

Title: Appointment of the Competent Authority and Approach to National Discretions for the Interchange Fee Regulation IA No: RPC-3083(2)-HMT Lead department or agency: HM Treasury Other departments or agencies: Payment Systems Regulator / Trading Standards / Financial Conduct Authority / the Competition and Markets Authority	Impact Assessment (IA)		
	Date: September 2015		
	Stage: Final		
	Source of intervention: EU		
	Type of measure: Secondary legislation		
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Summary: Intervention and Options	RPC Opinion: Submitted
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Cost of Preferred (or more likely) Option				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Two-Out?	Measure qualifies as
£0	£0	£0	No	NA

What is the problem under consideration? Why is government intervention necessary?

The Interchange Fee Regulation (IFR) was published in the EU Official Journal on 19 May 2015. Price caps and other key regulatory clauses will come into effect in the UK on 9 December 2015 in a move to improve competition and contribute to the digital single market. The UK is required to put in place an appropriate and effective regulatory regime to enforce compliance. The IFR caps interchange fees charged for the acceptance of debit and credit cards. These fees are set by the card networks and paid by the merchant's bank (called 'merchant acquirers') to the customer's bank (called 'issuing banks') for the acceptance of card-based transactions. We are submitting this final impact assessment following a public consultation.

What are the policy objectives and the intended effects?

Our policy intention is to comply with the requirements of the IFR in order to avoid infraction proceedings by the EU Commission. However, we intend to implement the IFR using existing regulatory structures and processes to ensure efficiency and avoid unnecessary additional costs. The primary objective of the IFR more widely is to cap interchange fees, given there is no market incentive for card schemes to keep these low. The IFR also seeks to tackle restrictive business rules, such as the lack of transparency of fees incurred by merchants from their banks. This EU-wide measure will also contribute to the digital single market by improving trade across borders.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

We do not have options available to us for how to implement the basic requirements of the IFR (given it is a directly applicable regulation), only for how we supervise and enforce those requirements. We have considered two options here:

1. Use existing bodies to oversee and enforce the IFR; or
2. Set up a new body for this purpose.

Option 1 fulfils our policy intention of implementing the IFR in the most efficient and appropriate way possible, including keeping down additional costs for regulators and industry. The consultation confirmed this as the most appropriate approach.

Will the policy be reviewed? It will be reviewed. If applicable, set review date: 06/2019					
Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro Yes	< 20 Yes	Small yes	Medium Yes	Large Yes
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)			Traded: n/a	Non-traded: n/a	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: _____ **Harriett Baldwin** _____ Date: 18/09/2015

Summary: Analysis & Evidence

Policy Option 1

Description: Implementing the Interchange Fee Regulation by Designating the Payment Systems Regulator as the Competent Authority

FULL ECONOMIC ASSESSMENT

Price Base Year n/a	PV Base Year n/a	Time Period Years 1	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate: n/a

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	£0	£-0.3 million	£-2.6
High	£0	£0.3 million	£2.6
Best Estimate	£0	£0	£0

Description and scale of key monetised costs by 'main affected groups'

The costs of the IFR to businesses are £0. The net losses to issuing banks will be directly passed on to the merchant (which we can expect to be passed on to consumers in the form of lower prices). Further details of this are provided in our pre-consultation impact assessment.

The costs for designating the Payment Systems Regulator (PSR) to supervise compliance of the IFR have already been accounted for in the PSR's annual budget (£1.2 million per year for supervision of the IFR). Further analysis has shown that there is a lower and upper range of £900k and £1.5 million, which gives us a median estimate of £1.2 million. This option would not incur any set-up costs as the PSR is already established and has a cleared budget for its ongoing annual costs.

Other key non-monetised costs by 'main affected groups'

Having engaged with relevant bodies during consultation, we are assured that other set-up costs, for example, designating an appeals body for PSR decisions and an obligation on merchants to display what types of cards they accept, is negligible.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	£0	£0	Optional
High	£0	£0	Optional
Best Estimate	£0	n/a	n/a

Description and scale of key monetised benefits by 'main affected groups'

As mentioned above, implementing the IFR will create a net gain to merchants (although will net to £0 to the economy as a whole). Respondents from the consultation have estimated that the gain to businesses as a whole could be in the region of £700 million per annum. We can expect to see these savings for merchants passed on to consumers in the form of lower, or slower-growing prices.

Other key non-monetised benefits by 'main affected groups'

As the PSR is already established, this option will allow the UK to meet its commitment of having a 'competent authority' (i.e. a regulator) in place to supervise the IFR. Government can also demonstrate the efficiency of its regulatory practice by not duplicating efforts through the set-up of a new body. It also simplifies compliance by having a single lead regulator supervising the payments market.

