><td>0.15%</td><td>2.0</td><td>5.0</td><td>1.5</td><td>1.8</td><td>3.0</td><td>1.8</td><td>2.0</td></tr>
<tr><td>Strategic Merchant 3*</td><td></td><td>3.0</td><td>8.0</td><td>1.75</td><td>3.6</td><td>4.5</td><td>3.6</td><td>3.0</td></tr>
<tr><td>Strategic Merchant 4*</td><td></td><td>4.0</td><td></td><td>2.0</td><td></td><td>6.0</td><td></td><td>4.0</td></tr>
<tr><td>Strategic Merchant 5*</td><td></td><td>8.0</td><td></td><td>3.0</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Strategic Merchant 6*</td><td></td><td>10.0</td><td></td><td>4.0</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Tokenised Contactless (<=$15)**</td><td></td><td>4.0</td><td></td><td>5.0</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Tokenised Contactless (>$15)**</td><td></td><td>15.0</td><td></td><td>15.0</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Consumer Standard: Card Present**</td><td>12.5</td><td>4.0</td><td>8.0</td><td>4.0</td><td></td><td></td><td>4.5</td><td>4.0</td></tr>
<tr><td>Consumer Standard: Card Present (SNDC)***</td><td></td><td></td><td></td><td>11.0</td><td>13.6</td><td>11.0</td><td></td><td></td></tr>
<tr><td>Consumer Standard: Card Not Present/ Electronic/Digital***</td><td>12.5</td><td>15.0</td><td>0.20%</td><td>0.20%</td><td>14.5</td><td>15.0</td><td>14.5</td><td>15.0</td></tr>
<tr><td>Consumer Premium: Card Present***</td><td rowspan="2">0.20%</td><td>15.0</td><td rowspan="2">0.20%</td><td>15.0</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Consumer Premium: Card Not Present***</td><td>0.20%</td><td>0.20%</td><td></td><td></td><td></td><td></td></tr>
</table>

* Strategic Merchant rates apply to merchants that meet certain qualifying criteria to be deemed strategic by the scheme. These criteria, and the strategic merchant level assigned, are typically based on merchants meeting certain volume and/or growth thresholds.

** Tokenised Contactless transactions are those made with a mobile device at point-of-sale.

*** Standard card transactions are those made using basic card products. Premium card transactions are those made using premium cards (for example, Visa's Platinum or Mastercard's World card products), which typically offer additional rewards or services to cardholders.

Sources: ePAL; Mastercard; Visa

A second key issue is whether the interchange regulations should be expanded to include transactions on foreign-issued cards. Interchange fees on transactions on foreign-issued cards are significantly higher than those on domestic cards. There are currently no restrictions on the interchange fees levied on these transactions, and schemes are not required to publish inter-regional interchange fee schedules. In the 2015–16 Review, the Bank decided not to bring transactions on foreign-issued cards into the regulatory framework, but indicated that it would continue to watch developments in this area. In 2019, the European Commission (EC) announced that it had accepted legally binding commitments from Mastercard and Visa to: reduce their inter-regional interchange fees to caps set by the EC; refrain from circumventing the caps; and publish inter-regional interchange fees. With foreign-issued cards representing an increasing share of card payments at Australian merchants over the past decade, there could be a case for adopting a similar approach in Australia.

3.2.1 Need for government action

Level of interchange benchmarks and caps

There is not a strong public policy case for lowering the weighted-average benchmarks or the credit card cap at this point in time. The current interchange settings have been in effect for only 4 years and appear to be working well. There has been a significant decline in merchants' average cost of accepting card payments over the past two decades, to levels that are relatively low by international standards.

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. For example, a 15 cent interchange fee on a $15 transaction is equivalent to 1 per cent of the total value of the transaction. This is up to 15 times the interchange rate of the same transaction for larger strategic merchants. It is also significantly higher than would apply based on the *ad valorem* cap on debit transactions of 0.2 per cent, and higher than the interchange fee incurred if a credit card had been used (which is capped at 0.8 per cent). The Bank's assessment is that this practice is likely to persist in the absence of further regulatory action. While merchants have the option of recovering higher payment costs by surcharging debit transactions, in practice this may not be feasible due to the risk of customers abandoning the transaction and merchants may find it difficult to impose differential surcharges based on transaction value. Routine surcharging of debit transactions would also not be a desirable outcome, given that debit cards are now the most prevalent payment method for retail goods and services, and are increasingly replacing cash for low-value transactions. Accordingly, a change to the Bank's card regulations is necessary to address the unreasonably high cost of some low-value debit transactions at smaller merchants.

Foreign-issued cards

While the share of total card payments in Australia made using (more expensive) foreign-issued cards has grown over the past decade, it remains low – at 3 per cent in 2019 (and significantly lower since then due to the reduction in international travel during the COVID-19 pandemic). The impact of foreign-issued cards on system-wide payment costs, therefore, does not appear to be significant at this point in time. However, given the significantly higher cost of foreign card transactions, there is a case for low-cost regulatory intervention to increase the competitive pressure on such fees.

3.3 Scheme fees

Scheme fees are payable by both acquirers and issuers to the card schemes for the services they provide, mostly on a per-transaction basis. Scheme fees, like interchange fees, affect the costs faced by merchants in accepting card payments. They are also an important component of the costs borne by issuers for providing card services to their customers. However, while schemes publish their schedules of interchange fees, there is far less transparency around scheme fees. The Bank understands that the international schemes have schedules of hundreds of individual fees, which are usually a combination of both global and domestic fees, but these are not published. Issuers (and to a lesser extent, acquirers) often receive bespoke rebates or discounts on these standard fees to encourage card issuance and exclusivity arrangements.

The Board has held concerns for some time that the opacity of scheme fee arrangements to end-users of the payments system may be limiting competitive tension between the card schemes, as well as between acquirers (by obscuring their margins). Indeed, a number of stakeholders have told the Bank that scheme fees have been growing over recent years and represent an increasing proportion of merchant service fees in Australia. Industry participants have also reported that some schemes have responded to LCR by reducing scheme fees on routable transactions, while increasing fees on debit transactions that cannot be routed by merchants (such as those made through digital wallets). If scheme fees charged to acquirers continue to increase, this could put upward pressure on merchants' payment costs, offsetting the benefits of the Bank's interchange regulations. In Europe, for example, the European Commission (2020) found that the potential merchant savings arising from the interchange caps implemented in 2015 had been partly offset by higher scheme fees. Another international study (CMSPI 2020) also found that higher scheme fees eroded merchant and consumer savings generated by interchange regulation in various jurisdictions.

The opacity of scheme fees 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 interchange fee regulations.[9] For example, one scheme recently introduced a new fixed scheme fee, levied on acquirers for each physical merchant outlet that they service, regardless of the volume of transactions processed at each location. Fees such as this could reduce competition in the market for debit card payments, because they could be used to fund incentives to acquirers and merchants to route DNDC transactions to that card scheme (in ways that schemes with less market power cannot match).

3.3.1 Need for government action

The Bank generally views transparency as an important mechanism for improving efficiency and promoting competition in the payments system. The Bank previously considered some possible options for greater scheme fee transparency as part of the 2007–08 Review, but did not proceed with specific regulatory action. However, in light of the recent developments noted above and the growing importance of card payments in Australia, the Bank felt it was timely to reconsider requiring greater disclosure of scheme fees.

In the absence of greater transparency, it would be easier for the card schemes to implement changes to fee schedules or related rules that may be anti-competitive or have the effect of circumventing the interchange fee regulations. Scheme fees could also continue to increase and lead to higher payment costs for merchants, particularly if the competitive pressure arising from DNDCs and LCR were to lessen. There is also a case for greater transparency of scheme fees to end-users to improve price signals in the payment 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.

9 The net compensation provisions implemented by the Bank following the 2015–16 Review are intended to limit the extent to which schemes can circumvent the interchange benchmarks and caps by increasing the level of scheme fees on acquirers to fund payments and other incentives to issuers.

4. Policy Options

To address the issues identified above, the Bank proposed a number of options for regulatory reform in the Consultation Paper published in May. These proposals were informed by the extensive consultation with stakeholders that the Bank had undertaken during the preceding 18 months. The policy options for each of the key issues discussed in this paper are outlined below.

4.1 Dual-network debit cards and least-cost routing

4.1.1 Dual-network debit card issuance

Given recent industry developments and the issues discussed above, the Bank has considered three broad options in relation to the issuance of DNDCs, which represent an escalating degree of regulatory response:

Option 1: Maintain current arrangements

Issuers would continue to make the choice between issuing DNDCs and SNDCs based on commercial considerations. The Bank would continue to monitor market developments without any formal regulatory intervention.

Option 2: Explicit expectation of DNDC issuance for the major banks

The Bank would state an explicit expectation that the major banks would continue to issue DNDCs, with two card schemes to be provisioned in all form factors, including mobile wallets, offered by the issuer (where the functionality is supported by the scheme). There would be no presumption as to which two debit networks were included by issuers; various combinations of domestic and international schemes might be feasible. The Bank would also set a cents-based interchange cap that was lower for SNDC transactions than for DNDC transactions, which would lessen the incentive for SNDC issuance.

Option 3: Regulation mandating DNDC issuance for the major banks and medium-sized issuers

The Bank would require – through a change to Standard No. 2 of 2016 – that all issuers above a certain size threshold must issue only DNDCs, with two card schemes to be provisioned in all form factors, including mobile wallets, offered by the issuer (where the functionality is supported by the scheme). In designing the mandate, the Bank could draw on similar rules relating to dual-network debit cards in other jurisdictions, such as the United States.[10] Under Option 3, there may not be a case for a lower cents-based interchange cap for SNDC transactions, depending on where the threshold were set.

10 The US Federal Reserve's Regulation II (Debit Card Interchange Fees and Routing) implements the so-called 'Durbin Amendment' to the Dodd-Frank Act. Among other things, it prohibits all issuers and networks from: restricting the number of networks over which electronic debit transactions may be processed to less than two unaffiliated networks; and inhibiting a merchant's ability to direct the routing of the electronic debit transaction over any network that the issuer has enabled to process them.

4.1.2 Tying conduct

The Bank has considered two options to address the potential for international schemes to link strategic interchange rates on credit card transactions to merchants' value or volume of debit card transactions ('tying conduct').

Option 1: Leave the ACCC to investigate and take enforcement action against any anti-competitive tying conduct

Consistent with current practice, any alleged anti-competitive tying conduct would be investigated by the ACCC under the *Competition and Consumer Act 2010* (CCA).

