Domestic schemes in 2016
A global status report

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FOREWORD & ACKNOWLEDGEMENTS

In 2014 I published research (*National Payment Schemes: Drivers of Economic & Social Change* by John Chaplin, Andrew Veitch and Prof. Dr Jürgen Bott) into the prospects, strategies and economic efficiency of domestic card schemes and switches. For the 2nd International Conference of Regional Card Organisations we decided to carry out further research to help with the planning of the conference and also as a reference document for domestic schemes and organisations such as World Bank that regularly advise national authorities on such matters.

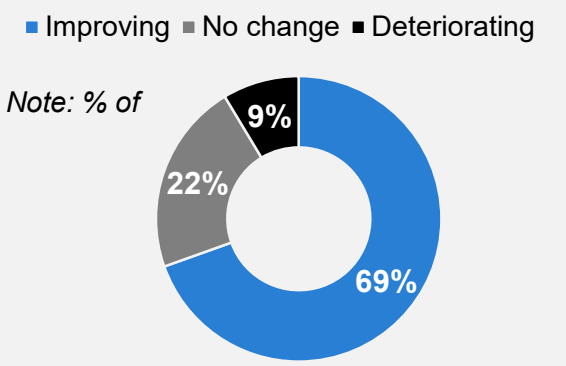
I am grateful to my colleagues, especially Emiliano Anzellotti of Conzorzio Bancomat, for helping to develop the research and for the active support of the 25 organisations that have contributed their expertise and thoughtful opinions.

John Chaplin

London – September 2016

HOW DOMESTIC SCHEMES SEE THEIR OVERALL PROSPECTS

Figure 1: How do you see the future prospects for your scheme compared to two years ago?



There is a much greater sense of optimism about the future than in the 2013/14 research. 43% of the schemes see their prospects as much better and 26% as a little better. Only 9% think that their prospects are deteriorating but there is a specific concern about players such as Apple signing global deals with global schemes, which creates issues for domestic players.

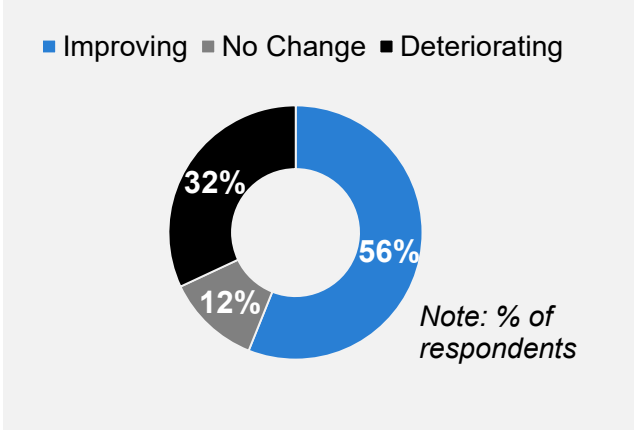
"Global decisions and alliances are increasingly sharing the market landscape across a number of channels and this risks the domestic schemes from being excluded."

"Visa Europe's sale to Visa Inc. has made issuers and acquirers realise that being too dependent on Visa and MasterCard laps can be counterproductive for their business objectives. So they are understanding better the need for a domestic scheme that cooperates with other European domestic schemes, in order to have the best solution for domestic transactions."

In 2013/14, 32% of schemes felt that prospects were deteriorating and the combined positive score (much better + a little better) was 56% compared to 71% in this new research. So despite the continued aggressive targeting of domestic volume by the international card schemes, domestic schemes clearly feel that they have an increasingly important role to play.

"In four years' time, RuPay card base has grown to 37% of the card base in the country and out of 680 million cards, RuPay cards now account for 290 million."

Figure 2: How do you see the future prospects for your scheme compared to two years ago? (2013/14 survey)



"Requirement for domestic tailoring and innovation has increased and the ICS can't easily provide the flexibility."

