

## Imposing surcharges based on payment methods: Canada's current situation and a comparative analysis abroad

*Executive summary and final report (condensed version)*

June 2019

### Introduction

Credit cards have become an extremely widespread payment method used by consumers to pay their purchases, and nowadays few merchants don't offer their customers this payment option. In 2016, the value of transactions paid by credit card to physical or virtual points of sale in Canada reached \$462 billion. Various factors apparently contribute to this increased use of credit cards by Canadians: the quickness and simplicity of transactions, the security offered by this payment method, detailed monthly account statements, travel insurance, the (additional) warranty for products purchased, the generous rewards programs often accompanying premium credit cards, etc.

However, credit card use entails various fees charged to merchants accepting this payment method. Those fees, called a "merchant service charge" (hereinafter MSC) or a "merchant discount," include interchange fees, and are charged to merchants by credit card networks for processing payments. The amount of interchange fees corresponds to a certain percentage of the transaction amount, which varies according to different criteria.

In 2010, it was estimated that merchants had paid around \$5 billion in "hidden credit card fees." That year, interchange fees (hereinafter IFs) generally varied between 1.5% and 3% per purchase, and that percentage could be higher for certain credit cards with more-generous rewards programs.

According to many critics, IFs charged by credit card networks, combined with certain rules they impose on merchants who accept cards from those networks, entail anticompetitive constraints, substantial costs for merchants – particularly harmful to small and medium size businesses – and reportedly result in consumers paying more for goods and services, whatever the payment method chosen. Merchants, prohibited by credit card issuers from imposing a surcharge or refusing credit card types that charge higher interchange fees, are forced to include those additional fees in displayed prices. Some critics thus view those hidden fees as a way of subsidizing credit cards – mainly those accompanied by rewards programs – by consumers who pay otherwise than by credit card.

In that context, the Competition Bureau filed an application before the Competition Tribunal in 2010 to require Visa and MasterCard to cease certain practices entailing, notably, higher IFs in Canada and imposing anticompetitive constraints on merchants. The Competition Bureau's application initiated a series of developments and interventions on the issue of IFs: The Competition Tribunal rendered a decision in 2013; a voluntary code of conduct was established

### La force d'un réseau

#### Nos membres associatifs

ACEF Appalaches – Beauce – Etchemins  
ACEF de l'Est de Montréal  
ACEF de Laval  
ACEF du Grand-Portage

ACEF du Nord de Montréal  
ACEF du Sud-Ouest de Montréal  
ACEF Estrie  
ACEF Lanaudière

ACEF Montérégie-Est  
ACEF Rive-Sud de Québec  
ACQC  
Centre EBO d'Ottawa  
CIBES de la Mauricie

7000, avenue du Parc, bureau 201, Montréal (Qc) H3N 1X1

T : 514 521-6820 | Sans frais : 1 888 521-6820 | F : 514 521-0736

info@uniondesconsommateurs.ca | www.uniondesconsommateurs.ca

for the credit and debit card industry; and depending on the stakeholders, demands were made that legislative measures be adopted to cap IFs, or to prohibit, or authorize, surcharges on consumers using credit cards.

Finally, in November 2014, a voluntary agreement was reached between the Canadian government, Visa and MasterCard, to set IFs at an average effective rate of 1.5% for a period of 5 years. A similar agreement was reached in August 2018 between the same parties, joined by American Express.

While Canada has not opted for a regulatory approach to limiting or eradicating the undesirable effects of IFs or the IFs themselves, other jurisdictions have done so. Some governments have set a ceiling on this type of fees or have allowed merchants to directly levy a surcharge on credit card users to cover the IFs entailed by credit card use. Still, the issue of whether or not to allow merchants to impose a surcharge appears central to the debate.

The purpose of our research was to understand the benefits and risks for consumers of authorizing a consumer surcharge in Canada, to identify best practices among foreign initiatives, and to observe the effects of authorizing a surcharge.

Our research aimed at answering the following question: What method of imposing and disclosing payment fees would most likely offer consumers better protection, transparency and fairness? Our methodology included a review of the literature on the situation in Canada, a study of legislation in Canada and abroad (the United Kingdom, Australia and the United States) and a survey of the various stakeholders.

Our report presents the results of our research and the recommendations based on it.

## The situation in Canada

Canada has no specific regulatory framework for interchange fees. Despite repeated demands from independent actors, governments appear determined to allow the network operators to dictate the rules of the game, whether through contracts with anticompetitive clauses or through voluntary codes of conduct. The country thus has one of the worst records in the world for IF rates imposed on merchants, and the networks' unfair strategies and practices are well protected.