Option 2: Explicitly address tying conduct

The Bank would seek voluntary undertakings from the designated card schemes that they will not engage in tying conduct; if this was not feasible, it would introduce a new standard to explicitly prohibit such conduct by designated card schemes.

4.1.3 Least-cost routing

In relation to the provision of LCR functionality, the Bank has considered three policy options:

Option 1: Maintain current arrangements

The Bank would continue to monitor market developments in the provision of LCR across all relevant payment channels without any formal intervention.

Option 2: Explicit guidance on the provision of LCR by acquirers and payment facilitators

The Bank would state an explicit expectation that all acquirers and payment facilitators would offer and promote LCR functionality to merchants in the device-present environment; acquirers and payment facilitators would be expected to report to the Bank every 6 months on their LCR offerings and on merchant take-up. There would be no similar expectation regarding LCR in the online environment at this stage. However, 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. If expectations for the provision of LCR were not met, the Board would consider formal regulation.

Option 3: Explicit regulation on the provision of LCR by acquirers and payment facilitators

The Bank would require – through a change to the Bank's standards – that relevant payments service providers offer or support LCR for both device-present and online DNDC payments. The Bank would also set explicit rules for LCR in the online environment to ensure that the interests of merchants and consumers are appropriately balanced.

For all 3 options, the Bank also considered whether the Bank's information-gathering powers under section 26 of the PSRA should be used to require schemes to notify the Bank of all scheme rules and any changes to those rules (this would overlap with a similar proposal regarding scheme fee-related rules, discussed in the section on 'Scheme fees' below).

In response to stakeholder feedback on these options, the Bank also considered including in Options 2 and 3 an expectation or requirement that industry participants must enable LCR for mobile-wallet transactions.

4.2 Interchange fees

4.2.1 Debit cap

To address the high cost of some low-value debit (and prepaid) transactions that are subject to interchange rates at the 15 cents cap, the Bank has considered three broad policy options:[11]

Option 1: Retain the current debit interchange caps

This option involves no change to the status quo, where schemes can set fees on debit interchange categories up to the current cap of 15 cents per transaction (or up to 0.20 per cent for interchange fees specified in percentage terms).

Option 2: Reduce the cents-based debit interchange cap

This option involves reducing the cents-based cap for debit (and prepaid) cards. The Bank would lower the cap to 10 cents for transactions on DNDCs (and all prepaid cards) and 6 cents for transactions on SNDCs (with the different cap for DNDCs and SNDCs consistent with the interventions considered in section 4.1.1). The 6 cents cap would apply equally to SNDCs issued by the international schemes and to the remaining stock of proprietary, eftpos-only cards. There would be no change to the ad-valorem cap of 0.20 per cent for interchange fees specified in percentage terms.

Option 3: Require any debit interchange fees to be set in *ad valorem* terms

The cents-based cap for debit (and prepaid) transactions would be eliminated, and the ad-valorem cap of 0.20 per cent would apply to all debit and prepaid interchange categories.[12] The weighted-average benchmark would henceforth be set in ad-valorem terms. With an average debit card transaction value of $50 in 2020, a weighted-average benchmark of around 0.16 per cent would be equivalent to the current cents-based benchmark of 8 cents.

4.2.2 Foreign cards

To address the high interchange fees on transactions on foreign-issued cards, the Bank has considered three possible responses:

Option 1: No regulation of foreign-issued cards

This option would retain the status quo, where foreign-issued cards are outside the scope of the interchange standards.

Option 2: Publication of interchange fees on foreign-issued cards, but no regulation regarding fee levels

The interchange standards would be amended to require schemes to publish the interchange fees on foreign cards on their websites. However, the fees on foreign cards would not be subject to the interchange caps or benchmarks.

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11 Unless indicated otherwise, for the remainder of section 4.2 'Interchange Fees', references to debit card transactions or interchange should be taken as referring also to prepaid card transactions or interchange.

12 Different ad valorem caps for DNDCs and SNDCs would also be considered, in line with the interventions considered in section 4.1.1 'DNDC issuance' above.

Option 3: Extend interchange regulation to foreign-issued cards

Under this option, there would be caps on interchange fees on transactions on foreign-issued cards. The interchange standards would be amended to make transactions on foreign cards subject to the same caps as apply to transactions on domestic cards, though they would not be included in the calculations for the observance of the weighted-average benchmarks. The schemes would be required to publish interchange rates for transactions on foreign cards on their websites.

4.3 Scheme fee transparency

The Bank has considered three broad options in relation to scheme fee transparency:

Option 1: No additional disclosure requirements

This option would retain the status quo. The Bank would continue to seek disclosure of scheme fees only as required to assess compliance with net compensation rules.

Option 2: Schemes to publicly disclose all scheme fee rates and rules

The Bank would introduce a requirement in the standards for designated card schemes to publish all multilateral scheme fee rates, as well as all scheme rules relating to scheme fees, that apply to Australian scheme participants.

Option 3: Schemes 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 publication of some aggregate data

The Bank would – using its information-gathering powers under section 26 of the PSRA – require designated card schemes to provide access to all of their multilateral scheme fees, and scheme rules relating to scheme fees, that apply to Australian scheme participants, and to promptly notify the Bank of any changes to these. The Bank would also use its information-gathering powers to collect quarterly data from the card schemes on the aggregate value of scheme fees charged and rebates provided to Australian scheme participants (with the data split into categories based on various characteristics, including at a minimum: issuing and acquiring fees, debit and credit transactions, and domestic and international transactions). Schemes would also be required to provide a list of the top 20 fees by value and the share of total scheme fee revenue that each of these fees account for.

The Bank would consider publishing some of the aggregate data provided by the schemes, if they are sufficiently comparable, to allow the industry to compare the average levels and growth rates of these fees across card schemes. Larger scheme participants would also be required to report annually to the Bank the total scheme fees paid to, and rebates received from, each card scheme they participate in. This information would act as a cross-check on the data reported by the card schemes.

5. Costs and Benefits

This section sets out the likely benefits and costs of each proposed policy option for all affected stakeholders. Ideally, in assessing the effects of the proposed policy options we would like to be able to precisely quantify the net welfare benefits. However, it is difficult to do so since changes in payment patterns can also arise from advances in technology, changes in end-user preferences and habits, and from broader macroeconomic factors. It is also difficult to precisely estimate the effect of previous reforms on payment patterns to date, and it is similarly difficult to estimate the likely effect of new reforms on the future evolution of the system. The task is further complicated by the need to assess the overall benefit to society of any changes in payment patterns, taking into account both benefits derived from the various payment services and the costs of producing those services.

While there are a range of factors that make it challenging to quantify the welfare effects from the Bank's reforms, the large size of the payment card market implies that any move towards a more socially optimum mix of card transactions would likely result in substantial welfare gains. For instance, in 2020/21 total card transactions amounted to over $660 billion and total fees paid by merchants in accepting card payments were almost $4 billion, so even small changes may translate into material welfare improvements.

In addition to the broader economic and payments market impacts, the options outlined above will involve some implementation and compliance costs. For the most part, compliance costs arise from changes to IT systems and reporting obligations. It is impossible to obtain an exact implementation cost for these changes. IT systems are different across schemes and financial institutions and the costs of adjusting them can vary substantially. The Bank sought and received some high-level guidance and cost estimates from stakeholders, which the Bank has taken into account when assessing the potential regulatory burden. These compliance costs estimates are subject to substantial uncertainty and are provided here as indicative yardsticks.

Using the regulatory burden measurement framework, it has been estimated that the measures under consideration could increase compliance costs for some industry stakeholders (see below).[13] The Treasury Portfolio has not identified any offsets at this stage of the 2021-22 Mid-Year Economic and Fiscal Outlook process. However, the additional compliance costs under most of the proposed policy options are quite small.

5.1 Dual-network debit cards and least-cost routing

5.1.1 Dual-network debit card issuance

The Bank has long supported the issuance of DNDCs because they facilitate competition between the debit schemes, which can drive down payment costs for merchants. The average cost of accepting Visa and Mastercard debit transactions has fallen in recent years, following the lowering of the debit

13 In line with the regulatory burden measurement framework, each table below shows the estimated annual regulatory compliance cost (over and above business-as-usual costs) of each policy option for each sector, averaged over 10 years. See also Appendix B.

interchange benchmark and coinciding with the introduction of LCR of DNDC transactions; there has been a decline of about 5 basis points since June 2018 (**Graph 3**). A significant part of this reduction is due to the international schemes lowering interchange and scheme fees on routable transactions in response to the increased competitive pressure. In addition to encouraging downward pressure on fees set by schemes, DNDCs also allow merchants to directly reduce their payment costs by routing transactions to the lowest-cost scheme. To give a sense of the magnitudes involved, in 2020/21 each 1 basis point reduction in the average cost of accepting debit card payments would have been equivalent to an annual saving for merchants of around $39 million. While merchant payment costs are determined by many factors, this estimate indicates that they would likely be materially higher in the absence of DNDCs. A widespread shift towards SNDCs – which could occur under the status quo (**Option 1**) – could therefore impose significant efficiency costs on the system. Accordingly, policy action to limit the shift away from DNDCs is likely to be in the public interest.

The two regulatory options proposed in Section 4.1.1 involve imposing requirements on issuers above a certain size to continue issuing DNDCs, with both networks provisioned in all relevant form factors (including mobile wallets). For each option, the system-wide benefits must be weighed against the costs that would be imposed on individual issuers and others. At the system-wide level, there is a risk that unless DNDC issuance is near-ubiquitous in the market, the direct benefits of LCR for larger merchants with access to strategic interchange rates would not be realised, for the reasons outlined earlier. Even in the current situation – where there is very limited issuance of international-scheme SNDCs – some larger merchants are finding LCR unattractive due to the growing pool of non-routable transactions (such as those made using mobile wallets). If LCR is no longer viable for larger merchants, this could undermine ePAL's ability to compete for smaller merchants as well, potentially threatening its commercial viability and reducing the competitive tension between the debit schemes.

Under **Option 2**, the Bank would state an explicit expectation that the major banks would continue to issue DNDCs. While an 'expectation' would not be a formal legal requirement like those contained in the Bank's standards, the Bank sees it as highly likely that institutions would comply with such an expectation that applied also to their peers, especially since the Bank would make it clear that if they did not comply, the Board would seriously consider formal regulation to achieve the desired result.[14] Setting an expectation would be a light-touch regulatory approach that would still ensure reasonably broad-based issuance and use of DNDCs – the major banks account for nearly 80 per cent of debit transactions – while allowing smaller issuers to make their own commercial decisions about their debit card issuance; this could improve the ability of smaller issuers to compete with the major banks, by allowing them to avoid the costs associated with supporting 2 debit networks. Since the Bank does not expect that all smaller issuers would stop issuing DNDCs, the share of debit transactions made using DNDCs would likely be somewhat higher than 80 per cent. The downward pressure on fees set by schemes and the overall efficiency benefits of DNDC issuance would be higher than under Option 1, but lower than under Option 3.