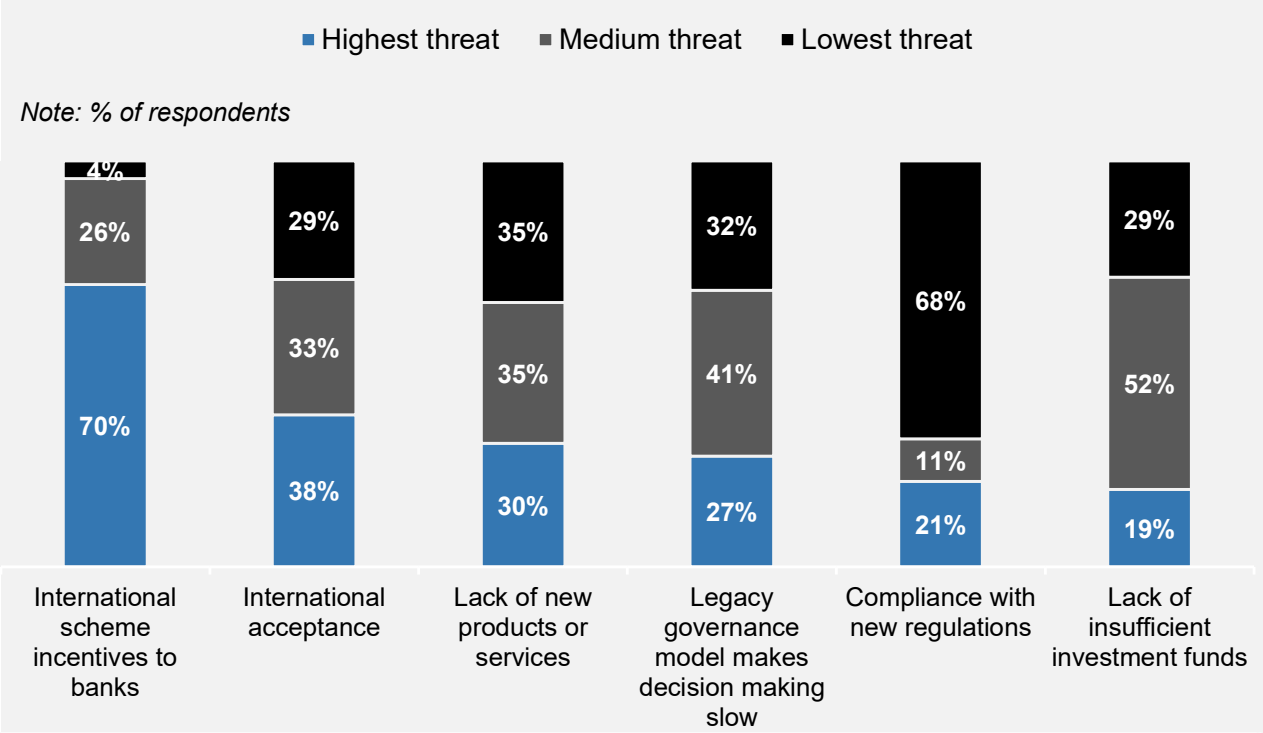
THE MAIN THREATS AND CHALLENGES TO DOMESTIC SCHEMES

"The key threat is that posed by international schemes because, right now, they are the only ones well positioned to guarantee worldwide acceptance, and besides, they have deep pockets."

"Our better pricing is offset by the international schemes gaining competitive advantage in digital."

Despite the overall sense of optimism, all of the domestic schemes find that running their businesses and remaining relevant is a difficult task. The new research shows that the use of incentive payments to issuers by Visa and MasterCard is still by far the most serious threat. This finding is consistent across multiple regions and is despite the fact that in many countries competition law or industry regulation should prevent these incentives.

Figure 3: What are the main threats to domestic schemes?

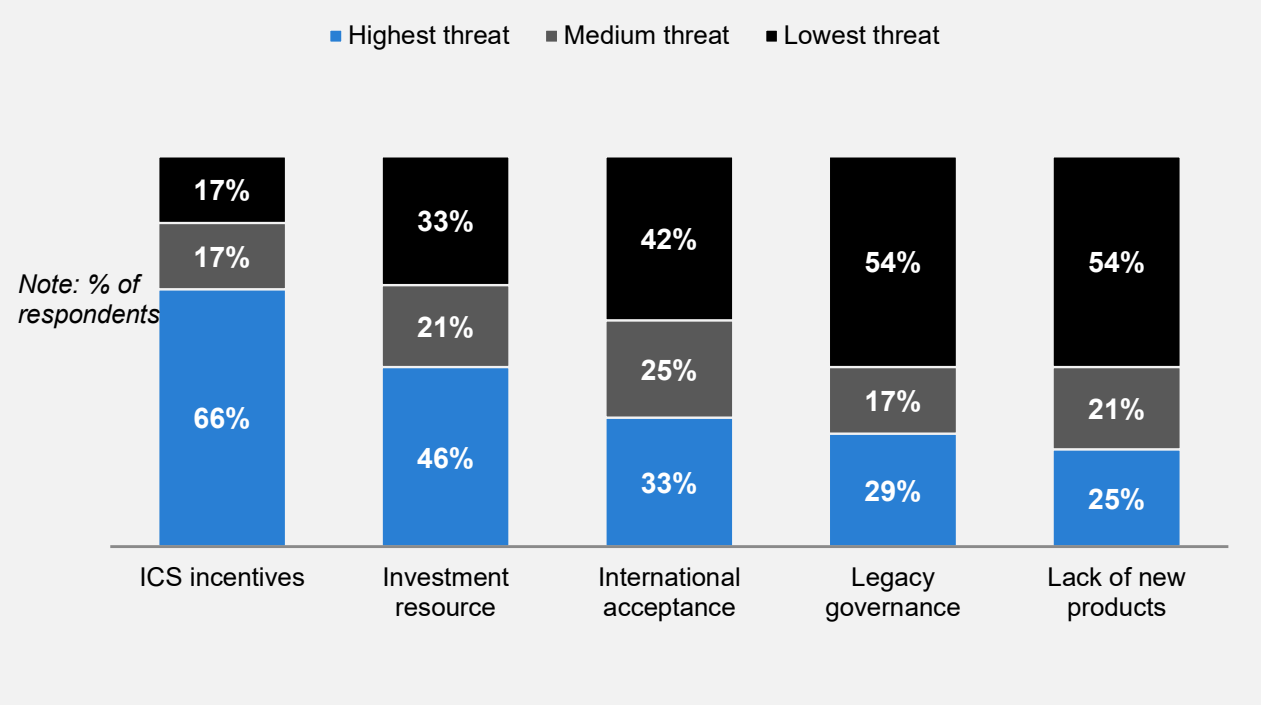


Arranging international acceptance is seen as the second most significant challenge especially now that the Visa and MasterCard international schemes are generally not in favour of cobadging with domestic schemes except as a short-term market entry tactic. An increasing number of domestic schemes including Rupay, Verve and Mercury have partnered with Discover and both Unionpay & JCB are increasingly positioning themselves as international partners but clearly all of those organisations have work to do if they are to be seen as equal to Visa and MasterCard.

