PSR Cross Border Interchange Fees Interim Report - Consultation Response

Date: 14.02.2024

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Executive Summary

Issuers:

- Generally do not support an interim cap – there is in an insufficient body of evidence or a demonstrated urgent and material need to do so
- The approach in the Interim Report draws wide conclusions from a slim body of evidence – even stating the purpose of interchange is to incentivise issuers to sign up to one four party scheme or the other - that conclusion is not accepted
- Merchant costs are important, but the Interim Report focusses on those costs alone, too readily dismissing the value of cards to the UK economy as a whole, to merchants and to consumers
- The approach should bear in mind the Future of Payments Report which states the cards work well and that the UK has one of the leading card propositions globally – it also recognises that sustainable commercials are required for open banking (as does JROC) and this principle should apply to the cards industry too
- Any future study on pricing (such as a merchant indifference test) needs to take into account merchant cost, but also the other success factors embedded in the card proposition to merchants and consumers

Merchant Acquirers:

- Are more supportive of reduced costs
- Are concerned about the practical implementation on their core platforms and how much notice they will have to execute

1. Introduction

We welcome the Payment Systems Regulator's (PSR) review of cross border card interchange fees and its interim report (the “Interim Report”). We acknowledge the complexity of this issue, especially given the varying perspectives arising from different business models and roles within, or outside, the four-party arrangement.

This response first considers views from the issuer community. Acquirer views are represented in section 10 below.

2. Context

2.1 It is worthwhile recalling a broader context, before considering the issues raised in the Interim Report.

2.2 The legal position post-Brexit led to the removal of the Interchange Fee Regulation (IFR) 0.2% cap for debit card and 0.3% cap for credit card transactions for transactions between the EEA and the UK. In the absence of any applicable cap, Mastercard and Visa changed their multilateral default rates to the rates set out in the EU Commitments[1]. It is worth noting that the EU Commission concluded that these caps ensure costs for retailers accepting inter-regional consumer card payments did not exceed those of alternative methods, such as cash or e-wallets. These commitments expire in late 2024.

2.3 The focus of the cross-border interchange consultation is on interchange fees payable to EEA issuers by UK acquirers, while the review of interchange fees payable to UK issuers by EEA acquirers has been stopped. We believe that the reduced scope means that the consultation now covers only a few per cent of all UK card transactions processed by UK acquirers.

2.4 The Interim Report finds that the increase in cross border interchange fees post Brexit did not correspond with any increased issuer risks, costs, or added value. The Interim Report also notes that the PSR did not see any evidence of any difference in the risk and costs to issuers between domestic and cross border transactions.

2.5 The Interim Report's approach is based on the economic theory of pass-through, suggesting that reductions in merchant acquirer input costs should ultimately benefit consumers (to the extent this is passed on by acquirers to merchants).

2.6 The Interim Report sets out proposals to reintroduce the IFR caps to transactions between UK merchants/acquirers and EEA consumers/issuers as an interim measure and to conduct a further study to set a long term cap for those transactions, using a merchant indifference test (MIT).

2.7 Joe Garner's Future of Payments Review Report was published in November 2023[2]. It called for a National Payments Vision and recognised merchant costs as an issue but placed greater emphasis on the lack of viable alternatives to card payments. It recommended the development of open banking with necessary consumer protection and commercial arrangements for all participants. The Review noted the efficiency of card systems in serving both merchant and consumer needs and that they work well.