The Bank does not expect that Option 2 would impose any significant costs on the major banks that they would not otherwise have incurred. The major banks have all indicated their willingness to continue issuing DNDCs in the absence of regulatory intervention. Given the high volume of eftpos transactions processed by the major banks, the cost per transaction of supporting a second debit network is relatively low. Since the major banks are shareholders in eftpos, they also have a financial incentive to support its operations.

14 For the purpose of estimating regulatory costs, where an option involves the Bank stating an explicit expectation, the assumption is that this expectation is followed by industry members as if it was regulation.

Under **Option 3**, the Bank would impose a formal regulatory requirement that all issuers above a certain size must issue only DNDCs. Broader DNDC issuance (than under Options 1 and 2) would yield system-wide benefits for competition and efficiency. In particular, merchants (especially smaller ones) would have a greater capacity to reduce their payment costs because more transactions would be routable (or capable of being steered to the lowest-cost network in the case of mobile wallet transactions). The Bank has considered, and consulted on, several different thresholds. One option would be that any authorised deposit-taking institution (ADI) accounting for more than 1 per cent of the debit market, by transaction value, would be required to issue DNDCs; as of the first half of 2021, this would have captured 8 out of a total of 94 retail-focused ADIs. This threshold would account for a large share of the debit market – around 89 per cent – with the likelihood that in addition some smaller issuers would continue to issue DNDCs reflecting their own assessments of the costs and benefits of including two networks. However, given the growth of (non-routable) mobile-wallet transactions, it is likely that LCR would remain unattractive for many larger merchants even at much lower issuance thresholds, unless the Bank also took additional policy action in other areas (such as mandating LCR for mobile wallet transactions, as discussed below).

Further, the benefits of more DNDCs on issue must be balanced against the costs that individual issuers face as a result of supporting DNDCs. Many issuers have told the Bank that they incur significant additional costs from issuing debit cards with two networks instead of one, as there are limited cost synergies in connecting to two debit networks. In particular, technical differences between the schemes were said to result in material duplication of issuers' compliance and development costs. Differences in scheme rules and back-office processes also reportedly mean that supporting two schemes increases the ongoing day-to-day costs of operating a debit card portfolio. Given the largely overlapping functionality provided by the three debit schemes, some smaller issuers felt that supporting a second debit network yields little benefit to their customers but generates significant costs, absorbing funds and resources that could be used elsewhere in their businesses. Small and medium-sized issuers reported that the additional cost burden of supporting a second debit network makes it harder to compete with the major banks, which can spread the costs of supporting two networks over a larger customer base.

While estimates vary regarding issuers' costs of supporting two networks, the compliance and development costs alone are likely to be more than a million dollars per year for mid-sized issuers. They are likely to be lower for smaller issuers which rely more on aggregators such as Cuscal, ASL and Indue, but they are still significant amounts in the context of the overall costs of running a debit card portfolio (particularly on a per-transaction basis).[15] Accordingly, Option 3 would impose a material

15 This is based on ongoing consultation with several stakeholders on the cost of issuing DNDCs – particularly information provided by two issuers and one aggregator, reporting on behalf of its members. The estimate of one million dollars is a lower bound, and refers to the incremental operating costs of supporting an additional debit scheme. While a detailed breakdown of this value is not available, stakeholders indicated that over half of this cost is incurred meeting scheme compliance mandates. Significant costs are also incurred supporting the operational aspects of these mandates, for example, back-office processes, staff training and fraud monitoring. The remaining costs relate to new function development – including duplicated functionalities – for product enhancements.

additional cost on the small and mid-sized issuers that would otherwise have switched, or have already switched, to issuing SNDCs.[16]

Under both Options 2 and 3, the Bank would not expect issuers to transition their existing stock of eftpos (single-network) proprietary cards to DNDCs; these existing cards would be effectively grandfathered. This would avoid both a material expense for issuers and disruption for some customers. At the same time, it would have little negative effect on competition for several reasons. These cards account for a relatively small share of cards on issue; they appeal to a limited demographic; and they are declining in importance, with most issuers in the process of phasing them out and ePAL hoping to replace them with DNDCs with eftpos as the first (or 'front of card') network. Also, while the average interchange rates on these cards is higher than the average for transactions on eftpos DNDCs, it is similar to the average interchange fees on transactions through the international debit schemes. From a level-playing-field perspective, going forward both eftpos and the international card schemes would be free to support and incentivise new SNDC issuance by smaller issuers, and all SNDCs, including eftpos proprietary cards, would be subject to the same interchange fee regulation.

Overall, given that the issuance of DNDCs by the major banks is the main influence on the number of DNDCs in the market, the Bank expects that the economy-wide benefits from requiring DNDC issuance by the major banks would easily outweigh the costs to those banks (especially since those banks would likely issue DNDCs in any event). However, for the very small issuers it is highly unlikely that the public benefits of DNDC issuance would outweigh the material fixed costs they would incur, because their contribution to the ubiquity of DNDCs would be practically zero. Accordingly, the optimal threshold, at which the benefits of DNDC issuance just match the costs, is likely to lie somewhere between these two extremes. As noted above, it is impossible to estimate the costs of different thresholds with any degree of reliability (see footnote 11). However, the Bank's judgement is that a threshold set at 1 per cent of the debit market, by transaction value, would be likely to yield a net public benefit, because it would only capture 4 more institutions but would cover an extra 10 per cent of the debit market. At lower thresholds, the Bank has much less confidence that the cost imposed on issuers to support DNDC issuance would be outweighed by the public benefits.

Separately, Option 2 also proposes a lower cents-based interchange cap on SNDC transactions than on DNDC transactions. This would ensure that the schemes cannot provide issuers with interchange-based incentives to issue SNDCs. Switching to SNDCs would reduce the cost burden faced by an issuer, so there is little justification for schemes to provide higher interchange revenue at the same time. A lower cap on SNDCs would also reduce the cost of transactions on these cards, benefiting merchants and consumers. Under the related proposal in Section 4.2.1 (Option 2), it was proposed that the new cap for SNDCs would be set at 6 cents. However, stakeholder feedback suggested that smaller issuers of SNDCs would be particularly penalised by such a cap, resulting in a material reduction in interchange revenue for such issuers, which would adversely affect their ability to compete given limited alternative revenue streams.

16 The compliance costs of Option 3 are difficult to estimate with any degree of reliability, and would vary significantly depending on both the chosen issuance threshold and the broader package of reforms adopted for DNDCs and LCR. Even without taking into account the interdependencies with other policy proposals, few issuers were able to provide estimates of the additional costs that they would incur under this policy option; where cost estimates were provided, there was considerable variation across institutions. Furthermore, it is impossible to know how many of the institutions that would be captured under the chosen threshold would have continued to issue DNDCs in the absence of a regulatory mandate, and therefore the incremental compliance costs (over and above business-as-usual costs) that this would impose.

Finally, the impact on cardholders of either Option 2 or Option 3 should also be relatively low. If a bank does indeed switch from issuing DNDCs to SNDCs (with an international scheme as the only network on the card), the bank's customers would lose access to functionality that is currently only provided by eftpos, such as the ability to withdraw cash at most point-of-sale outlets or receive immediate Medicare rebates at some medical practitioners.[17] However, those customers that place a high value on such functionality would be free to switch to any other issuer that still offers DNDCs. It would be up to each individual issuer that is not *required* to issue DNDCs to determine whether the impact on customers as a result of dropping eftpos functionality outweighs the costs it faces in supporting that network. Indeed, a potential benefit of this choice could be increased competition between the schemes to deliver additional functionality for cardholders.

5.1.2 Tying conduct

If the international schemes engage in tying conduct, it would undermine the benefits of LCR and limit competitive pressure in the market, imposing considerable costs on the payments system. As noted earlier, a recent investigation by the ACCC has resulted in a (time-bound) court-enforceable undertaking from Visa that it would not engage in tying conduct, suggesting that the Bank could continue to rely on the relevant provisions of the CCA and the ACCC's enforcement powers to address such conduct (**Option 1** in Section 4.1.2).

While the ACCC would obviously retain the ability to take *ex post* enforcement action after any anti-competitive conduct has occurred, there may be some merit in the Bank also putting in place an ongoing regulatory requirement that would seek to prevent all schemes from engaging in tying conduct (**Option 2**). This could be either by obtaining specific undertakings from the international card schemes regarding tying conduct or, if the schemes were not willing to provide voluntary undertakings, explicitly regulating tying conduct using its powers under the PSRA. Option 2 would also provide ongoing certainty for all merchants negotiating with the schemes about permissible contract terms. This would ensure that merchants would be better placed to take advantage of LCR for debit transactions, benefiting both merchants (through lower payment costs) and consumers. Option 2 would also facilitate competition by ensuring that neither of the international schemes is able to leverage its power in the credit card market, putting all of the debit schemes on an equal footing.

Compliance with the voluntary undertakings or a Bank standard could be monitored through an annual certification requirement (and potentially enforced through the Bank's ability to issue directions under the PSRA). The Bank does not expect this to impose any significant regulatory burden on the international schemes.

Average annual regulatory costs of Option 2 (from business as usual)[18]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.003	$0	$0	$0.003

17 One of the international schemes does allow cardholders to withdraw cash at point-of-sale terminals at one of the large supermarket retailers.

18 Both international schemes provided estimated compliance costs for two tasks under Option 2 (the international schemes would need to provide voluntary undertakings to the Bank that they will not engage in tying conduct and would need to certify compliance with the voluntary undertaking). The start-up cost estimates for these tasks ranged from 2-6 full-time-equivalent (FTE) work days, while the average annual ongoing cost estimates ranged from 1-4 FTE days.

5.1.3 Least-cost routing

Device-present environment

The payments industry has made considerable progress in developing LCR functionality for the device-present environment without any explicit regulatory requirements, albeit following considerable suasion by the Bank over a number of years. While some large acquirers still provide somewhat limited functionality, the Bank expects that competition in the acquiring market – together with continued regulatory suasion – will continue to drive desired improvements in LCR availability and functionality. Accordingly, formal regulation requiring all acquirers and payment facilitators to offer LCR for device-present transactions (**Option 3** in Section 4.1.3) does not appear to be warranted at this stage.