Although the burden of having to comply with new regulations especially in Europe is often discussed, it did not rank highly as an issue.

> *"Awareness from the banks is increasing in terms of the threat posed to most of them by the international schemes for domestic transactions. Nice opportunities may be on the horizon for domestic schemes."*

Figure 4: What are the main threats to domestic schemes? (2013/14 survey)



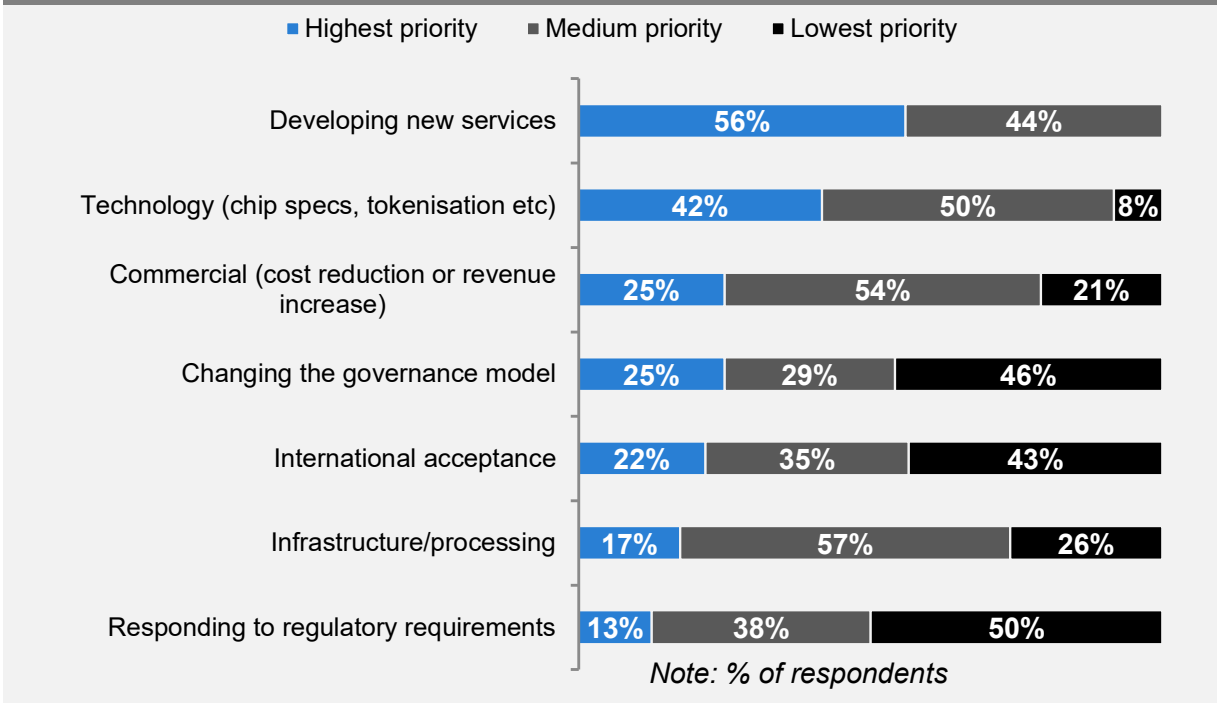
In 2013/14 lack of investment resources was seen as the second most significant challenge but this time it was rated much less highly. There have been some notable cases of the banking community funding domestic schemes in Brazil, India and Turkey with substantial resource and in other markets such as Denmark, Nigeria, Puerto Rico and UAE schemes have been supported financially by private equity investors.

PRIORITIES AND REMIT OF DOMESTIC SCHEMES

In terms of scheme priorities, the picture was very clear. Development of new services was clearly rated as the highest priority. 56% of schemes rated it as top priority and none rated it as a low priority. This shows that schemes have recognised that they cannot continue to just provide the legacy services of which they were originally based. The second highest priority was technology and especially chip specifications and tokenisation. The reason for this high priority is that for chip specifications many schemes now don't think it is a good idea to use the Visa and MasterCard specifications and in terms of tokenisation the technology lockout strategy of the international schemes creates an imperative for domestic schemes to provide comparable functionality. Some schemes have argued that compliance with ever-changing regulatory requirements is their top priority. However the research showed that most schemes see this as a 'business as usual requirement' that must be attended to rather than as a top priority.