Key assumptions/sensitivities/risks n/a	Discount rate	n/a
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BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: n/a	Benefits: n/a	Net: n/a	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Implementing the Interchange Fee Regulation by Setting up a New Regulator

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year	Time Period Years 1	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate:

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	£6.05 million	£0.9 million	£6.95 million
High	£6.05 million	£1.5 million	£7.55 million
Best Estimate	£6.05 million	£1.2 million	£7.25 million

Description and scale of key monetised costs by 'main affected groups'

Setting up a new regulator would incur significant additional costs funded by levies to regulated bodies, which would be required to pay fees to the regulator to cover the cost of setting up the regulator, in addition to the ongoing annual supervision costs. Using the PSR's Year 1 costs as an analogue here, we could expect the cost of setting up a new regulator to be £6.05 million in the first year, with an ongoing annual cost of £1.2 million to supervise the IFR. Year 1 costs comprise familiarisation and staff costs, recruitment and training, accommodation and office services and IT set-up.

By not designating the PSR as competent authority, government would forgo an opportunity to exploit economies of scale, and access existing payments expertise. As with Option 1, the costs to business as a whole of implementing the IFR net off because losses incurred by issuing banks will be passed on as net gains to merchants. However, unlike Option 1, the costs of setting up a new regulator have not already been accounted for.

Other key non-monetised costs by 'main affected groups'

We would expect that it would take between 1-2 years to set up a new regulator, therefore we risk failing to comply with the implementation deadline of having an appropriate regulatory regime in place by 9 December 2015. Additionally, setting up a new regulator would mean duplicating existing work done to create and maintain the PSR – this duplication would cause reputational damage for government as it is demonstrably inefficient.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional	Optional	Optional
High	Optional	Optional	Optional
Best Estimate			

Description and scale of key monetised benefits by 'main affected groups'

As per Option 1, implementing the IFR will create a net gain to merchants (although will net to £0 to the economy as a whole). The British Retail Consortium has estimated that this could be in the region of £480 million per annum for retail businesses. We can expect to see these savings being passed on to consumers in the form of lower, or slower-growing prices.

Other key non-monetised benefits by 'main affected groups'

This option would allow us to achieve our obligation of providing a regulatory regime for the IFR, although it would not allow us to do this ahead of the key provisions coming into force on 9 December and without incurring unnecessary additional costs.

Key assumptions/sensitivities/risks	Discount rate	n/a
<p>We have calculated the expected cost of setting up and running a new regulator using the costs of setting up the PSR (as set out in the PSR's final stage impact assessment, February 2015) as an indicative guide. We have calculated the expected annual cost of the supervision of the IFR based on the PSR's own budget and estimated costs for the ongoing supervision of compliance with the IFR.</p>		

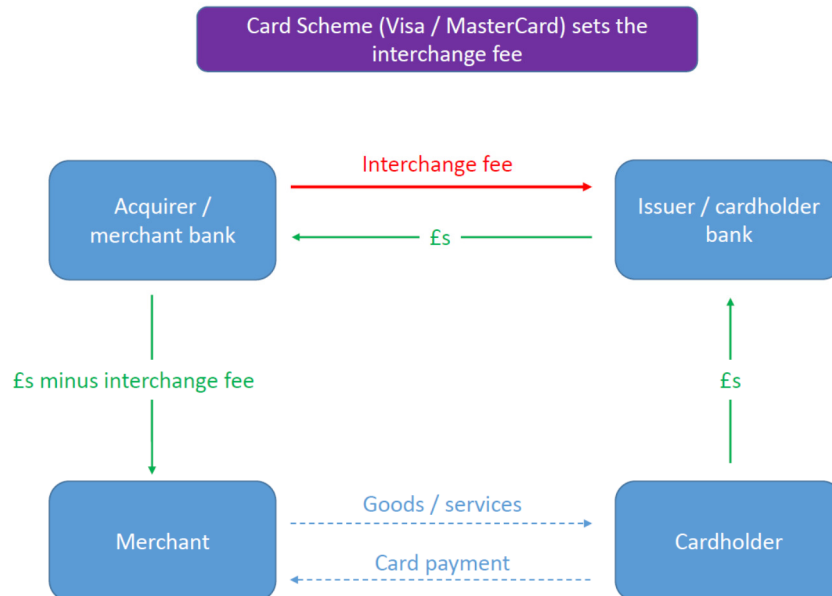
BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:	In scope of OIOO?	Measure qualifies as
Costs: £7.25 Benefits: n/a Net: £7.25	No	n/a

Evidence Base

Background to the IFR

1. The Interchange Fee Regulation (IFR) was published in the Official Journal of the European Union on 19 May 2015. The UK's objective is to put in place a regulatory regime by 9 December 2015 when the key provisions of the IFR come into effect, including price caps (other, minor provisions come into effect in June 2015 and June 2016). The regulator will be required to monitor effective compliance and enforce the IFR.
2. The key objective of the IFR is to cap interchange fees, which are set centrally by the card scheme and which merchants cannot negotiate. These fees are paid from the merchant acquirer (the merchant's bank) to the card issuer (the consumer's bank), as a percentage of each transaction made by the cardholder. The reason for the existence of this transfer is that merchants are willing to pay to be able to accept card payments, but, in many cases, customers are not willing to pay to have a credit or debit card. Therefore, the interchange fee is there to compensate the card issuer for the costs of recruiting and servicing cardholders.