Under **Option 2**, the Bank would instead state an explicit expectation that LCR functionality for device-present transactions would be offered by all acquirers and payment facilitators.[19] This would effectively formalise the Bank's messaging to the industry over the past few years. However, the formal statement would also include an expectation that acquirers and payment facilitators would actively promote the functionality to their merchant customers, and periodically report to the Bank on their LCR offerings and on merchant take-up. This expectation would generate some additional compliance costs for the payment service providers. However, industry feedback suggests that the key reason for the low take-up of LCR by merchants to date is lack of awareness and understanding of this functionality. The Bank is therefore of the view that the proposed expectation would generate material benefits by promoting greater awareness and take-up of LCR by merchants, and so increase the cost savings for merchants (and consequently, consumers) and the competitive tension between the debit schemes.

Average annual regulatory costs of Option 2 (from business as usual)[20]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.373	$0	$0	$0.373

Extending LCR to mobile-wallet transactions would yield significant benefits in terms of lower payment costs for merchants and ultimately lower prices for consumers. Merchants would see a direct benefit by routing to the lowest-cost network, and there would be indirect effects on payment costs from increased competitive tension between the debit schemes (putting downward pressure on the interchange rates and scheme fees that apply to mobile-wallet transactions). Without LCR for mobile-wallet transactions, the pool of non-routable device-present transactions is likely to continue growing, undermining the viability of LCR for large merchants and limiting the savings from LCR for smaller merchants. However, enabling LCR in the mobile-wallet context would require a significant change to the technical implementation of mobile payments for the whole industry, which would be

19 As noted in section 5.1.1, an 'expectation' would not be a formal legal requirement like those contained in the Bank's standards, but the Bank sees it as highly likely that institutions would comply with such an expectation, especially since the Bank would make it clear that if they did not comply, the Board would seriously consider formal regulation to achieve the desired result.

20 For the purposes of constructing this estimate, average costs were aggregated separately for major banks and for other acquirers, to account for differences in business size. The regulatory cost incurred by major banks is the average of cost estimates submitted by 3 major banks (scaled up). The cost incurred by other acquirers is the average of cost estimates submitted by 6 other acquirers, scaled up by the number of principal acquirers operating in Australia.

expensive and time-consuming. While there is only limited international precedent, the Bank understands that there would be two possible implementation models. One implementation model would require schemes to detokenize payment credentials for competing schemes, raising the likelihood of ongoing disputes about the commercial terms of, and access to, this service. The second model would require the cooperation of some payment service providers – most notably the mobile-wallet providers – that the Bank currently does not have the power to regulate; it would also require the significant modification (or replacement) of many payment terminals.

Online environment

In the online (device-not-present) environment, it is reasonable to expect that LCR could also generate material competition and efficiency benefits, just as it has done in the device-present environment. While ePAL is still in the process of building out its online capabilities, this is expected to be completed by the end of the year, with issuers due to enable their systems to process online eftpos transactions by mid 2022. From this point, it should be feasible for a merchant to route all online DNDC transactions if the functionality is provided by their acquirer, payment facilitator and/or payment gateway.

Option 2 would be a light-touch regulatory approach, under which individual industry participants could decide if and when they develop online LCR functionality based on their own commercial assessment of the relative costs and benefits. Indeed, several acquirers and gateways already offer or are developing LCR for online transactions, which suggests that competition in the market could drive broader development of this functionality over time. This approach would avoid many of the regulatory costs associated with formal regulation under Option 3. However, there are concerns that some acquirers and payment facilitators may not prioritise the development of LCR online without regulatory pressure. For example, some stakeholders have noted that the major banks – which are both the largest acquirers and the largest issuers in Australia – have a potential conflict of interest, since LCR would reduce the interchange fees received by the issuing side of their businesses. Furthermore, two of the major payment gateways are owned by the international schemes, and may therefore have an incentive to delay the development of eftpos' online functionality and online LCR. Some industry participants also argue that there is a risk that the way consumers pay online may change significantly over the next few years, which could make any investments in developing LCR functionality redundant. For example, consumers will be increasingly able to make payments direct from their bank accounts when shopping online, as traditional financial institutions and fintechs leverage open banking and the capabilities of the NPP (including its PayTo functionality), which may have advantages over card payments for many consumers.

Formally requiring acquirers and gateways to develop LCR for online transactions (**Option 3**), rather than leaving it up to the industry to decide if and when they do so, would therefore be expected to help lower payment costs for merchants sooner and to a greater extent (due to wider availability of the functionality). It would also more quickly increase the pool of routable debit transactions, making LCR more commercially attractive for larger merchants and improving ePAL's ability to compete for debit volumes.

However, formal regulation in this space would be very complex and may impose additional costs on industry participants. The compliance costs of requiring acquirers and gateways to develop an LCR solution (**Option 3**) are difficult to estimate with any degree of reliability. While the Bank has received some cost estimates for the development of online LCR functionality, the costs will vary widely across institutions based on their existing technology and the type of functionality they would plan to develop.[21] More importantly, it is impossible to know how many institutions would develop online LCR functionality in the absence of a regulatory expectation or a mandate, and therefore the incremental compliance costs (over and above business-as-usual costs) that these options would impose.

Explicit regulation on the provision of LCR online would be further complicated by the more complex payment processing chain for online transactions, which typically involves a range of payment service providers with many different business models and operating systems. Accordingly, it may be difficult to define formal regulation with the specificity required under the PSRA, without introducing inflexibility that prevents at least some industry participants from being able to develop the most suitable or cost-effective solutions for their business. Compliance may also require the co-operation of payment service providers that currently fall outside the Bank's remit, which is problematic. Furthermore, the Bank has a general presumption in favour of self-regulation, and has traditionally only intervened with formal regulation if the industry has not been able to address policy concerns on its own. Accordingly, it may be too early to formally mandate the development of online LCR functionality by acquirers. The Bank has therefore also considered an intermediate policy option, under which all acquirers, payment facilitators and gateways would be *expected* to offer and promote LCR functionality to merchants in the online environment within a defined period (similar to the expectation for the device-present environment under Option 2). While this would still impose a greater regulatory burden on the industry than Option 2, it would provide industry participants with greater flexibility and would help ensure the broad-based availability of online LCR for merchants (and hence the associated benefits) within a reasonable timeframe. The Bank acknowledges that developing online LCR functionality would require industry co-ordination, but notes that the industry has already set up a working group with AusPayNet for this purpose.

Regardless of whether the provision of LCR online is mandated or not, the Bank would want to ensure that schemes and other market participants cannot set up unreasonable barriers to the implementation or use of LCR online, as some have already attempted to do under the status quo (Option 1). The Bank would therefore publish a set of high-level guiding principles for how it would expect LCR online to operate in practice. These principles would seek to balance the interests of merchants, cardholders and schemes. In particular, they would help ensure that merchants can route online debit card transactions (and thereby benefit from lower payment costs) without introducing any material frictions into the checkout process. Under the principles, merchants would not be required to provide customers with the choice of network, but customers would always be informed if routing could occur. Customers would also ultimately benefit from lower prices on goods and services. Since the proposed principles would not be prescriptive, the additional regulatory burden of these principles on the payments system is expected to be relatively low.

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21 Six institutions provided feedback on the cost of offering and supporting LCR for online DNDC payments under **Option 3**. Most institutions emphasised the difficulty of estimating costs for the options considered, suggesting they needed more detail on the specifications of the LCR online solution as well as greater industry coordination to better understand compliance costs. Estimates submitted by acquirers and payment facilitators for the cost of developing an online LCR solution ranged from around $500,000 to upwards of $10 million.

5.2 Interchange fees

5.2.1 Debit cap

Reducing the cap on cents-based interchange fees – to 10 cents for DNDCs and all prepaid cards, and 6 cents for SNDCs (**Option 2** in Section 4.2.1) – would directly reduce the interchange fees paid by acquirers on a range of transactions. These lower fees for acquirers would be expected to result in a sizeable fall in the cost of some transactions for smaller merchants (which do not benefit from low 'strategic' interchange rates) and indirectly to lower prices for their customers. This option would not impose material additional compliance costs on the industry for several reasons. First, it would only change the level of a cap that is already in place (rather than changing the regulatory framework for interchange fees more generally). Second, the separate caps for SNDCs and DNDCs would be straightforward to implement because transactions on SNDCs and DNDCs can already be separately identified. And finally, schemes frequently change their interchange categories and the level of their interchange fees, so similar changes would routinely occur under the status quo.

Average annual regulatory costs of Option 2 (from business as usual)[22]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.07	$0	$0	$0.07

Some stakeholders have argued that lowering the cents-based cap would reduce the total interchange revenues flowing to issuers, with concerns that smaller issuers would be disproportionally impacted, as they are more dependent on interchange revenues. However, as Option 2 does not reduce the weighted-average benchmark for interchange fees on debit transactions, card schemes would be free to adjust their interchange schedules to seek to maintain issuers' interchange revenue, including by making greater use of *ad valorem* fees set at the 0.20 per cent cap (which would also be unchanged).

Card schemes and some issuers have also argued that decreasing the permissible range of debit interchange fees would reduce the scope for using differential fees to incentivise behaviour, including behaviour that benefits the system as whole (such as implementing new security features). However, there would still be considerable scope for differential pricing under the cents-based caps of Option 2. Further, the range of fees that could be set in *ad valorem* terms would be unaffected, since the *ad valorem* cap of 0.20 per cent would remain unchanged.

Option 2 would affect the *distribution* of payment costs across merchants and would reduce the disparity between the cost to small and large merchants for accepting similar transactions. In particular, there would be a reduction in the cost of many low-value transactions for smaller merchants, while adjustments to schemes' interchange schedules in response to Option 2 would likely raise payment costs for some other merchants.

Requiring all debit interchange fees to be set on an *ad valorem* basis (**Option 3**), would also achieve the policy objective of lowering the unreasonably high cost of accepting many low-value transactions for smaller 'non-strategic' merchants. A new *ad valorem* weighted-average benchmark could be set at

22 Three card schemes submitted cost estimates for tasks under this Option. The compliance costs for a representative scheme is an average of these estimates. The start-up cost estimates ranged from 1 full-time-equivalent (FTE) day to 45 FTE days. The average annual ongoing cost estimates ranged from 5 FTE days to 90 FTE days.

a level that kept issuers' interchange revenues, and so average payment costs for merchants, broadly unchanged. However, it would also have distributional effects, tending to raise payment costs for merchants with higher average transaction values. This higher cost would tend to be passed through to consumer prices, or absorbed in margins, depending on the pricing power of the merchant. Merchants with both higher average transaction values and limited pricing power would be the most adversely affected.