2.8 Developments in the field of open banking may provide some useful context. In June 2023, the Joint Regulatory Oversight Committee (JROC) published its Principles for Commercial Frameworks for Premium APIs[3] (the "JROC Principles"). To some degree some of those principles are relevant to any payments system, including cards. The relevant principles set out that fees and charges should:

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[1] Antitrust: Commission accepts commitments by Mastercard and Visa to cut inter-regional interchange fees (europa.eu),

[2] https://assets.publishing.service.gov.uk/media/6557a1eb046ed400148b9b50/Future_of_Payments_Review_report.pdf

[3] https://www.fca.org.uk/publication/corporate/jroc-principles-commercial-frameworks-premium-apis.pdf

- broadly reflect relevant long-run costs (Principle 1)
- incentivise investment and innovation (Principle 2)
- incentivise take-up of open banking by consumers and businesses and use of network effects (Principle 3)

These principles support the general concept that costs, innovation and investment need to be funded within the system. In open banking, the solution is to provide income for sending banks through a premium API charging model. In cards, issuers invest and incur costs (such as claims, service, security, fraud, digital wallets, card specific platform and innovation – these are all card related, not general banking overhead and are "relevant" long-run costs (Principle 1 above)). We do not think there is any good reason why the concepts applicable to open banking should not apply to the cards system.

2.9 The PSR is also consulting on its proposals to accelerate open banking in the field of variable recurring payments[4]. On the basis that account banks do not have relevant costs, the initial approach requires banks to facilitate the services without earning income for enabling account access.

Response to Consultation

3. Issuer concern : Legal certainty

A matter of current concern for many UK issuers is the legal risk that even at a prescribed cap, the interchange concept and rates are susceptible to legal challenge based on an alleged breach of competition law. This situation risks clogging up the UK competition and appeal courts for years and leaving issuers and schemes with potential long-term liabilities, which in turn cast unnecessary doubt over long term commercial returns and investments. Whatever the outcome of this consultation may finally be, issuers wish any cap to be legally certain and immune from further competition law challenge. This applies to domestic and cross border interchange. It is acknowledged that such an approach may be beyond the powers of the PSR and engagement with HM Treasury will be required to achieve certainty through legislation.

4. EEA Context

4.1 The EU Commitments cover cross border interchange receivable by "Rest of World" issuers outside the EEA, payable by acquirers within the EEA. The European Commission accepted the commitments made by Visa and Mastercard in 2019: "*The Commission concluded that, with the proposed inter-regional MIFs caps, the cost for retailers of accepting inter-regional consumer card payments does not exceed the cost of accepting alternative means for such payments, such as cash for Card Present Transactions and e-wallets (digital wallets) funded via bank transfers for Card Not Present Transactions*".

4.2 Post Brexit, the IFR regulation no longer applied to UK-EEA cross border card transactions. The Interim Report finds that the EU Commitments' cross border interchange rates were not an appropriate comparable to use for setting UK-EEA cross border interchange. The rationale is that the UK's continued access to the European SEPA payment scheme, differentiates the UK-EEA relationship from the EEA-Rest of World (non UK) relationship, in the context of inter-regional card payments and alternatives.

4.3 However, the Interim Report notes that SEPA payments for EEA consumer / UK merchant cross border payments are not a viable alternative to cards. We therefore question whether the inter-regional differentiation between the EEA and the Rest of World, based on SEPA

[4] CP23/12 VRP Expanding variable recurring payments: call for views (psr.org.uk)

access, is justifiable. Further, there is some merit in the argument that in the absence of any direct UK legislation or coordination with the EU, the rates set by the four party card schemes were as close to being legally certain than any other option, including maintaining at domestic rates (which as we note above are subject to legal uncertainty).

5. Proxy for a bigger issue?

5.1 The Interim Report concludes that post Brexit there is no evidence of a direct correlation between cross border interchange income and how that income was used to invest in fraud risk mitigation or improve services. The conclusion is based upon an assumption that the IFR rates were set by the EU at the appropriate level for intra EEA cross border card payments.

5.2 The approach overlooks the likelihood that in the context of cross border UK-EEA transactions, issuers operate at a loss at the old IFR rates. The Interim Report also finds a lack of difference between the domestic and cross border contexts. However, there is insufficient exploration of the costs issuers incur in cross border transactions as compared to domestic transactions – for example, UK issuers contend that UK-EEA cross border transactional costs, fraud costs and the cost of handling non fraud disputes are all higher.