3. However, there is a lack of competitive pressure to bring down the price of interchange fees, given that merchants cannot negotiate these fees down. It is in the interests of the card schemes to bid up the level of the interchange fee as that will attract more card issuers to issue their cards, so helping to grow the penetration of their network. There is little that merchants can do to prevent the value of the interchange fee being passed onto them, however, as for many merchants the main card schemes are "must take" (i.e. merchants are obliged to accept Visa and MasterCard given these cards' ubiquity). There is therefore insufficiently checked upward pressure on these charges, which must be absorbed by merchants or passed on to consumers.
4. The intention of the cap on interchange fees is to redistribute revenue from issuing banks to merchants and on to consumers. The EU Commission has estimated that interchange fees amount to £1 billion per annum in the UK alone. Figures from the British Retail Consortium have also estimated that a cap of 0.2% for debit cards and 0.3% for credit cards could save retailers in the UK £480 million each year.
5. As well as capping interchange fees, the IFR also aims to improve transparency and competition in the card market by removing barriers to entry. Furthermore, the revenue that banks make from cards has been substantial enough that they have not invested in developing other payments innovations.

Savings for Consumers

6. The Regulatory Policy Committee (RPC) in its response to our pre-consultation impact assessment requested that we provide details on the level of savings that would be passed on from merchants to their customers. This is difficult to predict, however with strong competitive forces at play particularly in the retail sector (for example, supermarkets), it is not unreasonable to assume that merchants will choose to pass these savings on in the form of lower or slower-growing prices in order to remain competitive.
7. We can also look at international comparisons to better understand the trend. In the US for example, following the introduction of caps¹ it was estimated that merchants passed on 69% of savings from interchange fee caps (\$5.87billion of the total \$8.5billion of savings enjoyed by merchants). Similarly, in Australia interchange fee caps were put on credit card transactions in 2003 and on debit card transactions in 2006. The Reserve Bank of Australia is confident that the bulk of savings from interchange fee caps have been, or eventually will be, passed through to the consumer.
8. It is also important to note that the IFR sets out an obligation on the European Commission to undertake a review scheduled for 2019. As part of the review, The Commission will look at “the levels of merchant pass-through of the reduction in interchange fee levels”.² In the UK, the government has been clear that merchants are expected to pass these savings onto consumers in the form of lower prices. The Commission’s review will show us to what extent this has happened.

Prime Minister’s EU Business Taskforce

9. Capping interchange fees was one of the key recommendations of the Prime Minister’s EU Business Taskforce report on reducing red tape. In 2013, the Taskforce published a report which drew on evidence from 90 UK businesses and business organisations, and over 20 business organisations across Europe. It sets out a range of proposals to ensure that the EU single market makes it easy for businesses in Europe to trade across borders, and to ensure that the EU regulatory framework is, and remains, competitive in the global market place.
10. In that report, the Taskforce noted that SMEs often pay higher rates than large companies, as they lack the financial power to negotiate better terms. Retailers can be unaware of the exact cost of interchange fees until after they are billed, which significantly increases risk and uncertainty, particularly for SMEs.
11. The report also noted that card transactions are increasing with the growth of electronic and mobile commerce. International customers increasingly expect to be able to pay by card. But high interchange fees deter SMEs in particular from selling across borders. Some are deterred from even offering card payments. Lower fees could save retailers across the EU billions of euros per year. This would enable more cross-border trade and e-commerce, thanks to harmonised, competitive and transparent fees.

Content of the IFR

12. This section sets out the directly applicable provisions of the IFR in more detail:

Chapter I – General Provisions

13. Chapter I sets out the scope of the IFR, and most importantly, the cards schemes and products which are exempted from the price cap (although these will still have to adhere to the other provisions within the IFR). These include:

¹ US Regulations capped debit card interchange fees at a fixed rate of \$0.21 per transaction, plus 0.05 per cent of the debit card transaction value. The Regulations also allowed for upward adjustment of no more than \$0.01 to an issuer’s debit card interchange fee if the issuer develops and implements policies and procedures reasonably designed to achieve the fraud-prevention standards set out in the interim final rule.

² IFR, article 17 (d)

- I. Commercial cards – these cards are limited to payments for business expenses only.
- II. 'Pure' three-party schemes – these are three-party card schemes which directly provide issuing and acquiring service themselves. These are exempt from the price cap.
- III. Three-party schemes with licensees – Member States have an option to apply a transitional period of three years whereby three-party schemes which license banks to issue or acquire their cards do not have to adhere to the cap. This can only be applied to domestic debit card transactions where a three-party scheme's total market share is less than 3% of the total value of annual card transactions in a Member State. This would catch smaller market players which use licensees to issue their cards. There is more information on this in the 'Derogations' section on page 12.