Among Canadian provinces, only Québec has adopted a provision of general application, in its *Consumer Protection Act*, which prohibits merchants from charging a higher price than that displayed, and therefore requires the most complete price disclosure possible from the start. To date, that provision has been interpreted as prohibiting merchants from adding to the announced prices any fees related to the payment method used by a consumer.

The Canadian government has dismissed all regulation proposals, and the Competition Tribunal chose in 2013 not to use its discretionary power to require that network operators remove anticompetitive clauses from their contracts. The federal government has also rejected the Tribunal's demand to urgently regulate credit card networks, and instead decided, on two occasions, to let the networks set their own rules and maintain their practices, in exchange for a few weak concessions.

The increased use of credit cards, which is the industry's primary objective, raises the risk of indebtedness among more-vulnerable consumers. And the rewards programs associated with those cards lead to their even greater use.

Including interchange fees in prices as a result of credit card use means that all consumers, whatever the payment method they choose, pay merchants part of those fees. The rewards programs are subsidized by consumers paying cash or using less-costly payment methods, often used by poorer consumers, thus favouring a regressive and unfair transfer of funds. That effect, as well as the greater indebtedness mentioned above, are at the heart of the credit card payment ecosystem. To date, nothing in Canada has resolved those issues.

## Foreign jurisdictions

Other jurisdictions have become aware of the necessity of regulating this industry. The consumer surcharge was first authorized in Australia to correct the imbalance of a system that favoured credit cards over debit cards. The Reserve Bank of Australia intended to give consumers clearer signals regarding the actual costs of the different payment methods and to change the system's tendency to transfer funds from consumers as a whole to a certain number of credit card holders.

### In Australia

Following the implementation of regulations for interchange fees in Australia (in 2003, authorizing the surcharge and putting a ceiling on IFs and, in 2013, prohibiting excessive surcharges), the following effects were observed: a greater volume of debit card than credit card transactions; lower fees paid by merchants; lower average interchange fees; increased annual fees for premium cards; the emergence of "no frills" credit cards with low interest rates and lower IFs than ordinary cards; and eventually, a reduction of rewards granted to credit card holders.

Overcharging has led in some cases to excessive and opaque surcharges imposed on credit card users. Excessive surcharges were particularly frequent in certain sectors (e.g., air transport, movies and theatres, telecommunications services, hospitality and tourism).

The 2013 regulation that required a "reasonable" surcharge doesn't seem to have borne fruit, perhaps because the regulatory body didn't have sufficient power; the level of compliance by companies has been disappointing. The new, stricter 2016-2017 regulations prohibit any surcharge greater than the cost of card acceptance by merchants and cap interchange fees; new implementation powers have been conferred to the Australian Competition and Consumer Commission. Those regulations also require financial institutions to provide merchants with precise data on the fees associated with the different cards, and merchants are obliged to base the surcharge amount on that information.

### In the United States

In a context where the credit card industry is poorly regulated, American merchants and even the government take legal action in an attempt to define what is (or should be) authorized or prohibited. The lawsuits have mainly raised arguments based on antitrust legislation and freedom of commercial speech. Credit card interchange fees are not regulated in the United States. They are among the highest in the world and have been increasing in recent years. Existing state laws that prohibited the surcharge as of 1976 largely result from lobbying by credit card companies. Since 2013, the surcharge has been authorized in forty states, and depending on future court rulings, it could be authorized in the ten remaining states. Major retailers don't apply the surcharge and its presence does not appear to be widespread in the United States. It is applied mainly by small independent retailers and in certain sectors: automobile, air transport/travel, etc.

While “no frills” cards with low interest rates are disappearing from the American market, rewards cards have taken over four-fifths of credit card purchases, and the total value of rewards has increased spectacularly in the last few years. Those rewards are funded notably by interchange fees, which consumers as a whole pay for, since the rewards’ cost is integrated in prices set by merchants. That amounts to a subsidy from consumers who pay cash, and from poorer people to those who pay by credit card.

### **In the United Kingdom**

In the UK, the surcharge became more widespread in parallel with the use of premium credit cards involving higher fees paid by merchants. However, the surcharges, whether excessive or corresponding to the fees actually borne by the merchant, had no direct effect on people – 40% of the British public – who have no credit card. Those who have a credit card, and thus who have to pay surcharges, have a higher income or work full-time in a greater proportion than the average. Excessive and opaque surcharges paid by credit card users were reported and criticized. The worst excesses appeared in the air transport sector and, generally, the travel sector.