5.3 The approach overlooks that in some years there will be heavy investment when new features, authentication/fraud tools or propositions are rolled out and in other years the investment may be less. The Interim Report too narrowly expects that interchange income must be traced through to in-year line-by-line spend. In the context of the value issuers bring and the costs they incur in providing cross border payments and comparing UK domestic and UK-EEA rates, more focus is needed on the baseline differential (rather than merely the post Brexit differential) between UK domestic transactions and UK cross border transactions.

5.4 All the above factors and assumptions lead to a generalised and unsubstantiated conclusion about the purpose of interchange (not just cross border) – namely to incentivise issuers to sign up to one four party card scheme or the other. Industry strongly rejects this assertion.

6. The Broader Policy Context.

6.1 Regulatory intervention should be made in the broader context of where the UK payments industry is today and where it needs to be in the future. In particular, the UK is preparing to launch a National Payments Vision as recommended by the Future of Payments Report. Recommendation 7 of that report states that policy makers need to "…*prioritise agreement of a commercial model for Open Banking so that there is scope to invest in both infrastructure and consumer protection. Without sustainable financials, it is hard to see that Open Banking can thrive over the long term*". The JROC Principles are caste along similar lines. The Future of Payments Report and the JROC Principles clearly identify the need for commercial arrangements to pay for the end-to-end proposition of a payment type. However, when looking at cards alone, the approach in the Interim Report, completely overlooks the propositional features present in cards that need to be built in open banking to compete with cards (e.g. customer protections). It is difficult to understand why zero interchange is mooted for cards, but commercials are proposed for open banking.

6.3 The approach in the Interim Report is stated to be on the basis of the PSR's statutory objectives (which include competition, service user and innovation objectives). Having overlooked baseline value and true costs, the focus becomes one of competition (by way of merchant cost) at the expense of service and innovation. Competition and payment policy should be promoting competition of payment types based on the end-to-end proposition for all users. A more balanced approach would of course include merchant cost, but also take into account the costs and investments incurred by all industry participants that develop value for both merchants and consumers alike, including speed, security, fraud protection, resilience, consumer experience and consumer recourse.

6.4 A more consistent policy approach is needed, that recognises that the value and proposition of any payment type requires commercials for all PSPs that cover costs and pay for innovation and investment.

7. Lack of Merchant Choice and Cost

7.1 The Interim Report notes that for merchants, cards are “must take” because alternatives either do not exist or are too expensive. Both statements can be challenged, for example e-wallets funded by e-money are widely available to consumers and businesses. Cards can represent a cheaper option that alternative payment methods and it seems odd that the Interim Report rules them out as an alternative option because they may be more expensive. E-wallet providers may actually challenge that they are more expensive.

7.2 Some industry participants have put forward the view that the best way to deliver competition and give merchants choice is to pursue the approach set out in the Future of Payments Report and encourage alternative payment types by building propositions that can compete with cards. Some point out there is little evidence base in the Interim Report for the assumption that reduced merchant acquirer input costs (interchange) automatically leads to lower prices for consumers. A merchant cost approach to competition, founded on zero or below cost issuer / sending bank commercials could be counter-productive. It risks harm to the future innovation and safety of the UK payments industry as a whole, leaving it behind our international competitors and failing to realise its potential to power economic growth.

8. The Merchant Indifference Test (MIT) – “MIT +”?

8.1 The Interim Report notes that the MIT methodology is accepted as the best way to determine interchange. However, its application needs to be nuanced. Merchants are indifferent to many of the benefits that consumers enjoy from cards. Arguably, under competition law cases before the courts, the four party card schemes are being assessed against the value to merchants alone and cannot bring value to consumers into the argument. The PSR on the other hand has service user objectives that include value but industry is circumspect as to whether value is being considered sufficiently (and what that value costs).