Chapter II – Interchange Fees

14. The IFR will cap interchange fees at 0.2% of the transaction value for debit cards and at 0.3% for credit cards. This sees a reduction from credit card interchange fees charged for payment transactions in the UK, which is currently on average 0.85% per transaction. Visa Debit cards fees will be largely unchanged. Debit card interchange fees are currently set at 0.2% plus 1p with a 50p cap. VISA will still be able to implement a 50p cap after the IFR comes into force, which prevents high interchange fees for expensive transactions, and therefore continues to incentivise card usage. Similarly, MasterCard will also have to reduce its debit card interchange fees. As with VISA, this reduction will be more pronounced for credit card interchange fees.

Chapter III – Business Rules

15. The IFR aims to remove or amend restrictive business rules to promote greater competition, consumer protection and improve transparency, for example, greater fee transparency for merchants. The provisions of chapter III work to:
 - I. Prohibit territorial restrictions with regards to licensing agreements between card schemes and banks. This promotes uniform rules and practices across the EU and contributes to the single market.
 - II. Mandate the operational separation of the payment card scheme and processing entities. The intention is to promote new entrants into the cardscheme and processing industries in an attempt to address the strong market position the dominant card schemes have in this area.
 - III. Prohibit card schemes from preventing a bank from including two or more payment brands on a single payment card. The intention is to promote non-discriminatory treatment of new payment brands into the market.
 - IV. Mandate that merchant acquirers should provide a breakdown of fees they charge to their merchant customers.
 - V. State that card schemes cannot apply rules that would prevent a merchant from steering a customer towards a particular type of payment card.
 - VI. Require merchants to make clear to customers the types of cards they accept at the point of sale.

Chapter IV – Final Provisions

16. This chapter sets out the requirements for the designation of competent authorities. Further detail of the policy options available to us and our preferred approach are set out in the sections below. Chapter IV also provides detail on the review of the IFR scheduled for 2019 and dates for entry into force.

Rationale for EU Intervention

17. The rationale for intervention by the EU Commission is to cap interchange fees so that card schemes are prevented from imposing high fees which cannot be negotiated down by merchants. In 2011, the EU Commission estimated that the total value of interchange in the EU was over €10 billion. Interchange fees vary considerably across the EU: from 0.3% in France to upwards of 2.0% in Poland. Rates within European states, including the UK, vary too. Furthermore, in September 2014, the European Court of Justice ruled that the way in which MasterCard set its

interchange fees was a violation of EU competition rules. This influenced other national competition law proceedings in the EU.

18. More widely, the objective of the EU Commission is to work toward a more integrated and better functioning single market. The IFR seeks to achieve this by harmonising business rules. In its impact assessment, the EU Commission stated that:

“To achieve this [i.e. a EU single market], and to promote EU wide services, efficiency and innovation in the field of card payment instruments, and card based payment transactions in an offline, online and mobile environment, there should be legal clarity and a level playing field. In addition, business rules and other conditions should be prohibited if they prevent consumers and retailers from having accurate information on fees paid in relation to payment transactions and thereby hinder the creation of a fully effective internal market”.

19. The EU Commission believes that an EU-wide regulation will benefit consumers (in the form of lower prices through the price caps), the internal market (by harmonising fees) and removing barriers to entry for new players in the card market (as revenues for issuing payment service providers function as a minimum threshold to convince issuing payment service providers to issue payment cards).

Rationale for UK Intervention

20. The key provisions of the IFR will automatically come into force on 9 December 2015 (there are some other minor provisions which will come into effect in June 2015 and June 2016). The UK is required to designate a competent authority (i.e. a regulator) which can effectively monitor compliance with the IFR in order to meet its treaty obligations and avoid the risk of infraction proceedings or domestic litigation.
21. The UK government has publicly supported capping interchange fees as a positive step in supporting the single market and promoting competition. Further benefits of the IFR include:
 - I. Large savings for UK businesses – figures from the EU Commission’s impact assessment suggest that this could be as much as £1 billion per annum in the UK alone. The British Retail Consortium has estimated that the price cap could benefit UK retailers by £480 million each year. Respondents from the consultation have estimated that the gain to businesses more widely could be in the region of £700 million per annum.
 - II. Savings for consumers – savings made by merchants could be passed on to consumers in the form of lower priced goods and services.
 - III. Supports the single market – the IFR provides clarity for effective business planning, particularly for those businesses looking to expand into other Member States, and improves trade across borders.

Main Affected Groups

22. Issuing banks will see a reduction in revenue as a result of implementing the IFR as it caps the fees paid to issuing banks for processing card payments. The designated regulator will incur an annual cost of £1.2 million for supervising and enforcing the IFR. Card schemes will bear this cost as the regulator recoups the costs of supervision from the regulated population.
23. However, the costs to business as a whole of implementing the directly applicable regulation net off because losses incurred by issuing banks will be passed on as net gains to merchants.
24. It is also important to note that the costs of supervising the IFR have already been accounted for under Option 1, which were approved in a final-stage impact assessment for the set-up of the IFR, which was submitted in February 2015. Therefore there will be no further costs to the

regulator or levies to industry (over and above the £1.2 million in levies already accounted for by the regulator) provided that we take our preferred approach (Option 1) which is outlined below.