A regulation adopted in 2012 to prohibit excessive surcharges did not yield the expected results; the surcharge was therefore prohibited and interchange fees were capped. The effect of those two combined measures is not yet known.

## Survey of stakeholders

We conducted a survey to obtain the viewpoints of as many stakeholders as possible; we deplore the merchants' lack of participation. Fortunately, our review of the literature, among other things, revealed merchants' positions on the subject, and the positions of network operators.

The answers to our questionnaire revealed, again, that the stakeholders' positions – even though the majority, even almost all, of respondents are consumer rights groups – differ widely.

While everyone agrees that the existing payment system is unfair and lacks transparency, no proposed solution is unanimous. Some respondents think allowing a surcharge for transactions paid by credit card is a possible solution, by ending the subsidy by all consumers, but particularly by the poorest ones, of rewards programs for credit card holders. Others think this cross-subsidy is a hypothesis that hasn't been proven, or that the surcharge's inconveniences negate its limited benefits, so that it should not be authorized. Many respondents expressed concern about a surcharge, notably due to the risk of excessive surcharges, of resulting confusion, etc.

Moreover, apparently everyone indicated that it would be necessary, even urgent, to cap interchange fees. One respondent opined that a regulatory body responsible for setting IFs should be put in place.

All the consumer rights groups think measures to raise the payment system's transparency should be adopted, particularly regarding IFs and surcharges.

The OPC, the only respondent that isn't a consumer rights group, pointed out that a merchant can legally grant a discount or another benefit to a consumer choosing to pay otherwise than by credit card.

## Conclusion

Canadian consumers' use of credit cards clearly shows they like that payment method very much. It is in fact used mainly for purchases rather than access to credit: over 70% of Canadians generally pay off their total credit card balance at the end of each cycle. But more and more, the loyalty programs appear to convince users to pay with their credit card whenever possible. For 82% of Canadians, rewards programs are a determining factor in their choice of credit card. So it's not surprising that almost 82% of credit cards issued in Canada in 2016 involved a type of reward.

However, the credit card is also a costly payment instrument, both for companies and consumers, notably because of loyalty programs. But those costs are hidden from consumers. Fees, representing a percentage of transactions, are charged to merchants for processing each credit card payment. Interchange fees, in amounts varying according to the type of card used – cards offering more “privileges” entail higher fees –, cannot, under the rules dictated by credit card networks, be charged directly to consumers. Those fees are thus included in merchants' prices and shared among all their customers, whatever the payment method they choose or the type of card they use. So in addition to a lack of transparency, this system generates serious social inequalities.

\* \* \* \* \*

As a complex economic system with multiple actors, but controlled by a very small number of powerful actors, credit card payments are subject to few regulations in Canada, thus allowing that system to benefit from its complexity and opacity. The latter is flagrant when we examine those fees that merchants must pay to participate in the system, and that the networks set unilaterally. According to the latest data, Canada features some of the highest interchange fees in the world, at a reported average of 1.78%.

For a long time, merchants have mobilized to denounce those fees, which they find unfair – as the lower foreign rates appear to confirm – and particularly harmful for small and medium size businesses. But consumers seem to be “blissfully unaware” of the cost related to credit card payments and their coveted rewards.

A merchant who must pay interchange fees has limited means to reduce them or recover them from consumers. Indeed, the issuers' contracts impose certain interdictions on merchants, and the surcharge is generally prohibited by laws requiring merchants to display the “full price.” A merchant thus has no other solution but to include those fees in the prices of all the goods and services he sells. That translates into higher prices, so that interchange fees are paid by consumers as a whole, including those who choose other payment methods or benefit from no rewards program. Studies have confirmed that the poorest consumers thus subsidize the rewards programs of the wealthiest. Of course, merchants are free – because the issuers' contracts generously allow it – to grant discounts to consumers who pay cash. While that does give the consumer a chance to

avoid paying interchange fees, it is recognized that the discount offer does not send consumers as clear a message on interchange fees that an eventual surcharge would.

Despite the finding, long established in Canada and elsewhere, that interchange fees cause problems and unfairness, the federal government, despite its constitutional authority to do so, has never seemed inclined to regulate in this area, or even to entertain the idea.

As opposed to what is observed in the United States, lawsuits brought in Canada against credit card network operators have not resulted in effective solutions to date. The Competition Bureau's legal action before the Competition Tribunal also did not bear fruit. Despite findings that Visa and MasterCard contracts included anticompetitive clauses, the Tribunal decided not to use its discretionary power to intervene, given that market's particularities and complexity, but instead enjoined the government to regulate it.