Option 3 would be a reasonably significant change to the interchange framework, implying greater adjustment costs for industry participants than Option 2 and the potential for unintended consequences. Also, a key rationale for the original cents-based benchmark and cap was that most of the costs of processing debit card transactions were unrelated to transaction value. The messaging cost of a $1 payment is no different to that of a $100 payment, and debit transactions are not subject to many of the *ad valorem* costs associated with credit cards (for example, they do not provide interest-free periods and typically do not offer rewards programs). While the Bank generally expects there will be some correlation between payment cost and transaction size, the original rationale for the cents-based nature of the benchmark remains relevant.

Average annual regulatory costs of Option 3 (from business as usual)[23]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.1	$0	$0	$0.1

5.2.2 Foreign cards

Applying the current interchange caps to foreign-issued card transactions acquired in Australia (**Option 3** in Section 4.2.2) would directly reduce the interchange fees paid by acquirers. These lower fees for acquirers would be expected to flow through to lower merchant service fees and more broadly to lower prices for consumers. The international schemes typically do not publish their 'inter-regional' or international interchange rates, but they appear to be mostly in the 1–2 per cent range. Transactions on foreign-issued cards comprised around 3 per cent of domestically acquired transactions prior to the COVID-19 pandemic. This implies that Option 3 would result in a reduction in annual interchange fees paid by acquirers of around $170 million. This foregone interchange revenue would be borne by the foreign issuers of the cards, at least initially.

The cost to schemes of complying with Option 3 would be small, since transactions on foreign-issued cards are already separately identified for the purposes of interchange payments and scheme fees on these transactions. However, schemes and regulators in other jurisdictions could react in ways that offset the benefits identified above. In particular, schemes could raise their scheme fees on foreign-issued card transactions acquired in Australia (and simultaneously lower the scheme fees paid by issuers in other jurisdictions, to effectively compensate such issuers for the loss of interchange revenue from activity in Australia). Option 3 might also have some marginal adverse effect on the international schemes' ability to compete for issuers' business in some foreign markets, if competitor schemes in those jurisdictions were not also subject to interchange regulation on transactions with Australian merchants.

23 Three card schemes submitted cost estimates under Option 3. Cost estimates varied substantially, in part because two card schemes already set some debit interchange fees on an *ad valorem* basis. An average of the three schemes' estimates was taken to account for the different business-as-usual practices of each business.

Average annual regulatory costs of Option 3 (from business as usual)[24]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.42	$0	$0	$0.42

Requiring schemes to publish their interchange fees on foreign-issued card transactions acquired in Australia (**Option 2**) would give all participants in the Australian payments industry visibility of such fees, which could potentially contribute some modest downward pressure on these fees. The cost to the schemes of complying with Option 2 would be insignificant, given that it would only involve publishing a handful of interchange rates on their websites. The Bank also cannot foresee any material unintended consequences of this option.

Average annual regulatory costs of Option 2 (from business as usual)[25]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.005	$0	$0	$0.005

5.3 Scheme fees

As noted earlier, the Bank generally views transparency as an important mechanism for improving efficiency and promoting competition in the payments system. Measures to increase transparency would normally be expected to improve price signals in the payments market, resulting in a better allocation of resources and downward pressure on costs. It is impossible to quantify the likely impact of greater transparency on the level and growth of scheme fees. However, some simple figuring can give a sense of the magnitudes involved. Based on the value of card transactions in 2020/21, a 1 basis point reduction in issuing and acquiring scheme fees would have resulted in savings of around $142 million across issuers and acquirers. Any savings made by acquirers (around $67 million in this example) would be expected to flow through into lower payment costs for merchants.

However, the benefits of transparency can only be realised if disclosures are meaningful and accessible to market participants. The benefits of disclosure requirements must also be weighed against the compliance costs that they would generate for the industry.

Under **Option 2** in Section 4.3, 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, as noted earlier, scheme fee schedules are very complex, with some schemes said to have hundreds of different fees. If schemes were to publish their entire fee schedules, it is likely that even payments specialists – let alone non-specialists such as smaller merchants – would find it difficult to understand and effectively make use of this information. It would also be difficult for both the Bank and end users of the payments system to track changes in the scheme fee schedules and identify whether any changes to the fees or rules may be anti-competitive. Furthermore, market participants would not be able to determine the actual net costs paid by issuers and acquirers, as the value of rebates and other payments received from the schemes would not be available. So while the costs of Option 2 are relatively low, the potential benefits are also expected to be minimal.

Average annual regulatory costs of Option 2 (from business as usual)[26]

24 This cost is an average of estimates provided by both international schemes.

25 This cost is an average of estimates provided by both international schemes. According to estimates provided, the ongoing cost for this option accounts for schemes' websites needing to be updated twice a year.

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.008	$0	$0	$0.008

Option 3 is expected to provide significantly more benefits than Option 2. Under this option, card schemes would be required to promptly notify the Bank of any changes to their multilateral scheme fees and related scheme rules. Such notification requirements would be expected to discourage any changes to fee schedules or related rules that may be anti-competitive or could have the effect of circumventing the interchange fee regulations, or at least allow the Bank to identify and take timely action against such changes. It would also give the Bank greater visibility over any developments in scheme fees that could push up payment costs and might warrant a policy response, particularly if the competitive pressure arising from DNDCs and LCR were to lessen.[27]

Under Option 3, the Bank would also collect, and potentially publish, aggregated or averaged data on actual scheme fees paid by issuers and acquirers. Again, this would allow the Bank to 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 may also provide industry participants with information that is easier to understand and compare across card schemes, and would therefore provide more useful price signals. For example, such data could help merchants better understand the composition of their card payment costs, including the size of acquirer margins (although the information on scheme fees would be general and not tailored to individual merchants' circumstances). This could increase competitive tension in the acquiring market and allow merchants to make more informed decisions about their choice of acquirer, the payment methods they accept, and their transaction routing options. Any consequent reduction in merchants' payment costs would be expected to be passed on to consumers in the form of lower prices.

The publication of aggregated or averaged scheme fees data could also be beneficial to smaller issuers and acquirers, which generally have less bargaining power with the schemes than their larger counterparts. Specifically, such data could indicate the average size of rebates or discounts received by large issuers and acquirers. If smaller acquirers were able to use this information to negotiate higher rebates or discounts for themselves, this would be expected to flow through to lower merchant payment costs. Greater transparency could also increase the competitive tension between the card schemes when competing for issuing contracts, leading to lower costs for smaller issuers.

However, while Option 3 would be expected to generate significantly greater benefits than Option 2, the regulatory burden would also be relatively higher. The cost to the schemes of providing the Bank with access to scheme fee schedules and fee-related rules, and notifying the Bank of any changes to these, would be minimal. This is because the schemes already provide this information and notifications to their participants. However, the other requirements proposed under Option 3 would generate some implementation and ongoing compliance costs for both the schemes and a few large issuers and acquirers. The schemes would likely need to set up new reporting processes to enable the provision of quarterly data to the Bank, particularly if the scheme fee breakdowns requested by the Bank differed from those that the schemes produce internally. Since scheme fees are a key revenue component for schemes, the Bank expects that these data should not be difficult to extract. Larger

26 This cost is an average of estimates provided by 3 card schemes. The start-up cost estimates ranged from 1 full-time-equivalent (FTE) day to 8 FTE days. The average annual ongoing cost estimates ranged from 3 FTE days to 5 FTE days.

27 As discussed earlier, industry participants have reported that over recent years some schemes have progressively increased fees on debit transactions that cannot be routed by merchants, while reducing fees on routable transactions.

scheme participants would also incur at least some initial costs to set up data collection and reporting processes if they were required to report their scheme fee data to the Bank on an annual basis. Indeed, some issuers and acquirers have indicated that it would be challenging to accurately report scheme fees paid and rebates received for different types of card transactions, given the structure and complexity of scheme fee schedules, billing arrangements, and internal data systems. However, the Bank considers that it would be important to obtain data directly from the issuers and acquirers as a cross-check on the data provided by the schemes, given the complexity of scheme fee data and the associated potential for misreporting. There would also be clear overlaps with current internal reporting for net compensation purposes, and a number of institutions have indicated that ongoing compliance costs should be relatively low once reporting processes are set up and automated. Additionally, a number of issuers and acquirers expressed their willingness to provide the proposed data to the Bank, in recognition of the likely benefits from greater transparency of scheme fees.

While it is difficult to accurately calculate the additional regulatory burden of Option 3 – since information systems, and therefore the costs of adjusting them, will vary significantly across reporting institutions – an estimate based on stakeholder feedback is provided in the table below.

Average annual regulatory costs of Option 3 (from business as usual)[28]

Change in costs ($ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$0.19	$0	$0	$0.19

28 Three card schemes provided cost estimates for their reporting obligations under Option 3. The start-up cost estimates ranged from 3-41 full-time-equivalent (FTE) days, while the average annual ongoing cost estimates ranged from 11-34 FTE days. The schemes that reported higher expected up-front costs tended to report lower ongoing costs, indicating that if more time is invested to set-up reporting processes, this could reduce the ongoing quarterly report burden. Seven larger issuers and acquirers – including 3 major banks and 4 other acquirers – submitted estimated costs for reporting their scheme fee data to the Bank on an annual basis. Estimates were fairly consistent across each of these institutions, with the exception of one institution that reported significantly higher start-up costs and ongoing costs. To account for this, a weighted average was used to construct the representative business for this task, so as not to overstate the industry-wide costs of this option.

6. Consultation

In November 2019, the Bank published an Issues Paper as the first stage of its Review of Retail Payments Regulation. The paper sought the views of industry participants, end users and other interested parties on a wide range of payments issues. The Bank received over 50 written submissions from a range of financial institutions, merchants, card schemes, consumer groups and individuals. Around 25 parties took up the invitation to discussion their submission with the Bank.

The Review was temporarily suspended in March 2020 in response to the COVID-19 pandemic. The Bank recommenced work on the Review in late 2020 and, over the following year, conducted a large number of follow-up meetings with a broad range of stakeholders in relation to the key issues being considered as part of the Review, including those covered in this RIS.

Following this extensive consultation, the Payments System Board approved the publication of a Consultation Paper in May 2021. This paper outlined numerous options for regulatory reform to address the policy problems identified in the Issues Paper, as well as 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. 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.

This section summarises the stakeholder feedback received throughout the consultation process in response to the three key policy issues discussed in the RIS.

