South African Reserve Bank

Interchange Determination Project, Phase 2 Card Results

1 Introduction

The purpose of this communiqué is for the South African Reserve Bank (the Bank) to share the results of the Bank facilitated interchange determination project (IDP), with specific reference to the card phase.

The feedback has been structured to provide high-level detail on the:

- project positioning and status;
- card payment-stream approach and industry-specific issues;
- outcome for the card phase; and
- next steps in this process.

2. Background and approach to Phase 2 of the IDP as it relates to cards

Phase 1 of the IDP was launched in 2011, following the recommendations from the Banking Enquiry Report. A key recommendation from the Banking Enquiry Report was that: *"We recommend that an independent, objective and transparent regulatory process for determining interchange in the payment card and other relevant payment streams be effected and enforced as soon as practicable".*

The Bank proposed a bank-facilitated and overseen process to revise interchange rates for ATM and card payment streams in South Africa. This proposal was supported by the National Treasury and the Competition Commission. The Bank thus contracted KPMG to facilitate Phase 2 of the IDP under the oversight of the National Payment System Department (NPSD).

The overall objective of the project encompasses the evaluation and determination of the costs of providing payment services in a particular payment stream, from which an appropriate interchange rate is determined. Two payment streams were selected for this phase of the project, namely ATMs and all the card-related streams.

The ATM payment stream was selected as the pilot phase, and some of the lessons learned were applied to the card phase as the second priority payment stream.

The ATM rates were communicated during December 2013 and need to be implemented by 1 April 2014.[1]

2.1. Project methodology and approach for the card phase

The Bank considered the card phase as a priority area for IDP as the card interchange rates were last determined over ten years ago, in 2003, and the card definitions had become outdated. Furthermore, the current card interchange consists of a three-tier interchange structure, and this does not take cognisance of innovation in this market, as well as safety features and risk profiles of transactions.

The card phase of the IDP commenced in 2013 and the team has had numerous interactions with all the stakeholders in this phase of the IDP, following a similar project cost-based approach adopted in the ATM phase.

International benchmarking highlighted a wide range of methodologies for determining interchange in the card sphere. Based on investigation and stakeholder interaction, it was decided that the cost-based methodology was still the most appropriate for the South African market. This methodology focuses on determining the true cost of offering a service (while being cognisant of directional interchange flow), and assesses current interchange against this cost.

The process to determine the interchange rates within the card sphere was notably more complex than it was for ATM, due to the multitude of qualitative considerations and a wider stakeholder community to be consulted.

To keep the team aligned and to steer the project appropriately, guiding principles were identified at the outset, and have been consistently adhered to throughout the project. The core guiding principle throughout the analysis process was the safety and efficiency of the national payment system (NPS), and ensuring that the interest of the NPS as a whole rather than that of individual or groupings of stakeholders was paramount.

[1] For more information go to: http://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/IDP/Pages/Default.aspx

Through the consultations with the stakeholders, a clear message received from the stakeholders was the need for change within this payment stream. It was indicated that the market was changing, but the card definitions and interchange structure were no longer catering for elements of growth, innovation and security. The Bank is confident that it has addressed these elements and the results being shared will bear testament to this.

The project team investigated and researched the card payment landscape and other related industry issues, and consulted with acquiring and issuing banks, card schemes, Payment Clearing Houses (PCH) system operators, merchants, fuel companies, industry associations, National Treasury, the Competition Commission and government representatives.

2.2. Items covered in this phase

The scope of the card phase included detailed investigations into:

- traditional cards (debit, credit and hybrid cards);
- self-service devices (SSDs);
- over-the-counter transactions (OTCs); and
- cash-back at point-of-sale.

Additional topics were also addressed to:

- determine if specific interchange rates were required for fuel transactions, government payments and low-value payments; as well as to
- clarify card-related market issues – including the clarification of card definitions.

2.3. Card-specific cost-based methodology

As noted previously, the project team followed a cost-based methodology approach and the participants were able to supply relevant costs associated with providing the in-scope services.