Problem Under Consideration

25. The IFR requires Member States to designate a competent authority and put in place arrangements for monitoring and enforcing compliance, penalties for non-compliance and dispute resolution procedures.

Policy objective

26. The UK's policy objective is to achieve compliance with the IFR by 9 December 2015 whilst ensuring that it avoids unnecessary additional costs to businesses. As such, we aim to implement a regulatory regime using appropriate existing structures where possible.
27. The key provisions of the IFR will automatically come into force on 9 December 2015 (there are some other, minor provisions which will come into force in June 2015 and June 2016). These are directly applicable to UK law. However, the UK is required to designate a competent authority by 9 December which can effectively monitor compliance with the IFR in order to meet its treaty obligations and avoid the risk of facing legal proceedings as a result of infraction. Our preferred approach and further policy options under this approach are outlined below. We consulted on these options during the summer and responses have been taken into account in our final preferred approach.

Description of options considered

28. The UK is required to have an appropriate regulatory regime in place to supervise compliance with, and enforcement of, the IFR. We have two options available to us:
 - I. Use appropriate existing regulatory structures (final preferred approach)

We intend to designate the Payment Systems Regulator (PSR) to supervise the IFR. The PSR was launched on 1 April 2015 with several objectives, one of which includes addressing competition issues in the payment systems market. The PSR was designed and costed with oversight of the IFR in mind. All respondents to the consultation supported this approach.
 - II. Create a new regulatory body

We discounted this option given that it does not achieve our policy objectives of implementing a regulatory regime in time for the key provisions of the IFR coming into effect on 9 December 2015, and complying in an efficient way which looks to reduce costs to government, regulators and industry.
29. We also considered a 'do nothing' approach. However, in practice, it will not be possible to 'do nothing' as the IFR places legal obligations on the UK – the UK would face infraction proceedings by the EU Commission and domestic litigation if we do not comply with the IFR, therefore we would not advocate this approach.

Assessment of Options

Option One – Approach to Analysis of Costs and Benefits – final preferred approach

30. Our preferred option is Option 1: to designate the PSR as the competent authority for the IFR. This will allow us to fulfil our two policy objectives: setting up a regulatory regime in time for when the key provisions of the IFR come into effect on 9 December 2015, and avoiding any unnecessary additional set up costs. It is important to note that all respondents to the consultation supported this approach.

31. The PSR launched on 1 April 2015 as the new economic regulator of the UK payments industry. Its three objectives are to promote competition, innovation, and the industry's responsiveness to the interests of end-users. It is the entity best placed supervise compliance with the IFR, given that it already has oversight of the main card schemes (including Visa and MasterCard).
32. The PSR was established in the Financial Services (Banking Reform) Act 2013 (FSBRA), which gives the PSR a series of powers, including: powers to issue directions to regulated firms; powers to levy penalties on firms that do not comply with directions; and powers to request information from all payment systems in the UK, including those it does not directly regulate.
33. **Costs:** Costs for the PSR's supervision of the IFR have already been accounted for in the impact assessment for the PSR ('The Regulation of Payment Networks', submitted to the Regulatory Policy Committee on 11 February 2015). The PSR has already budgeted £1.2 million for 2015/2016 for this supervisory work and expects a similar cost for future annual budgets. This includes enforcement costs, but also costs to undertake a market study, part of which will help inform any decision by government to take further action on the level of interchange fee caps. Please see the 'derogation' section below for more information.
34. Since the submission of our last impact assessment, the PSR has done further analysis on the costs of supervising the IFR. In our previous impact assessment, the estimated cost to the PSR for overseeing the IFR was £1.2 million. Following further analysis, the PSR now estimates that these costs could range from £900k-1.5 million (depending on the level of compliance from industry) giving us a median best estimate of £1.2 million.
35. Taking the higher estimate of £1.5 million, we can calculate that the maximum additional cost for overseeing the IFR by the PSR would be £300k, given that £1.2 million has already been accounted for in a previous impact assessment. In the event of the PSR raising fees to cover these additional costs, they have proposed a 'de minimis' volume and/or value market share threshold. This means that the PSR would either not collect fees from regulated bodies which fell beneath a certain threshold, or it would introduced a proportionate fee-collection approach. Either of these two approaches would ensure that smaller card systems would not be disproportionately affected. This is something that the RPC wanted to better understand, as per its comments in its response to the initial impact assessment.
36. The RPC also queried whether compliant businesses will face additional costs as a result of the introduction of a penalties regime. The PSR has confirmed that this would not be the case. This is because the PSR would expect to deduct its enforcement costs from the penalties it receives as per the regime in FSBRA. As such, it would not expect direct enforcement action which is required for issuing a penalty to impose additional costs on other parties, such as those which are compliant with the IFR.
37. **PSR powers:** The government will also need to set up several mechanisms and grant the PSR certain powers in order to comply fully with the IFR. In our last impact assessment, we set out the additional mechanisms that the PSR would need in order to fulfil its supervisory role under the IFR. Following consultation, we are clearer on the impact of these:
 - PSR's penalties regime. As set out in our previous impact assessment, the government plans to legislate for a penalty regime based closely on the existing penalties regime accounted for under the Financial Services Banking Reform Act 2013. This will not incur any additional costs given that this is the current arrangement for the PSR to issue penalties in respect of its other regulatory activity.
 - Designation of the Financial Conduct Authority (FCA) where certain provisions of the IFR overlap with the FCA's remit, specifically where it crosses over with the FCA's supervision of the UK Payment Services Regulations. This will prevent additional costs being incurred by the PSR in order to equip itself for a role already conducted by the FCA. The FCA will be designated for those articles which are concerned with conduct, namely relevant parts of articles 8 to 12. The FCA has confirmed that costs for supervision of these parts of the IFR are already accounted for in its role as regulator for the Payment Services Regulations. Respondents to the consultation also agreed with this approach. We are working closely with both the FCA and PSR to ensure that the respective remits of the regulatory bodies are clear.
 - Out-of-court-redress procedures. Our intention is to delegate powers to the PSR to allow it to assist in the settlement of business-to-business disputes beyond its enforcement role for

