Guidance Note on Interchange Determination in the National Payment System

26 November 2020

1. PURPOSE

1.1. The purpose of this communique is to provide all stakeholders with the outcomes of the deliberations pertaining to the determination of interchange in the National Payment System (NPS). This guidance note provides the way forward regarding the revision of the current interchange rates applicable to the interbank card stream i.e. point of sale (POS), Automatic Teller Machine (ATM) and Card-Not-Present (CNP) transactions. Consideration has also been given to the possibility of introducing interchange rates for the electronic funds transfer (EFT) and electronic money (e-money) streams.

2. BACKGROUND

2.1. The Payments Association of Namibia (herein referred to as "PAN") consulted the Namibian Competition Commission (herein referred to as "the Commission") on the involvement of banking institutions in the revision of interchange rates and whether such involvement would be in contravention of the Competition Act, 2003 (Act No.2 of 2003) (herein referred to as the "Competition Act"). The Commission provided an Advisory Opinion expressing that:

2.1.1. The current interchange model which was agreed upon multilaterally by banking institutions who are also competitors, was considered to be a form of price fixing in terms of section 23(3) of the Competition Act.

2.1.2. The envisaged revision of the interchange rates by competing banking institutions will be in contravention of section 23(1) read with sections 23(2)(a) and 23(3)(a) of the Competition Act.

2.2. Considering the above, PAN submitted an exemption application to the Commission to have the current interchange fee model exempted from the provisions of the Competition Act, with the aim of finding an optimal solution for the determination of interchange in the NPS.

2.3. Given the aforesaid, in consultation with the industry and in line with the payment systems regulatory provisions, the Bank conducted extensive research in order to comprehensively understand the concept of interchange, its importance to the NPS, banking institutions, merchants, and end users of payment services. The research phase involved the Bank conducting desktop research, industry consultations and engagements with card associations such as VISA and MasterCard, NamClear which is the domestic clearing house, and a sample of retail and fuel merchants, to determine the importance of interchange to these stakeholders. A summary of the Bank's research is provided below.

3. INTERCHANGE RESEARCH SUMMARY

3.1. Explaining Interchange

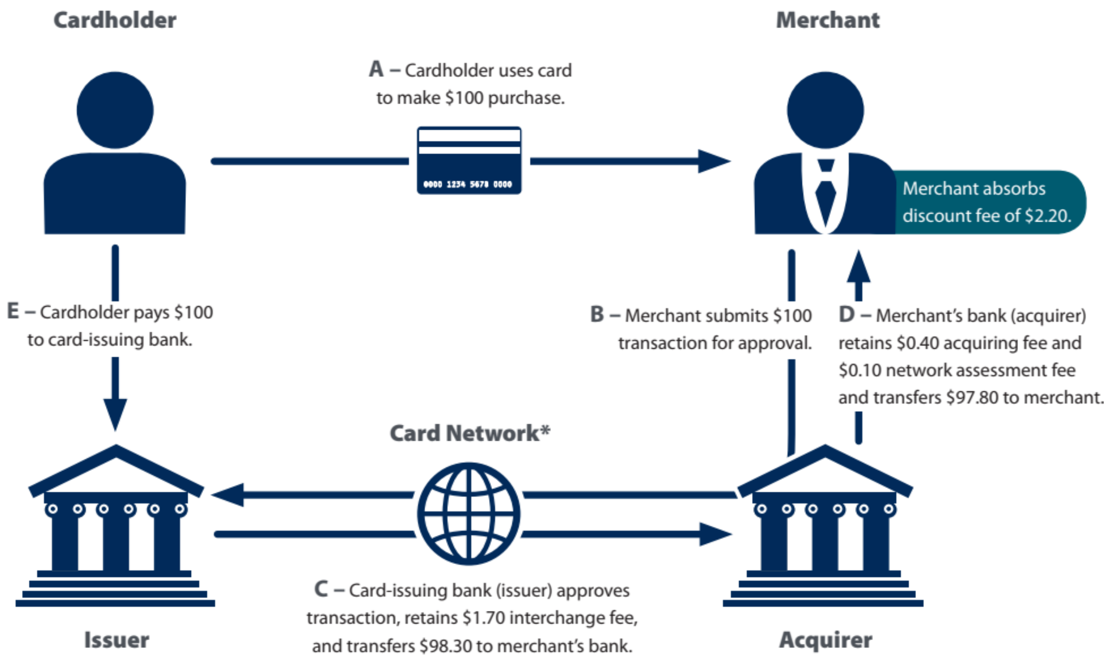
3.1.1. Interchange generally refers to the payment card processing fees normally paid by a card acquiring bank to a card issuing bank when a merchant, through a POS device, accepts a card payment for a purchase. Card interchange also applies to electronic commerce (e-commerce) transactions, also known as CNP. In the case of ATM, interchange refers to the payment processing fees paid by the issuing bank to the ATM acquiring bank when the issuing bank's client withdraws cash or makes use of other ATM services at the acquirer's ATM. This is referred to as reverse interchange[1].

3.1.2. Interchange fees are typically found in a four-party model card scheme and include parties such as VISA, MasterCard, and domestic interbank clearing houses such as NamClear. A four-party model card scheme consists of the issuing and acquiring banks, card accepting merchants and the cardholder (customer). Figure 1 below depicts a typical card transaction of how an acquiring bank pays interchange to an issuing bank for a card transaction performed by a cardholder at a merchant. In the Namibian NPS, the following three (3) card streams are administered by NamClear and attract interchange fees: ATM, POS Debit (the use of a debit

[1] https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp131.pdf

card on a POS device) and POS Credit (use of a credit or hybrid card on a POS device). The terms ‘interchange fees’ and ‘interchange rates’ are normally used interchangeably.