The investigation into SSDs and OTCs was conducted on a basis that is aligned with ATM, due to their similarity in nature with ATMs. This also applies to cash-back on a broader scale, with some key differentiating factors.

As card-based transactions are significantly different from the previously mentioned transaction types, the cost determination required a more tailored or enhanced cost-based approach.

The quantitative factors utilised for determining card interchange rates are as follows:

- Only the minimum costs that would have been incurred by a party for issuing and processing a local card product are included in the determination of interchange.
- Only costs incurred by the issuer that are beneficial to both the cardholder and the merchant, either directly or indirectly, are included in the determination of interchange.
- Standardised costs incurred specifically for the purpose of reducing/mitigating risks in the card payment system are included in the determination of interchange.

The qualitative factors utilised for determining card interchange rates are:

- access to financial services;
- stability in the financial services industry;
- innovation and future developments;
- concerns and views on the current interchange rate, that it doesn't cater for innovations, safety features and risk profiles of transactions; and

- impact on individual stakeholders, as well as segmented stakeholders.

After having considered both quantitative and qualitative elements, the project team determined the new interchange rates.

3. Interchange results

3.1. SSDs and OTCs

SSDs, OTCs and cash-back jointly represent approximately 3 per cent of the market, and interchange rates are currently set bi- and multilaterally.

Within the SSD and OTC market, there are limited acquirers and, as a result, the Bank has decided that there is insufficient comparative data to allow the project team to calculate and set appropriate interchange rates for transactions executed using these mechanisms. It was thus decided that the status quo in the market for SSDs and OTCs should prevail.

3.2. Cash-back at point-of-sale

In the case of cash-back transactions performed at point-of-sale, there are currently two sets of interchange rates in the market – one for pure cash-back transactions, and another for cash-back performed in combination with a purchase transaction. Based on the team's research and analysis, it has been decided to set a single rate for both these transaction types.

Cash-back transactions should be incentivised as an increase and uptake in cash-back transactions at merchants would be beneficial to all the stakeholders (banks, merchants, associations and customers) and this will support financial inclusion.

This single cash-back rate will be a fixed rate and thus an inflationary allowance has been applied, as well as an infrastructure incentive to promote the use of cash-back within the South African market. The incentive percentage applied was based on the short-term weighted-average cost of capital.

The new single cash-back at point-of-sale rate will be R1,11 and will be applicable from 1 January 2015.

3.3. Summary of industry-specific issues – Fuel

As part of the project, the team also investigated the possibility of introducing industry-specific interchange rates – specifically for government payments and fuel transactions. These two industries were selected based on stakeholder feedback.

The team examined whether it would be feasible to introduce a fuel-specific interchange rate. However, due to the unavailability of key information, together with broader industry issues that need to be resolved, this investigation could not be successfully completed at this point in time. As a result, no special fuel interchange rate could be determined at this time. But work will continue and inform any need for a potential future interchange rate in this area.

3.4. Summary of Industry specific issues – Government

Government institutions also face the challenge of having to accept mainly cash payments, and being exposed to the resulting risks related thereto. The project team considered the possibility of introducing a government-specific interchange rate, with the objective of encouraging a move away from cash towards card-based payments.

After consultation with survey participants and National Treasury, this investigation was halted as there is already sufficient commercial motivation for banks to roll-out infrastructure and engage with government in the drive to increase the acceptance of non-cash payments. As a result, no special government interchange rate will be determined at this time.

3.5. Summary of industry-specific issues – card definitions

One of the key industry issues that were addressed by the team related to card definitions. The card interchange rates were last revisited in 2003 and the associated definitions need to cater for current market realities and innovations, as mentioned previously.

Based on these factors, the results being shared will address:

- revised card types for the purpose of interchange and the related new card definitions; and

- a new interchange rate structure which incorporates key initiatives undertaken by the market, as well as risk management interventions.

3.6. Card types and definitions

The current card categories – being debit, credit and hybrid cards – were analysed in detail as part of this phase of the IDP. This included a comparison in the cost structures and levels for these card types.