breaches of the IFR. Following consultation, we still do not expect the number of such dispute resolution cases to be high. The majority of complaints to the PSR are likely to fall under the PSR's remit as the enforcement body of the IFR. We also assume that the largest businesses would prefer to settle any business disputes through the courts. We have also taken the policy decision to route all disputes relating to the IFR through the PSR, rather than promoting recourse to the Financial Ombudsman Service (FOS). This will ensure that all disputes are treated in a consistent manner. It will also avoid any additional burden to the FOS, which, as we understand, is already heavily resource constrained.

38. **Risks and sensitivities:** the consultation did not throw up any risks or sensitivities to this approach, given that the PSR was designed with the supervision of the IFR in mind, and has already accounted for the associated costs in its budget. The options section at the beginning of this document sets out our revised estimates of these associated costs. Our median best estimate is £1.2million, which, as we set out in our initial impact assessment, has already been accounted for in the impact assessment cleared by the RC when the PSR was set up.

Option Two – Approach to Analysis of Costs and Benefits

39. While Option 2 (create a new regulatory body) would eventually allow us to achieve compliance with the IFR, it would **not** meet our objective to do so by 9 December 2015, and not without incurring unnecessary additional costs. We therefore do not consider this an appropriate course of action, but rather, we have provided this option here as a counterfactual to our preferred approach (Option 1). It is also worth reiterating that no respondents to the consultation put this forward as a preferable approach.
40. We believe that the monetary cost of establishing an IFR-specific regulator would be broadly equivalent to the costs of setting up the PSR. We make this assumption based on: the similarities between the PSR's existing remit and the anticipated scope of the IFR (that being competition issues in the payments industry); the overlapping regulated population (card schemes); and the similar knowledge of the sector that would be required of staff in both regulators.
41. We have therefore assessed the monetary costs and benefits of creating and running an IFR-specific regulator using PSR set-up costs as an indicative guide. We have used figures from the final-stage impact assessment for the PSR, which was submitted in February 2015, and cleared by the RPC.
42. The PSR's revised estimates since our initial impact assessment provide a median average cost for supervising the IFR to be £1.2 million out of its overall budget of £15 million, as per our initial impact assessment. We can assume that this would be similar for an IFR-specific regulator.
43. We do not currently have data available to allow us to identify the exact costs of setting up a new regulator solely for supervision of the IFR as the costs of setting up the PSR accounted for its wider role of supervising the payments market, over and above enforcement of the IFR. These costs have not been separated out, but we can make an estimate of how much this might cost.

	PSR	IFR-specific regulator
Set-up costs	£15 million	£6.05 million
Ongoing costs for supervising the IFR	£1.2 million	£1.2 million
Total cost	£16.2 million (these costs have already been accounted for in a previous impact assessment)	£7.25 million (these costs have not been accounted for)

44. We know that the ongoing costs of the PSR supervising the IFR is 8% of the PSR's total annual budget (£1.2 million and £15 million respectively). The PSR's overall set-up costs were £11.2 million. If we assume that the same proportion of the PSR's budget will apply to the set-up costs as for the ongoing supervisory costs, we can expect a figure of £896,000 (i.e. 8% of £11.2 million) as a minimum.