The failure of the many bills – filed in the Senate as well as the House of Commons – that aimed at capping IFs appears to confirm the lack of political will to intervene. The parties that have held power in turn have rather preferred to reach agreements with network operators, notably in order to cap average IFs. Those compromises proposed by network operators so as to avoid any restrictive regulations thus guarantee, with the government's consent, astronomical levels of interchange rates and allow network operators to maintain the anticompetitive constraints they impose on merchants. Those constraints lead in turn to the maintenance of inequalities and to the regressive transfer of wealth resulting from the payment of IFs by Canadian consumers as a whole.

Concerned in particular by the systems opacity and the social inequality it fosters, by the arbitrary way the fees seem to be set by network operators, by tactics (contractual and others) motivating consumers to choose costlier payment methods, several foreign jurisdictions have decided to intervene. Regulations have pertained essentially to the control of interchange fees themselves, and to the regulation of surcharges related to credit card use.

Foreign interventions have had different objectives: reducing payment costs, leading consumers to choose less-costly payment methods, reducing fees paid by merchants, increasing competition in terms of processing fees, or ending poorer people's subsidy of rewards programs that benefit wealthier people.

Capping interchange fees has had drastic effects: Those fees are now 0.3% in the European Union and 0.5% in Australia. But capping those fees at an average rate (the approach also adopted in agreements reached in Canada) has had a perverse effect: the multiplication of “no frills” cards, lowering that average rate while maintaining high fees for the more generous cards. Accordingly, a maximum fee per card has also been imposed in Australia. A substantial reduction in rewards programs has been observed in those markets.



Lowering interchange fees doesn't solve the transfer problem that arises when the fees are included in prices and paid by everyone, but this problem reportedly becomes less critical if the fees thus shared are insignificant.

Regulating the surcharge is more complex. Several American states, for example, have prohibited surcharging. The prohibition has been challenged in the courts, which have declared it inapplicable. Other jurisdictions have allowed it, only to find out that it should be regulated more strictly, by capping in order to avoid abusive surcharges.

While merchants have applied the surcharge only in highly variable proportions (around 15% of businesses across the European Union in 2013, up to 40% of major retailers vs. 20% of small ones in Australia in 2014, but no more than 2% in the United States in 2012), market changes contemporaneous with this practice have still been observed: a reduction in IFs and rewards, a migration toward less-onerous payment methods, or changes in the types of cards offered to consumers.

The experience of foreign jurisdictions reveals that imposing a surcharge is not a perfect solution to the problems of IFs and resulting social inequality.

The inconveniences caused by surcharges include:

- A major risk of collecting a higher surcharge than actual payment processing fees (excessive surcharge);
- The necessity of increased monitoring, powers and resources for the regulatory body;
- Technical difficulties and difficult access to the actual cost of IFs for each transaction.

Some observers note that merchants who impose a surcharge will not necessarily subtract from their prices the amount that was included in it to cover interchange fees, and that credit card users could thus end up doubly paying certain fees, whereas other consumers would still not benefit from lower prices.

The risk, mentioned by some observers, of a ripple effect leading merchants to charge fees for other payment methods has not materialized in any jurisdiction we studied.

Imposing a surcharge still has benefits that may be greater than those inconveniences:

- Consumers' increased use of less-costly payment methods;
- Awareness of the cost of processing credit card payments;
- A lesser risk of indebtedness; and particularly
- The end of rewards programs' subsidies by poorer consumers to the benefit of wealthier ones.

Several stakeholders point out that authorizing the surcharge gives merchants more negotiating power regarding interchange fees, and that the network operators would tend to reduce interchange fees if a risk existed that credit card users would be informed of those fees and would

have to pay them. In that sense, the surcharge's effective adoption rate by merchants, which varies enormously from one jurisdiction to another, appears secondary.

We refrained from considering as disadvantages some of the possible effects of imposing a surcharge, i.e. a reduction of rewards programs and an increase in the annual fees of "premium" credit cards. In our view, the disappearance of those advantages would be far from a catastrophe. It's precisely the existence and multiplication of those programs that cause higher interchange fees, induce consumers to use their credit cards as often as possible, and increase cross-subsidy variances to the detriment of poorer people. The annual fees also contribute to that cross-subsidy by insufficiently covering the benefits offered to holders of certain cards.

This issue of rewards is so important to the industry that it's not surprising to find, in Canada and elsewhere, the emergence of fake groups, evidently funded by the industry, that claim to fight on behalf of consumers as soon as the possibility of regulations is raised, and that have impressive means to continue fighting so that rewards programs are not jeopardized. On the other hand, we may regret that the Canadian government congratulates itself for having succeeded in maintaining those unfair loyalty programs by allowing the industry to regulate itself (and to continue regulating merchants).

