Comments to the draft circular "Rationalisation of Merchant Discount Rate (MDR) for Debit Card Transactions" dated 16 February 2017 (Draft Circular), released for public consultation by the Reserve Bank of India (RBI)

The Future of Finance Initiative (**FFI**) is housed within the IFMR Finance Foundation (**IFF**)[1] and aims to promote policy and regulatory strategies that protect citizens accessing finance given the sweeping changes that are reshaping retail financial services in India. Our vision is for regulation and policy to develop to support universal access for all citizens to a range of channels through which they can transact securely and confidently.

A. **COMMENTS**:

We have listed our comments in the table below, referenced against the corresponding Draft Circular.

Sl. No.	Item	Paragraph Reference(s)	Comment
1.	Capping the Merchant Discount Rate (**MDR**)	3	We are supportive of the objective of enhancing and expanding card acceptance in the country. But the previous MDR caps have had limited effect on catalysing the acceptance infrastructure in India. In general, MDR is hard to regulate, since it is set by hundreds of banks or, in many cases, processors that serve as intermediaries between banks and merchants; and such competitive end-service pricing can include a number of additional, bundled or specialised services depending on the particular merchant, processor or acquirer (Rysman and Wright 2012).Furthermore, as observed by the Watal Committee on Digital Payments (**Committee**)[2], capping the MDR acts as a disincentive to the business of card infrastructure.

[1] IFF is a policy research and advocacy institution guided by our mission of ensuring that every individual and every enterprise has complete access to financial services. IFF has made several contributions to the Indian financial system and participated in engagements with financial sector regulators (the Reserve Bank of India (RBI), the Pension Fund Regulatory and Development Authority and the Securities and Exchange Board of India) and the Government of India. Notably, we were the technical secretariat to the RBI's 'Committee on Comprehensive Financial Services for Small Businesses and Low Income Households' (CCFS) (Chair: Dr. Nachiket Mor).

[2] Ibid. Pg.144 (Box 39)

			The Committee goes on to recommend the regulation of the **interchange fee**[3] component of MDR. This is consistent with global practices where interchange fees have been the subject of various kinds of government interventions, as illustrated in Section1 of the Appendix. Hence, we are of the opinion that regulating interchange fees would be a more effective approach for expanding card acceptance in India.
2.	Rationalisation of MDR based on Merchant Categorisation	4, 5, 6	We agree with intent of the new merchant categorisation based rationalisation with its focus on the needs of smaller merchants and providers of essential and subsidised goods. Nonetheless, in our opinion the proposed rationalisation of MDR caps would have the following adverse effects: • *Merchant classification criteria:* It is a settled position of law that a criterion which distinguishes persons or things that are grouped together from others left out of the group should pass the reasonable classification test. This implies that the classification should be founded on an 'intelligible differentia' having rational relationship to the object sought to be achieved by the law. However, the proposed classification system under the Draft Circular creates small, special, government and residual category of merchants without justifying such categories. For instance, an automobile dealer selling tractor spares as an ancillary business will be deemed to be a special category merchant (under item 4 of Annex 1 to the Draft Circular pertaining to Special Merchant Category), whereas the principal business of such a dealer may be to sell large automobiles for urban use. • *Skewed POS Infrastructure Deployment:* It can lead to skewed deployment of card acceptance infrastructure in those merchant categories with higher MDR. Specifically,

[3] An interchange fee is charged for every transaction with a credit or debit card performed at a POS where the owner (acquiring bank) is different from the bank that issued the card (issuer bank). These IFs can be either ad-valorem or fixed per transaction, and are paid to the issuer by the acquirer.

			acquirers will focus on 'other category merchants' for whom the MDR cap is 0.95% for physical POS and 0.85% for digital POS. This can defeat the objective of rapid expansion of card acceptance infrastructure among the remaining categories including small merchants.[4]
3.	Rationalisation of MDR based on type of POS infrastructure	4, 5, 6	We support the distinction between digital POS and physical POS infrastructure. This measure has the potential to accelerate digital payments among smaller merchants who cannot incur the high costs of a physical POS machine. We also believe that the launch of the Bharat QR code complements this measure.