45. However, this cost is unrealistically low due to the PSR benefitting largely from economies of scale it enjoys through its broader remit as supervisor of the payments market more widely. Therefore, we have taken the median of the minimum and maximum it would cost to set up an IFR-specific regulator.
46. The maximum cost we can estimate for the set-up of a new regulator is the cost to set up the PSR as a whole (£11.2 million). The IFR-specific regulator would not cost more than the overall costs for setting up the PSR as it would be a smaller body, only concerned with IFR. Even without the economies of scale, we do not expect that these costs would be greater than the cost of setting up the PSR. Therefore, if we take the median of the minimum and maximum expected costs to setting up a regulator specifically for the IFR, we can estimate the cost at £5.15million.
47. However, by setting up a new, IFR-specific regulator, the cost incurred by the PSR for planning to supervise the IFR (i.e. £896,000) would have gone to waste. If we also take these costs into account, we can estimate an overall economic cost of setting up a new IFR-regulator to be £6.05m.
48. There are further non-monetary costs of creating a new body to implement the IFR. These include:
- **Time:** taking the PSR as an example once again, we could expect the set-up of an IFR-specific regulator to take as long as two or three years. The government would have to formulate, and consult on, a complex range of policy proposals, get legislation passed to institute the new body, and undergo a range of recruitment and business-start-up activities before launch. This is a cost in terms of government time and staffing resources, and would in turn create an additional risk of compliance failure.
 - **Risk of UK compliance failure:** the UK is required to set-up a regulatory regime to supervise compliance with the IFR by the time the key requirements of the IFR come into effect on 9 December. The time taken to set up a new regulator would put the first viable UK implementation date at late-2016 at the earliest. This would put the UK at risk of failing to comply with EU law and therefore risk incurring a substantial fine (this could be in the region of tens of millions of euros). This is in direct contradiction with our objective to comply with the IFR in a timely way, and creates major legal and reputational risk for the UK. It is also true to say that a failure to implement the IFR by 9 December 2015 would mean that the market failure at work in the interchange fee system would remain unchecked, preventing the benefits of the IFR from being fully realised.
49. Given that setting up a new regulator to supervise compliance with the IFR would not meet our two primary policy objectives (establishing a regulatory regime by 9 December 2015 in a way which keeps costs down), we do not think that it would be appropriate to establish a new regulatory body for the purposes of enforcing the IFR in the UK.
50. **Risks and sensitivities:** It is difficult to predict the exact cost of setting up a new regulator, but we have calculated the expected cost of setting up and running a new regulator using the costs of setting up the PSR (as set out in the PSR's final stage impact assessment, February 2015) as an indicative guide.

Wider Impacts

Equalities Impact

51. The government has considered its obligations under the Equality Act 2010 and does not believe these measures will impact upon discrimination or other prohibited acts, equality of opportunity or good relation towards people who share relevant protected characteristics and others under the Act. The protected characteristics under the Equalities Act are: age, disability, gender reassignment, pregnancy, maternity, race, religion or belief, sex and sexual orientation.

Environmental, social and sustainable development impacts,

52. The government does not anticipate any impact upon greenhouse gases, wider environmental issues, health and wellbeing, human rights, and rural proofing and sustainable development. There may be some additional costs incurred by the justice system for breaches of the IFR. However, we anticipate these to be negligible, given that the IFR will be extending existing offences to more bodies. We are submitting a Justice Impact Test to the Ministry of Justice to get clearance on these points.

Small and Medium Sized Business Assessment

53. The directly applicable IFR will see a net loss to issuing banks through the capping of interchange fees, yet this will directly transfer to a net gain for all businesses, both small and large. With the directly applicable fees, the British Retail Consortium has estimated that the IFR could save UK retailers £480 million each year. Respondents to the consultation estimated that this could be in the region of £700 million to businesses more widely.
54. With regards to our options for implementing a regulatory regime, it is very unlikely that this would have a negative impact to SMEs. It is the regulated card schemes which pay levies to fund the Regulator, none of which are or would be SMEs.
55. In the Prime Minister's EU Business Taskforce report, published in 2013, the Taskforce noted that SMEs often pay higher interchange fee rates than larger companies, as they lack the financial power to negotiate better terms. Retailers can be unaware of the exact cost of interchange fees until after they are billed, which significantly increases risk and uncertainty, particularly for SMEs. Therefore the IFR will be a positive step in SME protections.
56. The report also noted that card transactions are increasing with the growth of electronic and mobile commerce. International customers increasingly expect to be able to pay by card. But high interchange fees deter SMEs in particular from selling across borders. Some are deterred from even offering card payments. Lower fees could save retailers across the EU billions of euros per year – benefitting SMEs in particular. This would enable more cross-border trade and e-commerce, thanks to harmonised, competitive and transparent fees.
57. 57. In terms of additional costs to SMEs, there is a requirement in the IFR that all merchants (both small and large) must display which types of debit and credit card they accept clearly to consumers. This helps customers choose which type of card they want to use for a particular purchase (for example, collect points on their credit card to put towards flights). However, we do not anticipate that this will be too burdensome as many merchants already do this through stickers and other material displayed at the point of sale.

Impact on competition

58. The IFR is a pro-competition measure, and therefore will have a positive impact on competition in the UK.

One-in-Two-Out

59. As this measure involves the implementation of an EU Regulation, and does not add costs to businesses other than where this is required by the FR, it is out of scope for the purposes of the one-in, two-out policy. We have taken care to implement a regulatory regime which limits additional costs to businesses, regulators, and government.

Derogations

60. The IFR is directly applicable. However, Member States have been given the option to go further than the directly applicable terms on interchange fee cap rates for domestic transactions only. Whichever option the UK decides to implement will still have a zero net impact
61. **Domestic credit card rates:** our preferred approach is to maintain the default 0.3% cap as provided for in the IFR. This will see interchange fees drop by more than 0.5% from current rates (which are approximately 0.85%), with significant savings to merchants having the potential to be passed on directly to consumers.