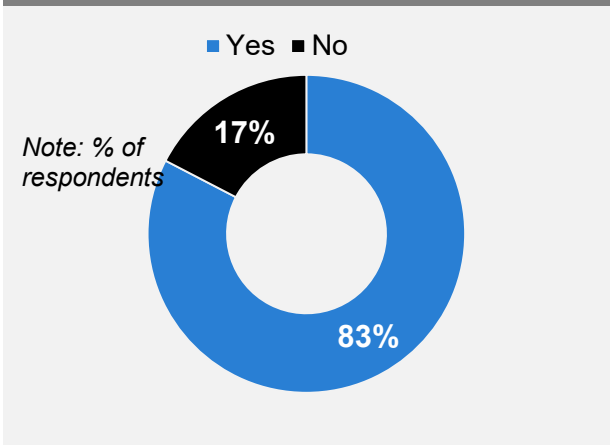
Responding to commercial pressures by increasing revenues and/or decreasing costs is rated as the third highest priority. As domestic payments become more of a utility service and in the face of fierce competition from Visa and MasterCard, domestic schemes have to continually improve their commercial performance.

Figure 5: What are the most important priorities of your scheme?



By a very large majority, domestic schemes were in favour of extending their remit beyond cards.

Figure 6: Should domestic schemes plan to extend their remit beyond cards?



"Domestic schemes should play a role in any type of payments. Plastic cards are just payments activators. Domestic schemes could apply their knowledge and experience to payments conducted with any activator."

Many felt that widespread adoption of mobile phones for payments was already happening and that domestic schemes have to embrace mobile as well as other forms of alternative payment. It was also felt that as the distinction between card and ACH payments breaks down, the commercial scheme management experience of card schemes positions them well to extend into ACH rather than the other way around. Some people commented that in their markets, alternative payment types were tending to lead to new scheme and if the card schemes do not extend their remit, then they risk being marginalised.

USE OF INTERNATIONAL STANDARDS

Whilst domestic schemes have the option to develop their own technical standards, EMV is used by almost all schemes and in many countries it is mandated by the regulator. There is less uniformity in terms of the AID that is used.

In terms of security standards, a similarly high proportion of schemes conform to the international PCI standards.

Figure 7: Does your scheme use international technical standards such as EMV?

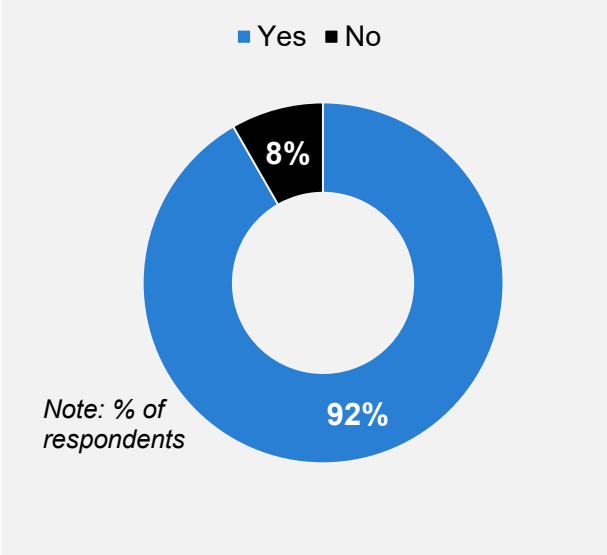
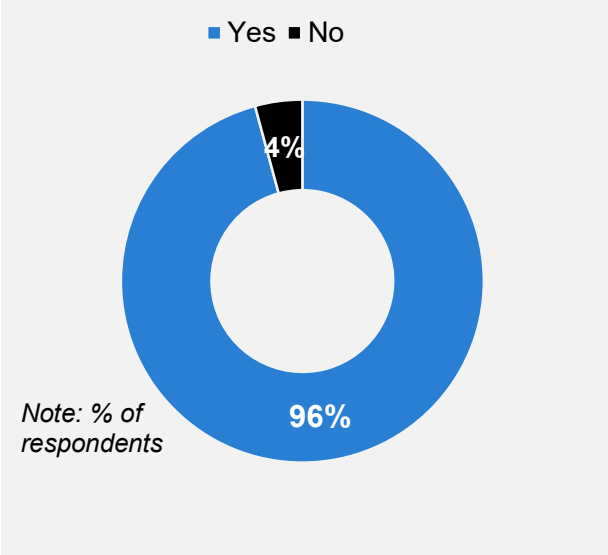


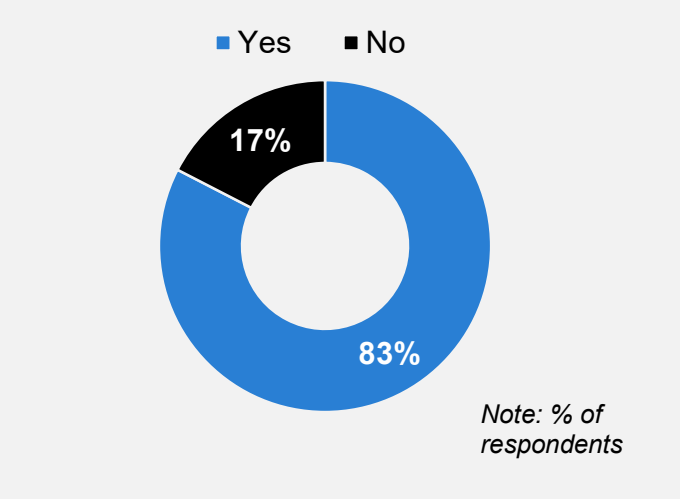
Figure 8: Does your domestic scheme use international security standards such as PCI?