[4] The RBI concept paper on card acceptance infrastructure discusses this issue (Reserve Bank of India 2016)

B. **APPENDIX**

Rationalisation of Interchange Fees

Evidence from a range of countries suggests that competition between well-established payment card schemes can lead to the perverse result of increasing the price of payment services to merchants (and therefore to higher retail prices for consumers). Consequently, different jurisdictions have regulated interchange fees (IF) based on the type of price distortion witnessed in their respective payment card markets.

The sections below are not exhaustive accounts of the regulations:

Section 1: List of Interchange Fee Regulations

Regulation	**Impact of select regulatory interventions on payment card market (usage and acceptance)**
European Union (European Commission) In April 2015, Regulation 2015/751 on interchange fees for card-based transactions limited domestic and cross-border (within the EU) interchange fees to a maximum of 0.2% for debit card transactions and 0.3% for credit card transactions from 9 December 2015. The fee caps were calculated after a multilateral survey of merchants based on the Merchant Indifference Test (European Commission 2015).	1) Overall rise in the number of debit and credit card transactions (Graph C). 2) MDR fees have decreased significantly (Graph D).
Australia (Reserve Bank of Australia) In 2003 the RBA introduced the weighted-average interchange fee benchmark for debit cards. These were reviewed in 2016: - current benchmark for debit cards stands at 8 cents per transaction	1) The aggregate resource costs incurred by financial institutions and merchants in accepting consumer payments have fallen from 0.8 per cent of GDP in 2006 to 0.54 per cent of GDP in 2013. 2) As a result, MDR has come down significantly (Graph F). 3) Increase in the number of debit card transactions (Graph E).

- the above were supplemented by ceilings on individual interchange rates: 15 cents, or 0.20 per cent if the interchange fee is specified in percentage terms, for debit cards. - merchants are allowed to add a 'permitted surcharge' on a card transaction in terms of the merchant's average cost of acceptance for each scheme. (Reserve Bank of Australia 2016)	
USA (Federal Reserve Board) The Durbin Amendment in the Dodd-Frank Bill (2011) ruled that the IF that an issuing bank may receive for an electronic debit transaction will be the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. The issuers that, together with their affiliates, have assets of less than $10 billion were exempted from the above standards (Federal Reserve 2011).	1) Overall rise in the volume of debit and credit card transactions (Graph A). 2) Limited impact on MDR, but average acquirer's margin went up significantly (Graph B).
New Zealand (Commerce Commission) Commerce Commission's 2009 settlement with VISA and MasterCard resulted in: - the "no surcharge rule" being prohibited, allowing retailers to pass on the cost of MasterCard and Visa transactions to the customer. - card issuers were allowed to set their own IFs, within a maximum limit set by card networks. - nonbanks allowed to become acquirers.	1) Issuers set the interchange fees at the maximum limit set by the card network operators. 2) Data showed the average fees that merchants/retailers pay to accept card transactions decreased.[5] 3) Number of card transactions increased overall.