6.1 Dual-network debit cards and least-cost routing

Many stakeholders expressed support for the continued issuance of DNDCs to some degree. Most merchant groups and some other stakeholders argued that all issuers should be required to support DNDCs in all form factors to maximise the benefits of LCR. However, other stakeholders highlighted that there are significant costs associated with supporting DNDCs, particularly for small and medium-sized issuers, and were in favour of only requiring the major banks to support DNDCs. Issuers noted that there are limited cost synergies from operating two debit networks despite the similarities in their product offering. Issuers flagged that there are cost duplications relating to investment spending, product upgrades and mandate compliance. Some stakeholders recognised this cost burden on smaller issuers, but argued they should still be required to issue DNDCs as part of their 'social responsibility' given the system-wide benefits DNDCs enable. However, small issuers also argued that the time and opportunity costs associated with issuing DNDCs hinders their ability to innovate and compete with the major banks; most issuers said that they would like the freedom to make a commercial decision about the issuance of DNDCs. The international card schemes and some major banks also argued that mandating DNDCs for all issuers would reduce competitive pressure in the market, eliminating eftpos' incentive to innovate and attract issuers.

Some stakeholders argued that without DNDCs, customers would lose valuable functionality only available through eftpos, such as cash-out at point-of-sale and real-time Medicare rebates. Other issuers felt that these services added little value to their customers. Issuers that have begun the process of switching to SNDCs argued that SNDCs reduced the complexity of their product developments and would allow them to launch new product offerings (such as the mobile 'pays') for their customers more quickly. Some stakeholders also noted that the shift towards digital 'form factors' such as mobile wallets made support for DNDCs more costly than was the case in a world with only physical cards.

Several stakeholders noted that the financial case for large merchants to adopt LCR would be undermined if SNDCs became more prevalent, particularly given the growth of non-routable mobile wallet and online transactions. Merchant groups and some other stakeholders argued that the Bank should take action to ensure LCR is possible on mobile-wallet transactions given their growing importance. More generally, these stakeholders argued that the adoption of LCR remains too low, and that the Bank should mandate the provisioning of LCR on an 'opt-out' basis and require that all merchants be provided with 'dynamic' routing functionality which realises the full possible savings from LCR. On the other hand, some stakeholders agreed that the Bank's suasion has worked, and that regulating LCR is not needed given recent industry progress. Some stakeholders also noted that discussions over LCR risked placing too much emphasis on the cost of accepting payments, and ignoring other functionality valuable to the merchant, such as security.

In the online environment, stakeholders generally agreed that the Bank should not mandate the provisioning of LCR. Some of the major banks noted that developing LCR functionality online would be costly, time-consuming and would likely require a coordinated industry approach. A number of stakeholders also argued that there are material differences between the security and product offerings of the debit card schemes in the online environment. Given the higher incidence of fraud in e-commerce transactions, some of these stakeholders argued that LCR online would increase fraud rates, adversely affecting all stakeholders in the online payments ecosystem. These stakeholders felt that consumer choice should be paramount, and that customers should be given a transparent choice between the debit card schemes or be clearly notified if their transaction is being routed.

However, other stakeholders argued that the Bank should mandate LCR online. They argued that schemes provide customers with comparable product offerings, and that there is (or soon will be) little difference between their security functionalities. These stakeholders also said that customers typically do not have a preferred debit scheme, and have a limited understanding of their debit options, so notifying them would only create confusion. They also argued that given merchants bear the cost of payments, merchant choice should take precedence over consumer choice. Nearly all stakeholders were opposed to any requirement to provide customers with an option to override a merchant's routing decision given the complexity and friction it would add to the checkout process.

6.2 Interchange fees

There was limited support among card schemes and banks for a further lowering of the interchange benchmarks, with many stakeholders noting that Australian interchange fees are already low by international standards. Many payments industry stakeholders argued that interchange revenue is essential to support continued investment in innovation, security and the provision of services by card issuers. There were some concerns about a reduction in the cap on cents-based debit interchange fees, with stakeholders expecting that this would lead to a corresponding fall in weighted-average interchange rates and limit the schemes' ability to use their interchange schedules to incentivise innovation and the adoption of certain functionality. In response to concerns raised about some smaller merchants paying high cents-based fees on low-value debit card transactions, a number of stakeholders provided feedback that only a very small share of transactions fall into this category, and argued that it would therefore not be appropriate to further reduce the interchange caps on all debit card transactions.

Several stakeholders noted that the proposed changes would impact individual issuers differently, depending on their transaction mix. It was also noted that smaller issuers would be disproportionately disadvantaged by any further interchange reductions, including from the lower cap on SNDCs, as they have fewer other sources of revenue to offset this, which could undermine their ability to compete; indeed, some issuers claimed that they were making a loss on many transactions due to the low interchange fees paid by strategic merchants. Relatedly, two issuers proposed a floor on interchange fees to reduce the difference between interchange paid by large and small merchants and provide certainty of income to card issuers. Some stakeholders also argued that merchants' right to surcharge provides sufficient competitive pressure on payment costs, and that the new interchange standards have only been in effect for a few years so it was too early to consider making any further changes.

In contrast, some merchant and consumer groups argued for a further lowering of the benchmarks to place downward pressure on card acceptance costs. Some stakeholders also pointed out that the cents-based cap on debit transactions has allowed schemes to set unreasonably high interchange rates (in percentage terms) on some low-value transactions. There were also concerns that the wide range of interchange fees has disproportionately benefited larger merchants by enabling them to negotiate discounted rates; these discounts have allowed schemes to raise the 'standard' interchange rates paid by smaller merchants to maintain a high overall level of interchange revenues for issuers.

There were mixed views on whether to extend the interchange regulation to transactions on foreign-issued cards. Those in favour generally cited the relatively higher costs of these transactions. Arguments against extending interchange regulation to foreign-issued cards included: the continued limited use of such cards in Australia; the international schemes having rules that prevent circumvention of domestic interchange caps by issuance of foreign cards; the unfair advantage it would confer on unregulated international schemes; and the lack of evidence on the eventual impact of the EU's recent move to reduce interchange on foreign-issued cards. The international schemes also highlighted that cross-border transactions have unique risks and complexities (including higher fraud rates) that increase issuer costs and justify higher interchange rates. In contrast, stakeholders were generally supportive of the proposal to require schemes to publish interchange fees for foreign-issued cards on their websites.

6.3 Scheme fees

There was widespread support among stakeholders for greater transparency of scheme fees. Several submissions noted that scheme fees are representing an increasing proportion of card payment costs, and that greater transparency could improve merchants' understanding of these costs and promote competition between the schemes. Some stakeholders suggested that smaller acquirers – which may pay higher scheme fees – could also benefit if greater competitive tension led to downward pressure on scheme fees. One stakeholder suggested that the lack of transparency of scheme fees made it impossible for merchants to compare fees under different pricing plans.

Some submissions discussed the form greater transparency should take; suggestions included requiring acquirers to publish the average total scheme fees paid to each scheme or requiring schemes to publish their full fee schedules. One respondent suggested that disclosure would need to be sufficiently detailed to help merchants make more informed decisions on transaction routing for different transaction types.

The international schemes argued against scheme fee disclosure, primarily due to the commercial sensitivity of scheme fee schedules. One scheme suggested that even aggregate scheme fee data is sensitive commercial information, due to the potential for issuers and acquirers to back-out the level of rebates received by their competitors. The other international scheme argued that scheme fee transparency would have little benefit while the lack of transparency of the acquirer fee remained. Both schemes questioned the usefulness of scheme fee transparency for smaller merchants (who preferred simplicity and were largely focused on the overall cost of their payments).

Another concern raised by the international schemes was that the publication of scheme fee data could have unintended, adverse impacts on competition. For example, one scheme argued that such disclosure might generate a market price point or focal point for services, while both were concerned that it would put regulated card schemes at a competitive disadvantage to other schemes.

Regardless of whether they supported scheme fee transparency, most respondents noted the complexity of these fees and the difficulty of ensuring that disclosures would be meaningful to merchants. Several issuers and acquirers said that it would be difficult for them to report accurate information on scheme fees for specific types of card transactions. One major bank suggested that the collection of annual scheme fee data from large issuers and acquirers under Option 3 would create an unnecessary compliance burden, although others did not raise any issues with this proposal. Many respondents also noted that the Bank would need to ensure that any assumptions and methodologies used for reporting scheme fee data were consistent across reporting institutions.

7. Preferred Options

The following section sets out the Bank's preferred regulatory options for the three key policy issues discussed in this paper. In determining the preferred options, the Bank has taken into account the stakeholder feedback received through its extensive industry consultation, while also seeking to balance the costs and benefits discussed earlier.

7.1 Dual-network debit cards and least-cost routing

7.1.1 Dual-network debit card issuance

The trend for some issuers to make the commercial decision to move from DNDCs to SNDCs is likely to continue in the absence of policy action. Over time, a continuation of this trend would likely impose significant costs on users of the payments system and consequently the broader economy, due to the loss of competitive tension between debit schemes and reduced benefits to merchants from LCR. Accordingly, the Bank does not support Option 1.

The Bank has seriously considered whether supporting DNDCs should be viewed as part of the social licence to operate for banks over a certain size. On balance, the Bank is persuaded that the likely economy-wide benefits from a requirement on the major and mid-sized banks outweigh the costs that would be imposed on these issuers.[29] This is unlikely to be the case for smaller issuers, where such a requirement could have an undue effect on their ability to compete with larger banks. Accordingly, the Bank's assessment is that a modified version of **Option 2** is the most appropriate course of action at this point in time. The Bank would state an explicit expectation that all banks with more than 1 per cent of the debit market, by transaction value, should in future issue only DNDCs, with access to both networks in all relevant form factors, including mobile wallets, so that cards with dual-network functionality would continue to account for the vast majority of debit cards on issue.[30,31] This 'expectations' approach, rather than formal regulation, is consistent with the Bank's traditional presumption in favour of self-regulation to address policy concerns. If this expectation were not met, the Board would consider imposing formal regulation in response. More broadly, if the cost of payments were to rise because LCR was no longer a viable option for many merchants and interchange fees or scheme fees were rising, the Bank would consider if any other policy actions might be in the public interest.

With the expectation for DNDC issuance applying to more issuers than originally envisaged under Option 2, there may be less need for major changes to the existing interchange regulation to dis-incentivise SNDC issuance. Nevertheless, the Bank's view is that it is not appropriate for schemes

29 In the United States, the regulatory requirement to issue DNDCs applies to even the smallest financial institutions, though issuers with less than US$10 billion in assets are exempt from the cap on interchange fees. The Bank sees no case for such an exemption in Australia.

30 The expectation to provision both networks in mobile wallets would only apply where such provisioning is supported by both the relevant debit scheme and mobile-wallet provider.