62. The credit card rate set by the EU Commission using the so-called 'Merchant Indifference Test' (MIT). The test is passed if interchange fees are set at a rate which renders a merchant indifferent to whether it is accepting a card or cash payment. This model was introduced because, in certain circumstances, accepting cash is cheaper than accepting cards, which dissuades merchants from accepting cards. Using the MIT methodology to set interchange fee rates should, therefore, help to set a rate which encourages greater card use.
63. The PSR launched a programme of work in April 2015, part of which looks at the impact of the IFR, as well as other trends and issues within the card payments sector. This programme of work is expected to last for around 12 months. The IFR consultation was clear that the government may reconsider the appropriateness for the UK market of introducing a lower cap on domestic credit interchange fees following the completion of this work.
64. Therefore, given the EU Commission's methodology and a lack of sufficient evidence base until the PSR reports next year, the government does not intend to implement lower caps at this time.
65. **Domestic debit card rates:** our preferred approach is to allow payment service providers the flexibility to apply a weighted average cap for domestic transactions for up to 5 years. This means that interchange fees cannot exceed more than the equivalent of 0.2% of the annual overall transaction value of all domestic debit card transactions within each payment card scheme. This will allow the status quo to be maintained for the vast majority of transactions and will help to provide an easier transition when the IFR caps come into effect on 9 December 2015. As with the credit card rates, the government may reconsider the appropriateness for the UK market of introducing a lower cap on domestic debit interchange fees following the completion of the PSR's programme of work. However, given the costs to banks will translate to savings for businesses the overall cost nets off at £0 whichever approach is taken.
66. As previously stated, the BRC has estimated that caps of 0.2% and 0.3% to debit and credit cards respectively could save retailers in the UK around £480million. Following consultation, respondents submitted further calculations which showed the impact of the UK government's approach, as set out above, would have on savings for all merchants. Respondents to the consultation estimated that this could be in the region of £700 million a year for all merchants.
67. The RPC asked for further information about why setting a lower cap would not be more beneficial to business. We need to consider the impact of lower caps on the industry as a whole. Reducing fees further would impact on banks' ability to provide valuable customer services. For example, some banks have already taken the commercial decision to withdraw rewards packages for their customers in anticipation of the interchange fee caps coming into effect in December. If we implement significantly lower caps, we will see this trend intensify to the detriment of consumers. Therefore, the government has decided to take a lower risk, interim solution through the weighted average approach. This will maintain the status quo for the vast majority of transactions and will help to provide an easier transition when the IFR caps come into effect on 9 December 2015. The government may choose to implement a different cap once the impact of the IFR is better understood. As such, the government may reconsider this position following the publication of the PSR's programme of work into the card market which will consider the impact of the IFR and is scheduled for spring next year.
68. **Three-Party Card Schemes:** the IFR also allows Member States to apply a transitional exemption period (up to three years) for domestic transactions under three-party schemes that license banks to acquire or issue their cards and which have a domestic market share of below 3% of card transactions. It is the government's intention to exercise this temporary exemption to allow these schemes to provide a transitional period in which three-party schemes which use issuers and acquirers can adjust their business models. We understand that this transitional period is necessary due to changes that need to be made to the specific arrangements which make up this model. This will allow three-party schemes which use issuers and acquirers time, for example, to renegotiate the fees that underpin the licensing agreements they hold with issuers and acquirers. The exemption is very limited in nature so it will have a negligible impact on the PSR's costs.

Impact on cross border trade

69. In its response to the pre-consultation impact assessment, the RPC requested information on the impact to cross-border trade given that there will be different domestic rates set across Europe. We do not consider that there will be a significant impact on cross-border trade because all cross-border transactions in Europe are capped at a 0.2% for debit and 0.3% for credit cards.
70. The aim of the IFR is to move to a more harmonised and competitive market with a greater degree of transparency of fees. Although interchange fees will not be competently harmonised throughout the EU, the IFR goes a long way in achieving this. The IFR will therefore help to promote cross-border trade compared to the current situation, where interchange fees are applied in a more sporadic way.

Implementation Plan

9 May 2015	IFR published in the Official Journal of the European Union
5 June 2015	Submit impact assessment to RPC for clearance
July 2015	Pre-consultation write-round (including RRC clearance)
August 2015	Consultation
Mid - September 2015	Submit impact assessment for final RPC clearance and write round for government response clearance
October	Final write-round (and RRC clearance)
November	Make and lay secondary legislation
9 December 2015	EU legislation enters into force
December 2015	Planned date for notifying the Commission of implementation
May 2019	Proposed date for Ministerial review

Summary

71. Our final preferred option is Option 1: to designate the PSR as the regulator of the Interchange Fee Regulation. Following write round clearance, we intend to publish a government response document at the beginning of October. We will then seek final write round clearance once we have received clearance from the RPC ahead of laying regulations in November. The key provisions of the IFR will come into effect on 9 December 2015.