8.2 When constructing the approach to the study, alternative payment types and their costs to merchants will be considered. The problem though is comparing “apples and apples”. The cards “apple” offers a superior proposition (e.g. payment and fraud protection) to other options. We submit that the value elements to merchants and the consumers (largely paid for by the merchants) should be taken into account (e.g. a SEPA payment with no consumer protection is not the same as a card or other payment that carries consumer protection). Where one payment type has additional features over others, those features should be included in the framework for determining regulatory pricing or caps. The historic MIT approach did not consider issuers’ costs. Issuers’ costs include specific card industry elements such as Apple Pay, but there are significant other costs directly related to issuing cards that are not general banking overhead costs (such as card platform costs, card fraud prevention technologies, customer servicing and handling claims, amongst others). Placing caps potentially below the aggregate of those uncapped input costs is not going to increase competition in the issuing sector, nor support further development in innovation or fraud protection.

8.3 The future study should take into account some of the pricing principles set out by JROC and the commercial principles set out in the Future of Payments Report. Payments incur costs and require investments to deliver the broader value to all users. The costs to issuers and the benefits to consumers and merchants must be taken into account, in addition to merchant costs, when considering the future level of interchange. The future methodology should therefore be "MIT +".

9. Interim Cap

Issuers have expressed strong opinions that an interim cap is inappropriate. It would be somewhat unprecedented to impose a regulatory price cap, in the absence of a full body of evidence and impact assessment demonstrating a need for it, or what that price should be. Whilst the cross border rates did increase, the Interim Report does not assess the current levels. In any event, interchange remains a small proportion of a merchant's total input costs (as compared to other input costs like energy, staff, raw materials etc). Imposing a temporary price cap, in the absence of an urgent and materially significant costs shock to merchants is also inappropriate. There is the potential that a temporary cap imposed in such circumstances will create a dangerous precedent in the UK more widely. The issuers point to the likelihood that a temporary cap sets expectations as to where a final cap will land and could be materially prejudicial.

10. Acquirer perspectives

10.1 The response comments above come from an issuer perspective. The following section is a merchant acquirer only view.

10.2 Acquirers are more supportive than issuers of reducing cross border interchange, as they argue that will ultimately benefit merchants. However, several acquirers have told us that implementing a new regime will require significant operational changes and is more than a mere "switch". For some that may involve creating a new "region" in their systems. For example, the current UK-EEA flow of card transactions in both directions would be treated as a single region. Imposing a cap on one way traffic which differs to traffic the other way, means that an acquirer will need to split the existing region into two. The change would impact interchange ++ and blended pricing and is a portfolio and platform issue. This development work is significant and depending on an acquirer's current configuration could take over 12 months. Those acquirers that created the new region when the new cross border rates were introduced will need to unwind that programme and start again. Those that did not build a new region in their systems (and thereby may have absorbed the increases in interchange) may need to initiate a new programme on their platforms.

10.3 Further, leaving aside the core platform change issue, repricing merchants is extremely complex and requires considerable analysis, in part related to the Consumer Duty. Portfolio repricing has to be planned and scheduled and usually occurs at periodic intervals.

10.4 Therefore acquirers request a reasonable period of notice before any new interchange caps are applied so that they can consider and execute any pricing and platform changes required.

10.5 Some acquirers told us that merchants want some certainty as to their future costs. Some also would rather implement any change once, not twice. Some would rather the old IFR cap became permanent as soon as possible, but this leaves open the legal and evidential basis for doing so. Other acquirers would rather wait until a full study is completed and are therefore not supportive of the two-step interim-then-final cap approach.

10.6 Acquirers accept that they generally pass on interchange onto merchants although they point out that interchange is only one of the factors that impact their final pricing to merchants.

10.7 Acquirers look forward to engaging on the costs study to make sure all relevant factors are considered, including the costs to them for making platform changes, costs and fair value for merchants but also ensuring all PSPs have sufficient economics to invest in innovation and value for payment service users.

If you have any questions relating to this response, please contact the below at adam.scarrott@ukfinance.org.uk.

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