SCHEME REGULATORY FRAMEWORK

The research shows that approximately 80% of domestic schemes are directly regulated by the domestic payments regulator or financial authority. However, of the 80% some are regulated as a scheme and others as interbank processors. In the remaining markets, the scheme itself is not regulated because the authorities consider that regulation of the banks that use the scheme is sufficient. Whatever the regulatory framework, most schemes were in favour of maintaining close relationships with regulators.

Figure 9: Is your domestic scheme directly regulated by the domestic payments regulator or financial authority?



Some of the European schemes commented that they are subject to a harsher regulatory regime domestically than the pan-European framework imposes on the international card schemes. There is also some evidence from outside of Europe that regulators can be reluctant to become educated about the rulebooks of the international schemes. Without such scrutiny, it is relatively easy for competition to become unfair.

REGULATION OF INTERCHANGE

"Most regulators in today's world will take an active interest in payments and interchange."

As demonstrated by the above comment, there is clearly a trend towards greater regulation with merchant interchange being directly regulated in 56% of countries. In markets where interchange is not directly regulated, the (international) schemes generally set the rates although in some cases rates are set bilaterally between issuers and acquirers.

Figure 10: Is interchange for merchant transactions regulated by the domestic payments regulator or financial authority?

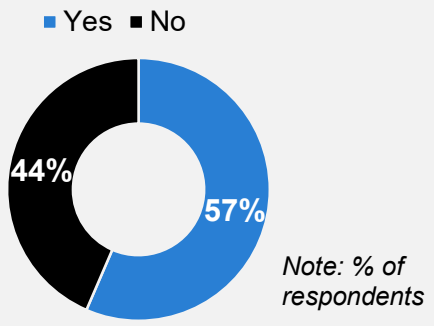
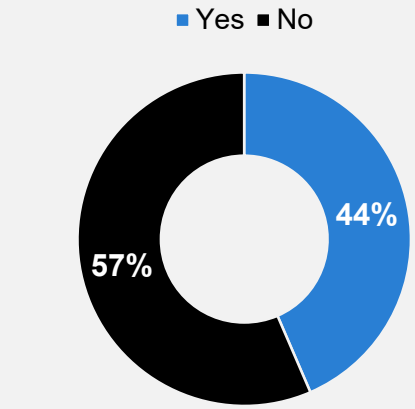


Figure 11: Is interchange for ATM transactions regulated by the domestic payments regulator or financial authority?



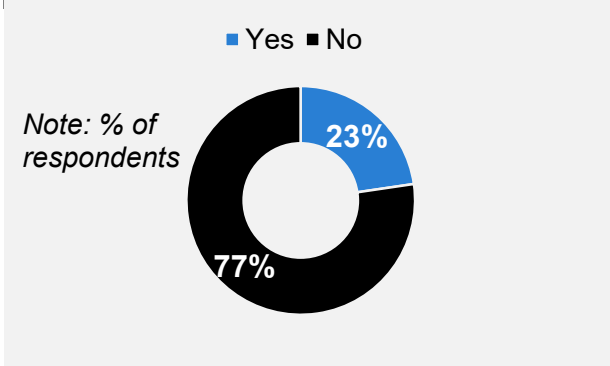
"Competition really monitors this fee more than regulation. Although we suspect regulation of surcharging will happen at some point."

Interchange on ATM transactions is less likely to be regulated than merchant interchange because it is felt in many markets that competition between banks provides a better model to control fees than direct regulation. The research shows that ATM interchange is regulated in 43% of markets and this is especially likely to be in markets such as Nigeria where the vast majority of transactions are still ATM and the authorities are keen to promote financial inclusion through lower transaction costs.

In markets where ATM interchange is not regulated, the regulatory authorities are increasingly interested in ATM surcharging due to the belief that ATM interoperability only works to promote efficiency if ATM surcharges are severely limited or indeed prohibited.

Some markets believe that for full and effective control of domestic transactions, it is necessary to have a domestic switch in addition to a domestic scheme. As a domestic switching operation is effectively a fixed cost business, efficiency for a country will be maximised if there is a regulation requiring all domestic transactions (whether on the domestic scheme or on the international schemes) to be switched within the country. The major international schemes resist this kind of regulation because it can lead a to a 50% reduction in the revenue that they can earn in a country.

Figure 12: Is there a regulatory requirement to switch domestic transactions within the country?



The research shows that currently approximately 77% of markets have no such requirement (including all of the EU) and 23% do mandate switching within the country.

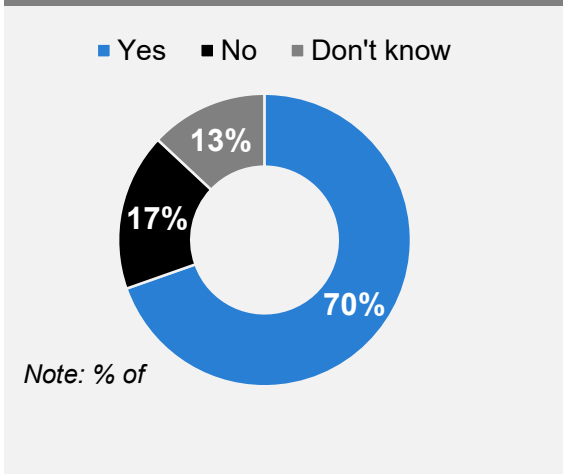
There is an irony that Visa as the largest international scheme fiercely resists any regulations requiring in-country switching and yet since inception has required that domestic US transactions are switched through their own US data centres.