Based on analysis and close alignment of debit and hybrid cards, both in nature and costs, it has been decided that – for the purposes of interchange – the hybrid card category will be eliminated. This effectively means that the revised card types will consist only of debit cards and credit cards, and current hybrid cards would need to be reclassified.

The relevant definitions for these two card types have been established in a collaborative effort between the stakeholders and the project team. The Bank will thus be working with the Payments Association of South Africa (PASA) to ensure that the transition from current card types to new card types is implemented in the course of 2014.

3.7. Card rates – new rate structure

As proposed by the stakeholders, the card rate structure needs to cater for innovation and the risk profile of a transaction. The first element considered relates to the overall rate structure. The current interchange rate in place for cards consists of a variable rate – and the new rate structure will retain this characteristic, being a percentage of the transaction value.

The new card interchange structure has however been adjusted and there are four key steps that need to be followed in determining the applicable tiers for the interchange rate.

Step 1 – Payment card classification, that is, debit or credit

Step 2 – Apply the base rate that forms the foundation of the interchange rate – based on the general costs of a debit and credit transaction

Step 3 – Consider the nature of the transaction and the associated risks (card-present transactions or card-not-present transactions)

Step 4 – Apply behaviour incentives to drive the adoption of safer and more efficient NPS through the incentivisation of EMV and 3D secure compliance.

The key differentiating factors from the current rate structure relate to the introduction of:

- card-present versus card-not-present elements;
- EMV margins; and
- 3D secure margins.

The introduction of margins to be applied will be dependent on issuer and acquirer compliance. This new interchange rate structure will result in 12 rates, as opposed to the current 3 rates. The Bank believes that a balance has been achieved between the required additional complexity (in the introduction of innovation and risk) and keeping the rates as simple as possible.

3.8. Rates to be implemented

The interchange rates that are to be applicable for the debit card and credit card transactions are as follows:

	Debit card	**Credit card**
Card-present purchase (issuer and acquirer EMV[1] compliant)	0,44%	1,48%
Card-present purchase (only the issuer is EMV compliant)	0,52%	1,55%
Card-present purchase (only the acquirer is EMV compliant)	0,36%	1,41%
Card-not-present purchase (issuer and acquirer is 3D Secure[2] compliant)	0,48%	1,73%
Card-not-present purchase (only the issuer is 3D Secure compliant)	0,53%	1,89%
Card-not-present purchase (only the acquirer is 3D Secure compliant)	0,43%	1,57%
Cash-back at POS	R1,11/transaction	

3.9. Implementation approach

As the proposed new interchange rates are more complex than the current rate structure, an accommodative implementation approach has been determined. In order for these new rates to remain relevant, the implementation date is set for 1 January 2015. This will afford the stakeholders sufficient time to implement the required system, process and resource changes to accommodate these new rates.

4. Conclusion

From as oversight perspective, the Bank envisages that this will not be a once-off exercise, but rather that the project will transition into an annual monitoring process that will be run by the Bank to ensure the appropriateness of the rates going forward.

The objective of the ongoing interchange monitoring process will be to gather information to assess the prevailing interchange rates, perform interchange and cost-trend analysis, assess any innovations in the market and re-evaluate the qualitative incentives in the applicable rates. It is, however, not the Bank's intention to necessarily amend the rates annually, but rather only as and when it may be deemed necessary.

The Bank appreciates the co-operation of the industry stakeholders during the IDP, and we hope that we can count on the continued support and interaction of stakeholders going forward. The sustainable survey, approach structure and overall process will be shared with the stakeholders within the next few months. The project team will be in contact with stakeholders to discuss the sustainable process and provide further clarity on this matter.

In conclusion, the Bank would like to take this opportunity to thank the project team, and those that worked closely with them, for the excellent work they have undertaken during Phase 2 (cards) of the interchange determination process. The co-operation of the banks and other stakeholders involved during this process is also appreciated.

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