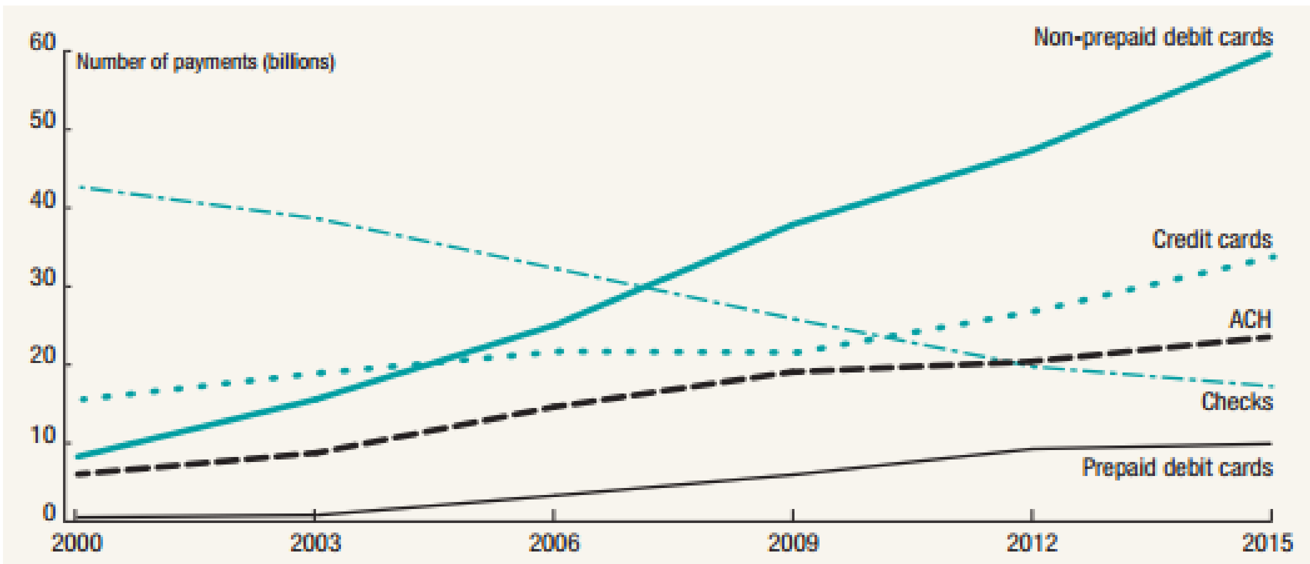
[5] (Commerce Commission 2013)

Mexico (Banco de México) In 2006 Banco de México and the Mexican Bankers Association agree to reduce IFs. Currently, in transactions with debit cards, the IF can be up to 1.15% of the total amount of the payment but this charge cannot exceed of 13.50 pesos (~ $0.69) (Banco De Mexico 2017).	
China (People's Bank of China) 2002: The People's Bank of China sets the maximum merchant fee rates and the division of the merchant fee which consists of the interchange fee, switch fee, and merchant acquirer fees (so called the 8:1:1 rule). 2011: The Chinese Ministry of Commerce proposes a cap on interchange fees at 0.3% of the sales value up to 100 yuan. The proposal also includes a cap for switch fees: China Union Pay (the country's only card network) cannot charge merchants more than 0.05% on credit card sales with a maximum of 5 yuan per transaction. 2016: The IF for a debit card transaction is capped at 0.35% of the transaction amount and the IF for a credit card transaction is capped at 0.45% of the transaction amount. Aggregate fees collected by a card issuer for a single debit card transaction shall not exceed 13 yuan. IF on credit card transactions are not subject to a similar aggregate yuan cap.	

Section 2: Impact of select regulatory interventions on payment card market (usage and acceptance)

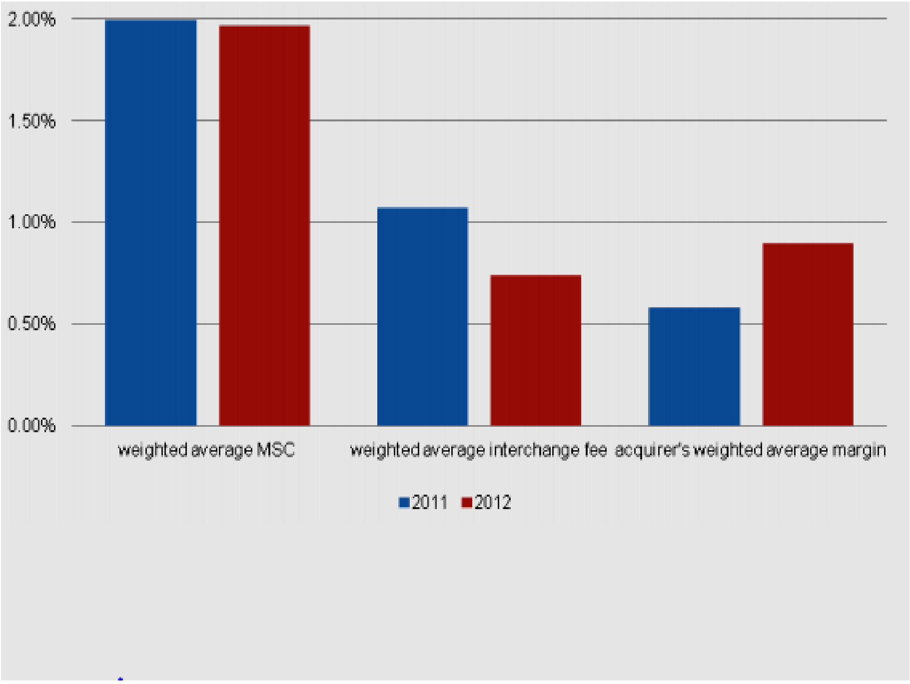
Graph A: Impact of US Interchange Fee Cap (Q3 - 2011) on Volume of Card Transactions[6]