"The objective of RuPay was to bring competition in the cards market."

A large majority of schemes (70%) feel that authorities have a duty to promote sustainable competition in the marketplace between payment schemes. This reflects the concern that it is possible for large international schemes to engage in anti-competitive behaviour (such as issuer incentives) to permanently weaken and even eliminate other players. Such an outcome is not optimal for market efficiency.

However 30% are in the 'don't know' or 'opposed' category. This does not mean they are relaxed about the approach of the large international schemes but rather because they consider that their regulators are not sufficiently knowledgeable about the payments ecosystem and that any regulations might well make the situation worse.

Figure 13: Does a domestic payments regulator or financial authority have a duty to promote sustainable competition in the marketplace?



"Payment Regulators must ensure that Competition Law is complied with at supply and demand level. That should ensure fair competition also between any intermediate companies that participate in service provision to clients."

"Care needs to be taken here. I think payment services need to be competitive, but payments infrastructure needs to be ubiquitous. To the extent that a scheme is part services and part infrastructure, then ideally some unbundling is needed."

Recognising that there are schemes that don't want further regulations, when asked the question "if the central bank/regulator could take one action in your market to ensure a level playing field between payment schemes, what would it be?" a number of interesting suggestions were made:

- Multiple mentions were made of the need to stop international scheme incentives to banks.

- There was a request that in common with the increasing general disquiet about multinational taxation all payment schemes must pay local taxes to level the playing field.

"Government officials in my country are not knowledgeable enough to oversee payments. Free competition is better."

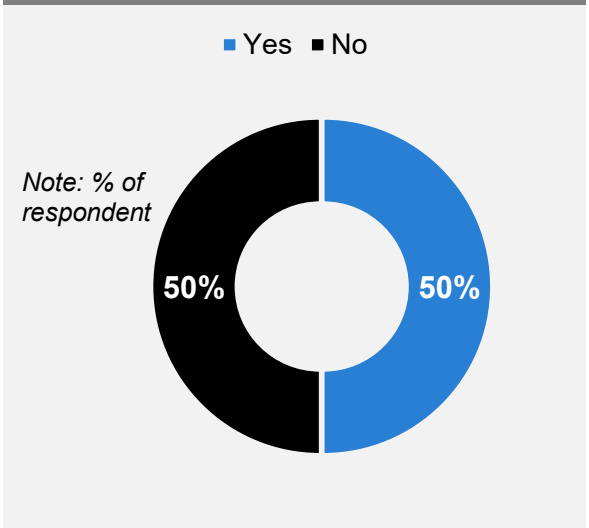
- To ensure that technology lockout does not occur as a result of international scheme rules, technology and processing requirements, which means that the international scheme has priority over the domestic scheme (applies to EMV, tokenisation, authentication and processing).

- There should be control of the interchange on premium products issued in other markets (e.g. USA) otherwise merchant fees get driven to ever higher levels.

- That when new domestic services are introduced to promote financial inclusion, that domestic schemes should be prioritised rather than international schemes as happened with the Nigerian national ID programme.

RELATIONSHIPS WITH INTERNATIONAL SCHEMES

Figure 14: Does your scheme have any formal cobadging agreements with international schemes?



50% of the domestic schemes have a formal relationship with an international scheme for cobadging of products. Most of the agreements that have been made over the past five years have involved Discover; they have included countries such as India, Nigeria and UAE. There are a few cases such as Egypt where the local scheme has a formal agreement with Visa and MasterCard but these are increasingly rare. There is considerable evidence that Visa and MasterCard see such arrangements as transitional and that arrangements with a domestic scheme will be dropped once they wish to enter the market directly with their own brands; Nigeria is an example of a country where such an approach was followed.

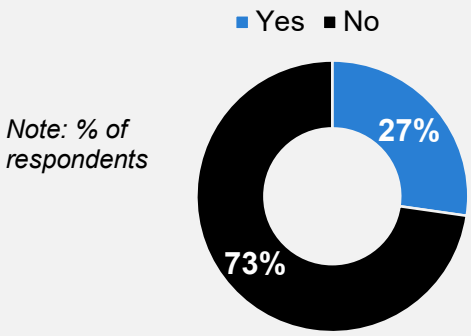
In countries where there is no formal agreement between the domestic scheme and international schemes, it is issuers that enter into separate arrangements. Over many years an operating model has evolved that allows cobranded cards to work for consumers and for issuers & acquirers. There are clear signs that these longstanding operating models are starting to break down principally because Visa and MasterCard now wish to be full players in the domestic transactions market and do not wish to concede market position to domestic schemes.