31 Under this option, the Bank would not expect issuers to transition their existing stock of eftpos (single-network) proprietary cards to DNDCs; these existing cards would be effectively grandfathered.

to provide smaller issuers with interchange-based incentives to issue SNDCs. Switching to SNDCs would reduce the cost burden faced by an issuer, so there is little justification for schemes to provide higher interchange revenue at the same time. Accordingly, the Bank's view is that the interchange standards should be amended to address this, to limit the possibility of schemes using interchanges rates in ways that would reduce competition and efficiency in the debit market. However, stakeholders argued that smaller issuers of SNDCs would be particularly penalised by the 6 cents cap on cents-based interchange fees as proposed under **Option 2**. In light of that feedback, the Bank favours adopting a modified version of Option 2. Instead of a lower cap for SNDCs than for DNDCs, the potential for high interchange rates on SNDCs would be limited by a 'sub-benchmark', requiring the *weighted-average* interchange fee on SNDCs from a given scheme to also be no more than 8 cents. (By implication, the weighted-average interchange fee on a scheme's DNDCs could in principle be above 8 cents, provided that the weighted-average interchange fee across all of the scheme's debit (and prepaid) transactions was no higher than the current 8 cent benchmark.) It is likely that any fall in interchange revenue for smaller issuers of SNDCs would be smaller than under Option 2, thereby addressing the concern raised by stakeholders.

7.1.2 Tying conduct

Given the potential negative impact of tying conduct on competition in the debit card market, the Bank favours action to prevent such conduct, either by obtaining voluntary undertakings from the schemes that they will not engage in such conduct or introducing a new standard to explicitly prohibit such behaviour **(Option 2)**. This would be a low-cost policy that supports competition in the debit card market by helping to ensure that schemes compete solely on the basis of their debit card offerings. The principles outlined would underpin the provisions of any voluntary undertaking (or new standard).

Principle 1: Merchants are able to make decisions with regard to the routing of DNDC transactions without implications for the interchange rates that are applied to their credit transactions.

1. If a merchant chooses to route DNDC transactions via a competing debit card network, schemes will not (for that reason, whether solely or in combination with other reasons):
   (a) withdraw or deny access to, or increase, strategic credit interchange rates otherwise available to the merchant;
   (b) withdraw or deny access to, or increase, the credit segment interchange rates applicable to that merchant; and/or
   (c) otherwise increase the merchant's cost of accepting credit card payments.
2. Schemes will not make the offer of strategic credit interchange rates conditional on a merchant's debit volume/value or debit routing decisions.
3. Schemes will provide written reasons to a merchant for any withdrawal or denial of, or increase in, a merchant's strategic credit interchange rate.
4. Schemes will communicate to relevant merchants and acquirers that merchants' debit routing decisions and debit volumes/values will not influence their eligibility for strategic credit interchange rates.

Principle 2: Schemes will not incentivise merchants to route DNDC transactions through their network by leveraging credit during negotiations.

5. Schemes will not unreasonably delay the negotiation of strategic credit interchange rates with merchants. If a merchant requests to negotiate or seek certainty about applicable credit interchange rates prior to the negotiation of debit interchange rates, schemes will accommodate such a request.
6. Prior to commencing negotiations, schemes will provide merchants with clear criteria that apply for determining merchant eligibility for credit interchange rates (including strategic merchant rates and segment rates), including a clear statement that a merchant's volume/value of debit transactions and its debit routing decisions will not impact a merchant's eligibility for credit interchange rates.
7. When determining or applying merchant eligibility criteria for credit interchange rates (including strategic merchant rates and segment rates), schemes will not take into account a merchant's debit transaction volume/value or debit routing decisions. When determining the rate that applies to a category of merchants (including strategic merchants or segment merchants), schemes will not take into account the debit transaction volume/values or debit routing decisions of one or more of the merchants in the relevant category.

Schemes would be required to certify compliance annually.

7.1.3 Least-cost routing

The Bank's view is that explicit regulatory requirements regarding the provision of LCR for **device-present DNDC transactions** (Option 3) is not necessary at this point in time. Instead, the Bank would state an explicit expectation that all acquirers should offer and promote LCR functionality to their merchant customers (Option 2). Further action seems unnecessary given the progress that has been made to date, with all major acquirers now offering LCR in some form, together with the fact that competition in the acquiring market should lead to further improvement in LCR functionality and awareness.

In the Bank's view, stating an expectation or requirement that industry participants must enable LCR for **mobile-wallet transactions** is not justified. While the benefits could be significant, these would likely be outweighed by the costs associated with reconfiguring the technical implementation of mobile payments for the whole industry, as well as other legal and practical challenges. However, to strengthen competition in mobile payments, the Bank will engage with mobile-wallet providers that do not currently support the provision of both networks on DNDCs and encourage them to do so. Combined with the expectation that the larger issuers will provision both networks on DNDCs in mobile wallets (where supported by the relevant schemes and mobile-wallet provider), this will increase the proportion of mobile payments for which consumers have a choice of debit network, thereby increasing competitive tension between the schemes.

In the **online environment**, eftpos' complete suite of capabilities, and so the potential for significant savings from LCR, will soon be available. However, the Bank is concerned that Option 2 would not be sufficient to ensure that enough industry participants implement online LCR functionality in a timely manner, which would significantly limit the potential benefits that could be realised by merchants. Furthermore, there is some risk that the provision of online LCR may be hindered by schemes or other market participants taking divergent, and in some cases restrictive, approaches to its implementation.

The Bank therefore sees merit in taking action to facilitate the broad-based availability of online LCR for merchants and realise the consequent benefits in terms of lower payment costs. Given the Bank's traditional presumption in favour of self-regulation, as well as the technical and operational complexity involved in developing LCR functionality, it seems too early to intervene with explicit regulation. Instead, the Bank will state an explicit expectation that all acquirers, payment facilitators and gateways would offer and promote LCR functionality to merchants in the online environment within a defined period. The Bank's current expectation is that this functionality would be developed by end 2022. If this expectation was not met, the Bank would subsequently consider more formal regulation. The Bank acknowledges that developing online LCR functionality would require industry co-ordination, and welcomes the AusPayNet working group that has been set up to begin this process.

To address the risk of schemes or other market participants impeding the development of online LCR, the Bank will also expect the industry to abide by the principles set out below. In determining these principles, the Bank has considered stakeholder feedback, and attempted to balance the interests of merchants, cardholders and schemes. The Bank is persuaded that the majority of customers do not have a strong preference between debit card schemes. Further, given that merchants incur the cost of processing a transaction and bear much of the fraud risk, they should be able to route transactions via their preferred network, without significant friction being added to the checkout process. This outcome would be consistent with the approach being taken in the United States.

Principles for LCR in the device-not-present environment

1. Merchants (or their acquirer or gateway) can decide whether or not to give customers the ability to choose which debit network will process their transaction. If a customer has been given the ability to choose their preferred debit network and they have made an explicit choice, this choice of network should not be overridden by the merchant or any other party in the transaction process. This would apply, for example, where the checkout page provided the explicit choice of debit network or where the customer used a digital wallet with a preselected debit network.

2. If a customer has not made an explicit choice of network and the transaction may be routed by the merchant or another party in the transaction process away from the 'front-of-card' network, there should be reasonable notification that routing could occur. In the case of new recurring transactions, it would be appropriate to notify customers only at the time of setting up the arrangement. In the case of existing recurring transactions, merchants should notify customers that their transactions may now be routed. The Bank does not propose to prescribe exactly how such notifications should occur.

3. If transactions may be routed by the merchant or another party in the transaction process, the merchant's website and checkout pages should not mislead customers about the choice of payment methods available, or the network that will process their debit transaction. In particular, the wording or visual cues presented when a customer pays with a debit card should not give the impression that a particular scheme will process the transaction if that is not the case; for example, if a checkout page shows a collection of scheme logos to signal how a customer initiates a card payment, the transaction should not be routed via a network that was not shown amongst the logos.

4. Card schemes should not impose rules or technical standards that have the effect of significantly reducing the likelihood of acquirers and gateways providing, and merchants choosing, LCR. For example, schemes should not have rules that:

(a) require merchants to give customers an explicit choice of debit network when first choosing their payment method (as this could preclude LCR).

(b) require merchants to notify customers about routing *in any specific way* (as this could introduce significant friction into the checkout process).

(c) require merchants to get customers' explicit consent to the merchant's routing choice, and/or to give customers the ability to override the merchant's routing choice (as this could introduce significant friction into the checkout process).

Finally, the rule implemented by one international scheme relating to online LCR has highlighted once again that scheme rules can have significant policy implications. Accordingly, the Board's view is that the Bank should be notified of all scheme rules and any changes to those rules. This could be achieved with minimal compliance burden for the schemes, as they would simply provide the same access to rules and notification of changes that is already provided to scheme participants.

7.2 Interchange fees

7.2.1 Debit cap

In the Bank's view, significant changes to the interchange framework to address the high cost of some low-value debit transactions, such as requiring schemes to set all debit interchange fees on an *ad valorem* basis (Option 3), are not justified due to the high adjustment costs for participants and the potential for unintended consequences. Accordingly, the Bank favours a reduction in the cap on cents-based debit card interchange fees (**Option 2**) to reduce the possibility of very high effective interchange rates on low-value transactions at smaller (non-strategic) merchants. This option would also reduce the disparity between the cost to small and large merchants for accepting similar transactions. It would not significantly change the overall interchange framework, and would not impose material additional compliance costs on the industry. This option would still provide schemes with the flexibility to set higher interchange rates on some types of transactions to incentivise certain behaviours, including by leveraging the unchanged *ad valorem* cap. Schemes would also have the ability to restructure their interchange schedules if they wished to minimise the impact of the lower cap on aggregate issuer revenues, given that the weighted-average benchmark would be unchanged. To address concerns by stakeholders about the disproportionate impact on smaller issuers of having a lower cap for SNDCs, the Bank favours a modified version of Option 2 whereby the same cap of 10 cents would apply to both SNDCs and DNDCs (with a separate policy measure to address the potential for schemes to incentivise SNDC issuance through interchange, as discussed in section 7.1.1).

7.2.2 Foreign cards

Given the higher cost of foreign-issued cards, the Bank's view is that there is a public interest case for increasing the transparency of interchange fees on such cards by requiring schemes to publish these on their websites (**Option 2**), rather than persisting with the status quo (Option 1). Greater transparency across schemes of the cost of accepting payments on foreign cards could increase competitive pressure on these fees, with minimal compliance costs. However, given the limited impact on system-wide costs and the absence of evidence that issuers are circumventing the domestic benchmarks through encouraging offshore issuance, broader regulation of these interchange fees (Option 3) is not warranted at this stage.

7.3 Scheme fees

The Bank sees considerable merit to greater transparency in scheme fees. In addition to better informing merchant negotiations and routing decisions, improved transparency would help shine light on any changes in scheme fee arrangements that might be anti-competitive or seek to undermine the interchange regulations. 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). However, greater transparency is unlikely to materialise without policy action.