[Y axis: No. of transactions (billions)]



[6] (Federal Reserve 2016)

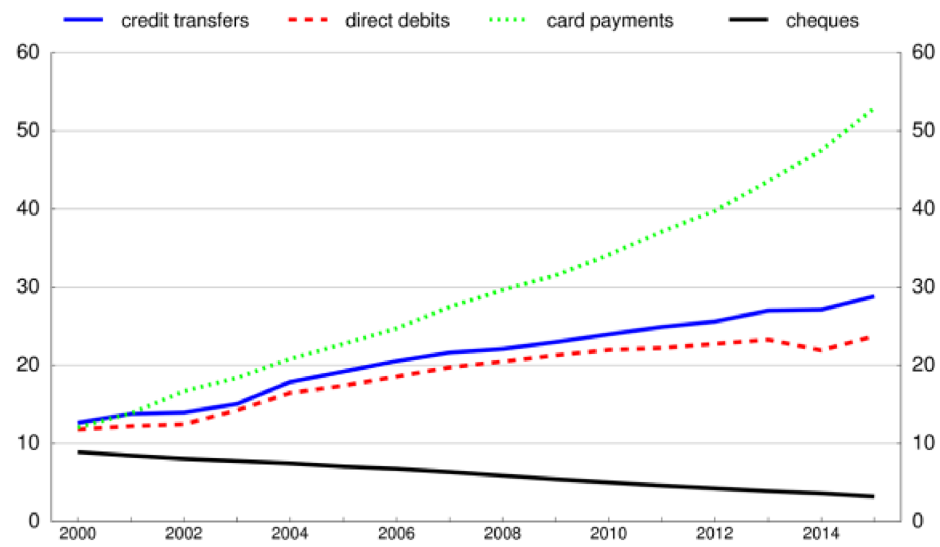
Graph B: Impact of US Interchange Fee Cap (Q3 - 2011) on MSC (MSC ≈ MDR) and Acquirer's Margin[7]



[7] (Zywicki, Manne and Morris 2014)

Graph C: Impact of EU Interchange Fee Regulations (2006 onwards) on Volume of Card Transactions[8]

(Y axes: number of transactions per annum in billions)



[8](European Central Bank 2014)

Graph D: Impact of EU Interchange Fee Regulations (2006 onwards) on Merchant Service Charges (MSC ≈ MDR) in Spain[9]