Figure 1: Typical Card Transaction



Source: https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2011/pdf/eb_11-05.pdf

3.2. The Importance of Interchange

3.2.1. Interchange is an integral part of interoperable payment systems. Without interchange, banking institutions will not be encouraged to issue interoperable cards that can be used for making online payments, purchases at other banks’ POS devices or withdrawals from other banks’ ATMs. Equally so, acquiring banks will be forced to remove their interoperable and sophisticated POS devices and ATMs countrywide, and replace them with POS and ATMs that only accept their own cards. The ramifications of not having an interchange model could result in some banks suspending the introduction of innovative payment services or opting to operate three-party model card schemes that provide very limited payment options and are inefficient.

3.2.2. According to VISA[2], without interchange fees, banking institutions will find it difficult to cover costs of operating card services, such as fraud prevention programs, system maintenance, and customer call centres. The absence of interchange fees also disincentivises innovation by banking institutions and the issuing of cards, and further increases customer fees relating to card services. Furthermore, MasterCard[3] equally positions that interchange fees enables banking institutions to issue electronic payments to deliver value to merchants, governments, and end customers. MasterCard further states that setting interchange fees at the appropriate level is important because if rates are too high, card acceptance by will be negatively affected; and if rates are too low, issuing banks will have no incentive to cover the risks of issuing payment cards.

3.3. Assessment of the Current Interchange Model

Upon assessing the current interchange model, the following factors represent a rational justification for a review of the current Namibian interchange model:

3.3.1. The current interchange model was adopted in 2008 and developed based on statistical, economic and social circumstances in South Africa, which do not fully reflect or consider the realities in Namibia. Since then, the interchange rates were never revised.

3.3.2. The current interchange model only recognises fuel as a regulated commodity with its separate interchange rates, however, other regulated industries and products were not considered.

3.3.3. There have been significant changes in the Namibian economy over the years such as inflation and exchange rate fluctuations that have impacted cost drivers for card issuers that normally pay interchange to card acquirers. The model was never updated to reflect these changes.

3.3.4. The model is rule-based and does not reflect the prevailing tendency in the payments environment towards risk-based policies, which compensates parties who implement best practice and superior risk mitigation controls.

3.3.5. The current interchange model only caters for card interchange with a limited scope of transaction types and therefore does not take into consideration all types of card related transactions.

3.3.6. Furthermore, the current model does not cater for other existing interbank payment streams such as EFT and e-money.

[2] https://www.visa.co.uk/about-visa/visa-in-europe/fees-and-interchange.html
[3] https://www.mastercard.ca/en-ca/about-mastercard/what-we-do/interchange.html

4. INTERCHANGE DETERMINATION IN THE NPS

4.1. The Bank hereby provides the following way forward:

4.1.1. Given the research conducted, the Bank concluded that interchange is a key component of a smooth functioning and innovative NPS. Having an appropriate interchange model will benefit banking institutions and other system participants, merchants, and users of payment services. Additionally, the current interchange model is outdated and therefore needs to be revised to reflect the prevailing dynamics in the domestic NPS and the economy.

4.1.2. The Bank is mandated by the Payment System Management Act, 2003 (Act No. 18 of 2003), as amended (herein referred to as "the PSM Act"), to oversee the NPS and ensure that it is safe, secure, cost effective and efficient. Furthermore, the PSM Amendment Act gives the Bank powers to determine standards for user fees and charges related to the provision of payment services which includes fees charged by one banking institution to another, and in this case, interchange fees. In light of the aforementioned, the Bank has resolved to independently revise and determine new interchange rates with the assistance of an independent interchange cost consultant.

4.1.3. The exercise will be referred to as the Interchange Determination Project 1, which will commence in 2021 for a minimum duration period of one (1) year and a maximum period of two (2) years, and taking into consideration the exemption period granted to the banking industry by the Commission.

4.1.4. This Interchange Determination Project 1 will only focus on the card stream. The Bank will at a later stage give consideration to introduce interchange rates for the EFT and e-money streams once the current project is completed.

4.1.5. The role of banking institutions in the project will be limited to only providing the Bank with information necessary to consider when introducing new interchange rates.

4.1.6. The Bank intends to execute the Interchange Determination Project 1 in three phases, starting with the first phase which involves appointing an interchange cost consultant and conducting a costing exercise; the second phase entails calculating new interchange rates based on the results from the costing exercise; and the third phase involves industry consultations and publishing the new interchange rates in the Government *Gazette*.

4.1.7. When determining interchange, the Bank will aim to first understand the true cost incurred by card issuing and acquiring banks as well as the value proposition provided through card payment services to merchants and cardholders by the banking industry.

4.1.8. The current interchange model was adopted from the South African market and the rates are set based on the card type (credit card, debit card and hybrid card) and only demarcated in to two sectors i.e. retail sector and fuel sector. The revision exercise will consider critical factors in the domestic market and interbank dynamics in the NPS to determine an optimal interchange model with suitable categories and sector demarcations.

4.1.9. Based on international best practices, interchange rates are usually levied based on the card product type. Specifically, card associations such as VISA and MasterCard set international interchange based on the target market and the value proposition that a card offers the cardholder and merchant i.e. whether the card is electronic, gold, platinum or black. The Bank will take these dynamics into consideration as part of this project.

4.2. The Bank will continue to engage and update the banking industry stakeholders during the envisaged project.

For any queries or required clarifications regarding this guidance note, kindly contact the Director: Payment and Settlement Systems Department, Ms. Barbara Dreyer on telephone number +264 61 283 5284 or on email: Barbara.Dreyer@bon.com.na.