The lack of trust between domestic schemes and the Visa and MasterCard international schemes was reflected in the following comment:

> *"I would recommend all domestic schemes seek a formal cobadging arrangement, but be careful of a monopoly cobadge partnership."*

Given the crucial nature of how multiple brands coexist on a single payment instrument, one might have expected there to be widespread regulation. However, as the default model was that the domestic scheme was responsible for domestic transactions and the international scheme partner for cross-border transactions, in most countries there is no formal regulation of a situation that historically worked relatively well.

Figure 15: Are there regulatory requirements in your market that affect the cobadging of domestic and international schemes?

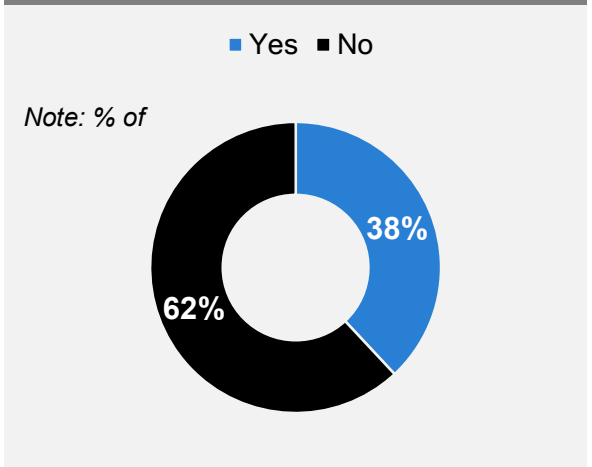


That situation is starting to change and Europe is now introducing regulations that start to govern cobadging. And with technology such as tokenisation and contactless providing new ways for schemes to assert ownership over transactions, some respondents commented that regulators need to take a more proactive approach to prevent anti-competitive behaviour.

In the absence of formal regulation of transaction routing, it could be considered important that a domestic scheme that allows cobadging with an international scheme has scheme rules that govern transaction routing. However, 62% of domestic schemes have no such rules.

This is important because the Visa and MasterCard international schemes have rules that on cobadged cards by default all transactions belong to them. If the domestic scheme has no such rules and if there is no regulatory authority requirement, the domestic scheme is in a weak position to assert any control. Where there are rules to govern transaction routing, either at a national or scheme level, there is not great consistency globally. In some markets, issuer preference is the rule (this is the Visa and MasterCard approach) but in other markets, acquirers and/or merchants can set the preference.

Figure 16: Does your scheme have rules that govern the routing of transactions from cobadged schemes?



DOMESTIC SCHEME OWNERSHIP AND PARTICIPATION

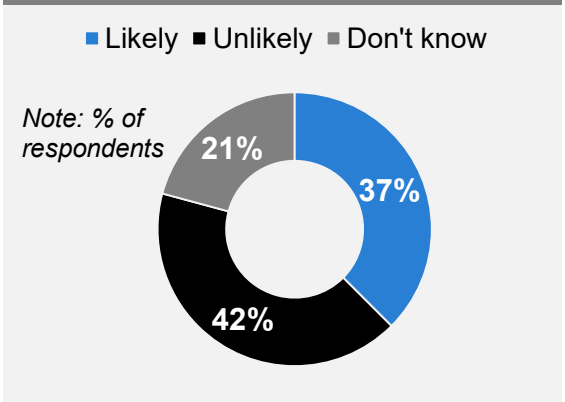
Card scheme ownership is still dominated by the retail banks that have a stake in 21 out of 22 of the schemes surveyed. In three of the schemes, the central bank also owns a stake. And in another three schemes, retail banks have diluted their ownership by bringing in private investors. One of the 22 schemes has a Stock Market listing and there is at least one further scheme that is part of a listed entity. It can be anticipated that some of the schemes that have private investors will also list on the Stock Market in future.

Figure 17: Who owns your scheme?

Ownership model	Number of schemes
Retail banks only	15
Retail banks + central bank	3
Retail banks + private investors	3
Stock market listed	1

A considerable number of schemes believe that their ownership is likely to change over the next five years although 42% see any change as unlikely.

Figure 18: How likely is your ownership to change in the next five years?