Requiring card schemes to publish all of their multilateral scheme fees and fee-related rules (Option 2) would be a low-cost way of increasing transparency of these fees. However, the usefulness to stakeholders of the detailed scheme fee schedules would be questionable, given their complexity. The Bank also acknowledges that there is a degree of commercial sensitivity about scheme fees and rebates.

Although Option 3 would impose a higher regulatory burden on the industry, the Bank's view is that these costs would be outweighed by the benefits of meaningful disclosure to both the Bank and industry participants, while also taking into account the schemes' commercial sensitivity concerns. Furthermore, stakeholder feedback to date suggests that the compliance burden would not be significant over the medium term, once the necessary reporting processes have been established. Accordingly, the Bank favours **Option 3** to address the issues associated with the opacity of scheme fees.

8. Implementation and Evaluation

8.1 Implementation

In deciding on the appropriate implementation timelines, the Bank has considered that a range of stakeholders would like to see the new regulatory settings put in place as soon as possible. In particular, merchant groups are supportive of a reduction in the cents-based debit interchange caps. Issuers and acquirers have also been asking the Bank for greater certainty about the regulatory expectations for DNDC issuance and the provision of LCR, particularly in the online environment. At the same time, the Bank is also mindful that some new regulatory requirements, particularly those relating to the periodic reporting of scheme fees, are likely to require some time for development.

Accordingly, the Bank plans to implement the preferred policy options as follows:

- ***DNDCs and LCR.*** The Bank's 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 have to report to the Bank on their LCR offering and on merchant take-up semi-annually, with the first reports due in January 2022 (relating to the second half of the 2021 calendar year).
- ***Interchange fees.*** The updated interchange standards would also be published soon after the Board makes its final decision, at the same time as the Bank publishes the Conclusions Paper for the Review. Effective 1 January 2022, schemes would be required to publish interchange fees on transactions on foreign-issued cards and to comply with the new lower cap on cents-based interchange fees. Compliance with the new weighted-average benchmark for SNDCs would be assessed on a rolling four-quarter basis, with the first compliance period being for the four quarters to 31 December 2022.
- ***Scheme fees.*** The Bank would use its information-gathering powers under section 26 of the PSRA to require designated card schemes to disclose to the Bank all of their multilateral scheme fees and scheme rules that apply to Australian scheme participants (including any changes to these), as well as quarterly aggregate data on scheme fees and rebates. The Bank would issue a formal notice detailing these disclosure requirements soon after the publication of the Conclusions Paper, with the expectation that the schemes would provide the Bank with access to their scheme fees and rules from the beginning of 2022. The schemes would have to start reporting aggregate data on scheme fees and rebates to the Bank by August 2022, relating to the quarter ending 30 June 2022. Large scheme participants would have to start reporting aggregate data on scheme fees and rebates to the Bank in August 2022, relating to the 2021/22 financial year.

8.2 Evaluation

The Reserve Bank will continue monitoring developments and risks in the retail payments market through its regular liaison with industry participants. This will allow the Bank to better understand the impact of its regulation and whether the regulatory expectations are being met. The Bank will also continue collecting data on key indicators, including interchange fees, scheme fees (if the relevant policy option is implemented) and merchant payment costs.[32] The Bank will also continue publishing data on merchant payment costs and may consider publishing data on interchange fees and scheme fees for the benefit of end users. The Bank also expects to conduct its next holistic review of the regulatory framework for retail payments around 2026.

32 Certain acquirers report merchant service fee data to the Bank as part of its Retail Payments Statistics collection.

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Appendix A: One Page RIS Executive Summary

RBA Review of Retail Payments Regulation – Regulation Impact Statement Summary

Policy Issues

The Bank has identified policy issues in three key areas:

- The low take-up of **least-cost routing (LCR)** functionality by merchants and several emerging challenges to the long-run viability of LCR, including: a growing number of card issuers choosing to issue single-network debit cards (SNDCs) instead of **dual-network debit cards (DNDCs)**; the rapid growth of non-routable transactions made using mobile wallets; the risk that some industry participants may hinder the development of LCR for online transactions; and the possibility of the international schemes making low 'strategic' interchange rates on merchants' credit card transactions conditional on debit volumes ('tying conduct').
- The possibility of smaller merchants facing unreasonably high **interchange fees** on some low-value transactions, and the high interchange fees on transactions on foreign-issued cards.
- The opacity of **scheme fees** for end-users of the payments system.

Benefits and Costs

- The recommended options would ensure broad-based issuance and usability of DNDCs without imposing a regulatory burden on very small issuers. Expectations for LCR provision would ensure broad-based availability of LCR and help improve take-up, increasing cost savings for merchants. Regulatory principles for online LCR would ensure that schemes cannot set up implementation barriers. Schemes would not be able to dis-incentivise LCR through tying conduct, and would have limited ability to provide interchange-based incentives for SNDC issuance.
- Lower interchange fees on some transactions would likely reduce payment costs for smaller merchants as well as the cost disparity between small and large merchants. Transparency of interchange fees on foreign cards could put downward pressure on these fees.
- Scheme fee disclosures would allow the Bank to monitor fee growth and identify changes in fees or rules that might be anti-competitive. Publishing summary data could increase competition and help reduce payment costs. However, the reporting requirements would impose some regulatory burden on

Recommended Options

- The Bank would state an explicit expectation that issuers with more than 1 per cent of the debit market would issue DNDCs in all form factors, and that all acquirers and payment facilitators would offer and promote LCR for both device-present and online transactions. The industry would be expected to follow a set of principles in developing LCR online. The weighted-average interchange fee on SNDCs would be limited to 8 cents. The Bank would seek voluntary undertakings from card schemes that they will not engage in tying conduct.
- The Bank would reduce the cap on cents-based interchange fees to 10 cents, and require the publication of interchange fees on foreign-issued cards.
- Schemes would be required to disclose to the Bank all of their scheme fee rates and rules. Schemes and some scheme participants would be required to report periodic data on scheme fees to the Bank.

Consultation Approach

The Bank has consulted extensively on reform options for retail payments regulation. In November 2019, the Bank published an Issues Paper and received more than 50 submissions from financial institutions, card schemes, merchants, consumer groups and individuals. Around 25 parties took up the invitation to discuss their submissions with the Bank. The Bank also conducted a large number of follow-up meetings with stakeholders about the key issues being considered as part of the Review over the following 18 months. In May 2021, the Bank published a Consultation Paper outlining proposed options for regulatory reform. The Bank received written submissions from 35 stakeholders and held over 15 additional meetings with interested parties. The Bank also sought estimates of the regulatory compliance costs of the various policy options from affected stakeholders.

the industry.

Appendix B: Regulatory Cost Estimates

The Bank estimated the regulatory burden of the reform options proposed in the Consultation Paper using the Regulatory Burden Measurement (RBM) framework. The Bank requested compliance cost estimates from 17 industry participants, including card schemes, major banks and other issuers and acquirers. Institutions were sent a template and encouraged to provide estimates for each task broken down into start-up costs and ongoing costs, along with a brief description of the costs included. Thirteen institutions submitted compliance cost estimates.

The proposals in the RIS impose costs on the business cost segment. Individuals and community organisations would not incur compliance costs under these regulatory options. The businesses were disaggregated by business types: card schemes, major banks, other issuers, and other acquirers, to acknowledge that the proposals in the RIS affect these business types differently. Disaggregation by business type also accounts for businesses being of different size (for example, major banks verses other issuers and other acquirers).

The Bank used the cost estimates received from 13 institutions, in addition to information obtained in consultation throughout the Review process, to construct estimated compliance costs for a representative scheme, major bank, other issuer and other acquirer. This was scaled by the number of actual institutions impacted, which depends on the issue and options presented. The Bank has a high level of certainty about the number of institutions impacted. The industry compliance cost for each option was estimated using the following formula:

$$\begin{aligned}
&Estimated\ industry\ compliance\ cost \\
&\qquad = (Number\ of\ impacted\ schemes) * (Representative\ scheme\ cost) \\
&\qquad + (Number\ of\ impacted\ major\ banks) * (Representative\ major\ bank\ cost) \\
&\qquad + (Number\ of\ other\ issuers) * (Representative\ other\ issuer\ cost) \\
&\qquad + (Number\ of\ other\ acquirers) * (Representative\ other\ acquirer\ cost)
\end{aligned}$$

As per the RBM framework, the annual average regulatory cost assumes a default 10-year duration, so start-up costs were averaged over 10 years. Consistent with the estimates provided by institutions, the ongoing costs are assumed to be constant over the 10-year period.

As requested, most institutions submitted labour cost data in full-time equivalent (FTE) work days.[33] Costs were aggregated industry-wide and converted to dollar value terms using a daily wage conversion rate of $568. This was calculated as follows. The average weekly cash earnings plus income tax was estimated at $1,510.02, using the average weekly ordinary time cash earnings for financial and insurance clerks of $1,278,[34] and the associated weekly income tax of $232.02.[35] Using average weekly ordinary time hours paid of 37.7 hours,[36] the average hourly rate plus income tax was $40.05. Scaling this up using the OBPR default multiplier of 1.75, the average hourly wage for OBPR calculations was around $71, with average hours worked per day of approximately 8 hours.

33 Where costs were submitted in dollar value terms, they were converted to FTE days using the average daily wage rate for OBPR calculations as described below.

34 Employee Earnings and Hours, Australia, May 2018. Data cube 13. Full-time non-managerial employees paid at the adult rate. Financial and insurance clerks. (https://www.abs.gov.au/statistics/labour/earnings-and-work-hours/employee-earnings-and-hours-australia/latest-release)

35 Calculated using the ATO simple tax calculator found at https://www.ato.gov.au/Calculators-and-tools/Host/?anchor=STC#STC/questions

36 Employee Earnings and Hours, Australia, May 2018. Data cube 13. Full-time non-managerial employees paid at the adult rate. Financial and insurance clerks. (https://www.abs.gov.au/statistics/labour/earnings-and-work-hours/employee-earnings-and-hours-australia/latest-release)

Subject to some exceptions outlined in footnotes to the relevant costings, the representative institution cost was the average of costs submitted across relevant institutions. If institutions provided range estimates as opposed to point estimates, the midpoint of this range was typically used.

There was substantial variation in the cost estimates provided by different businesses. In part, this is because businesses may differ in how efficient they are, how sophisticated their recording and reporting systems are and what is already business-as-usual (BAU) for that business. There is also variation because of uncertainty in costing. As such, the industry compliance cost estimates are also subject to considerable uncertainty.