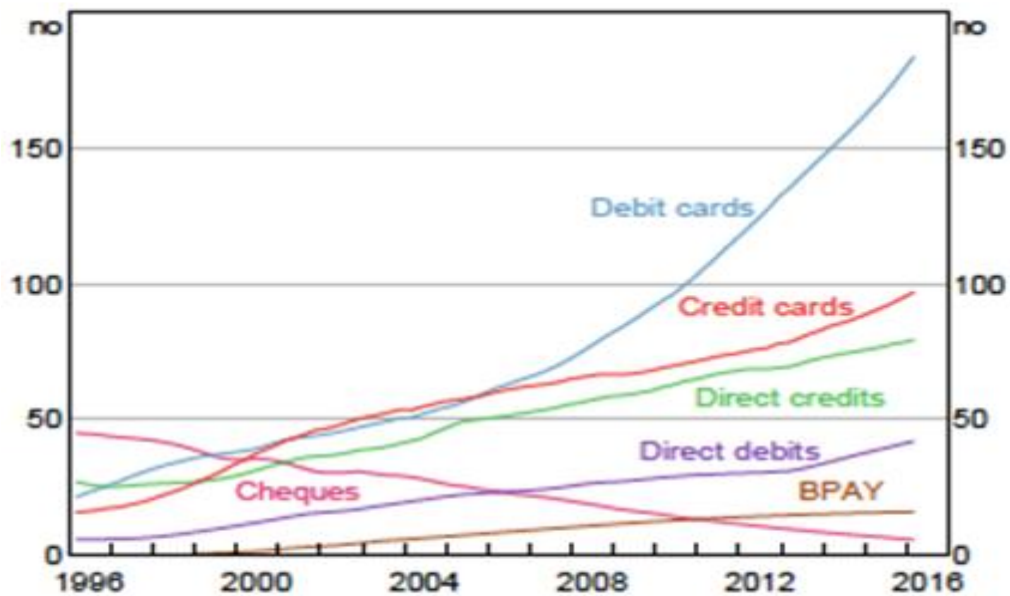
(Left Y axis: % of IF and MSC; Right Y axis:% difference b/w IF and MSC)

	2004	2005	2006	2007	2008	2009	2010
MSC	1.52%	1.52%	1.13%	1.02%	0.88%	0.81%	0.74%
IF	1.62%	1.55%	0.94%	0.91%	0.81%	0.77%	0.64%
Difference	-0.10%	-0.03%	0.19%	0.11%	0.07%	0.04%	0.10%

9 (Europe Economics 2014)

Graph E: Impact of Australian Interchange Fee Regulations (2003 onwards) on Non Cash Payments (per capita)[10]

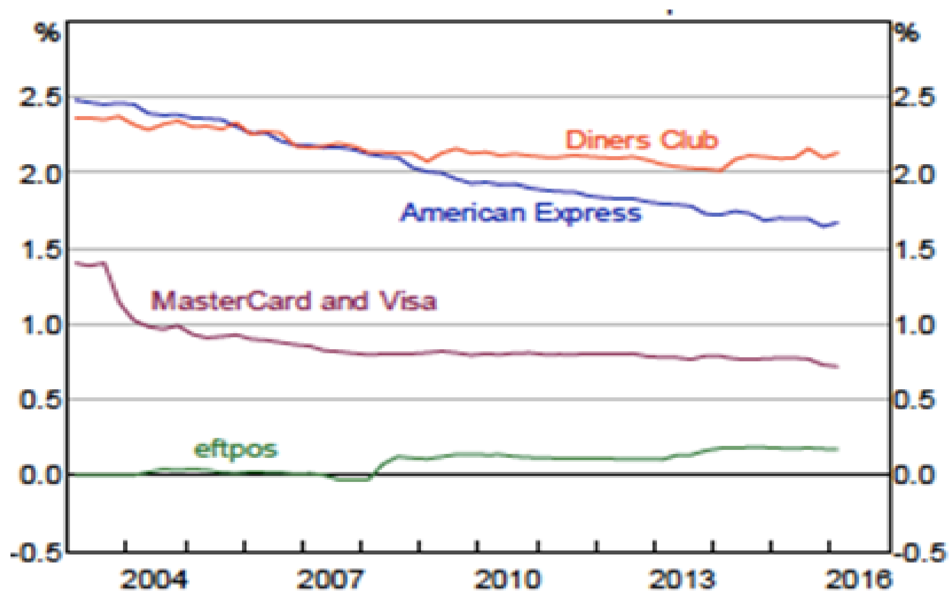
(Y axes: value of transactions per capita)



[10] (Reserve Bank of Australia 2016)

Graph F: Impact of Australian Interchange Fee Regulations (2003 onwards) on Merchant Service Charges (MSC ≈ MDR)[11]

(Y axes: % of total transaction value)



[11] Ibid.

C. **BIBLIOGRAPHY**

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