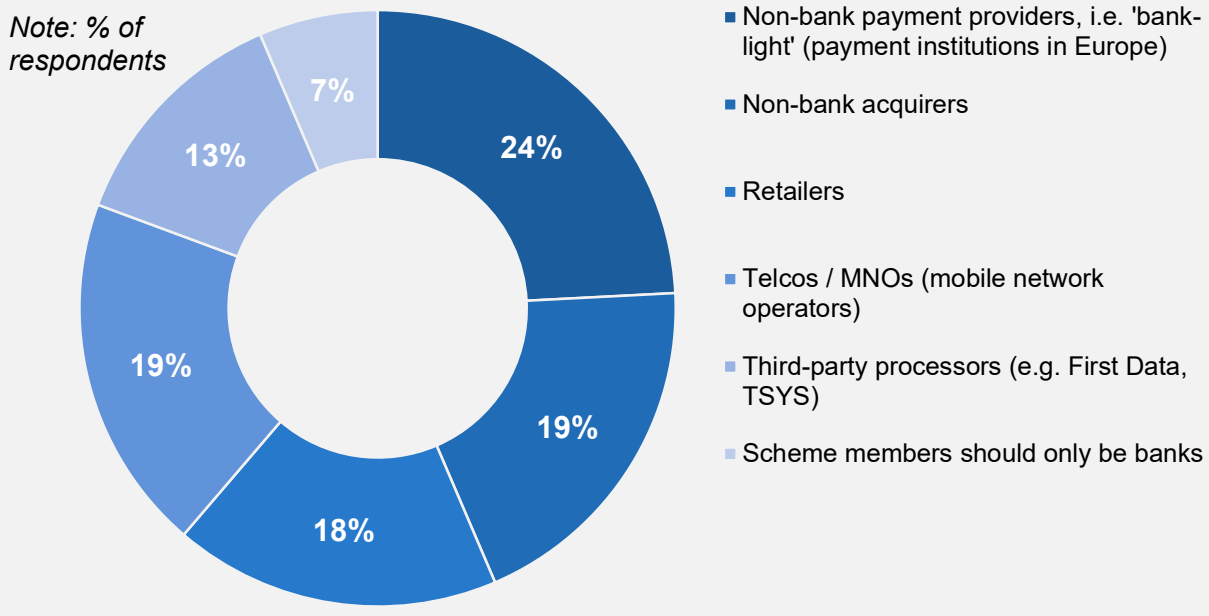
"Ownership may change between banks. But within the next five years I do not see the banks selling the scheme to anyone."

"Selling payments infrastructure off to private investors provides an attractive exit strategy for bank owners."

"If it does not change, we will not survive. The logical thing to do would be to set up a single 'Domestics Payments Company' for all products and services."

Even though there are differing views on future ownership of domestic schemes, there is a very large majority that believes direct participation in schemes cannot be restricted to traditional retail banks.

Figure 19: What entities should be able to join domestic schemes in future?

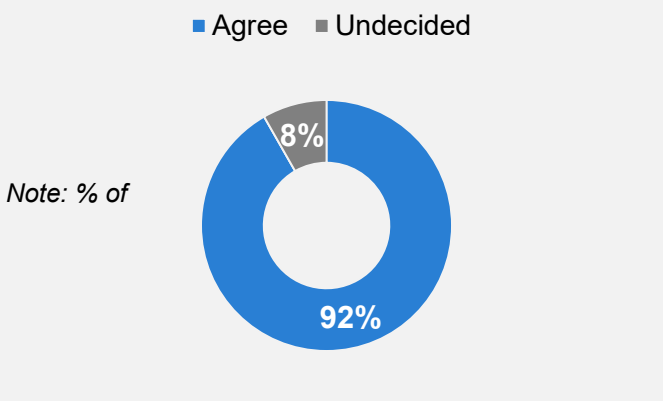


The overwhelming view was that if the regulators permit additional classes of organisations to provide payment services, then schemes must admit them directly on the same terms as traditional banks. This applies to non-bank payment providers (bank light), non-bank acquirers, MNO's and micro finance banks in developing markets.

COOPERATION BETWEEN SCHEMES

No schemes in the research argued that cooperation was a bad thing and most were strongly in favour.

Figure 20: For domestic schemes to be successful, cooperation between different schemes is often argued to be important.



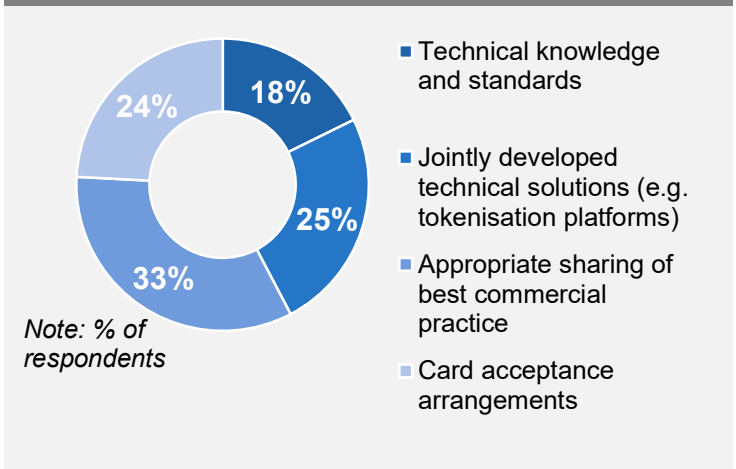
"In order for our domestic scheme to succeed, an intense cooperation is required at European level. Good work is already underway to that extent."

There was very strong support for cooperation and sharing in the area of infrastructure. A number of schemes commented on the dangers of relying on the technology of Visa and MasterCard because whatever the initial advantages, there are always substantial long-term risks in becoming dependent on competitors.

When looking in more detail at possible areas for collaboration, if we take high need + medium need as the best indicator of where collaboration would give the best returns, then the top two rated areas are:

- Sharing of technical knowledge and standards
- Jointly developed technical solutions, such as for tokenisation.

Figure 21: Which areas have the most potential for cooperation?



However, arrangement of mutual card acceptance is also seen as an area where domestic schemes should actively cooperate, although some schemes feel that they have satisfactorily addressed the issue. Sharing of best commercial practice whilst being rated lower than other potential cooperation areas is still seen as important by a number of schemes. And interestingly some respondents suggested that pooling information and lobbying efforts would be very worthwhile.