Some jurisdictions that have authorized the surcharge have had to intervene more drastically in order to limit overcharging that was unfortunately ubiquitous in certain sectors. The solution was simple: The surcharge is allowed only to cover fees actually paid by the merchant for payment processing. This measure has the benefit of requiring credit card issuers to provide access to accurate information on the rates applicable to transactions, and also addresses the lack of transparency for which the industry has long been criticized.

It is high time that Canada establish a just and fair payment system. It is unacceptable that the unfair transfer of credit card payment costs, which has long been recognized, the maintenance of disproportionate interchange fees – among the highest in the world – and the control of merchant practices by means of anticompetitive clauses are maintained with the complacent support of elected representatives.

It's time for lawmakers to become seriously interested in the issue and enact necessary regulations. Foreign initiatives offer avenues to follow, and proven models should be adopted as soon as possible.

The surcharge and IF capping, both adopted abroad, deserve to be considered. The respective advantages of capping interchange fees – capping the average and the maximum – as well as the surcharge may well be complementary. Each measure is likely to have specific and desirable effects.

We're well aware that our support of authorizing the surcharge puts us at odds with the other Canadian consumer groups. Their position is surprising, given that in all the foreign jurisdictions

we studied, consumer groups have supported measures authorizing the surcharge and have fought measures prohibiting it. We continue to believe that the expected benefits, particularly the elimination of reward program cross-subsidy, far exceed the disadvantages or risks of that practice.

Moreover, one argument raised by Canadian consumer associations poses a particular problem. Including interchange fees in all prices allows the display of a full price charged to everyone, whatever the payment method. That practice, it is said, thus enables greater transparency and avoids the complexity that could result from the addition to that advertised price of fees that could vary enormously depending on the credit card used, since different cards don't all entail identical interchange fees.

That argument in favour of the transparency represented by a full price required of everyone is appealing at first sight. However, the appeal quickly fades when we consider that this transparency comes at the price of camouflaging, within the price, specific fees that some consumers should not have to pay, because those fees only serve in reality to fund reward programs from which those consumers don't benefit and that are only generated by other people's use of a given payment method.

That same view of so-called transparency also explains the interpretation of legal provisions requiring an all-inclusive price to be displayed. As we argue in this report, in our view the price that should be displayed mandatorily is the cash price for which a consumer can obtain the good or service. Adopting this approach would also end practices such as advertising no-cost financing while cash payments entitle the customer to a discount. Thus, the costs related to the consumer's choice of a more onerous payment method could be added to the advertised prices without contravening the objectives of those legal provisions.

The multiplicity of applicable fees depending on the credit cards used is an issue with another level of complexity. It's clear that authorizing the surcharge should also entail information requirements, on the part of issuers as well as merchants, in order to meet the objective of transparency.

But that complexity will still have to be managed at the same time as the others, although it appears relatively minor compared to, for example, that of regulating the interchange fees corresponding to payment processing costs, or fairly sharing fees between the various actors.

One of the stakeholders who answered our questionnaire (PIAC) insists on the appropriateness of establishing a body responsible for setting interchange fees and ensuring the sector's monitoring. Creating such an *Interchange Regulatory Board*, to which would be conferred adequate investigation and ordinance powers, would certainly deserve to be considered as a tool for finally establishing in the payment system, independently, the necessary transparency and fairness.

As mentioned by another participant in our survey, past research indicates that consumers don't have a good knowledge of IFs and the way they are collected, and consumer resistance can be expected if rewards programs will likely be reduced by regulations. That resistance is certain, as the industry well knows while taking part in campaigns to raise discontent in advance. The organization adds that an information campaign will doubtless be necessary: "a fulsome consumer education and timely information effort would be needed. The distortions in decision-making and unfairness of loyalty programs would need to be fully exposed in plain language. Otherwise consumer resistance itself could be a problem."

Indeed, regulating interchange fees will likely require a vast information campaign. Despite everything, it should be possible to make consumers understand that someone actually pays for what the industry tells them they obtain for free. It should also be possible that if those privileges are paid for by poorer third parties, such unfairness deserves intervention. If that opposition still persists, the government will have to show some courage and fulfil one of its priority roles: to work toward social justice, in this case by ensuring the fairness and transparency of the payment network.

## Recommendations

In light of the above, our recommendations are the following:

**Union des consommateurs recommends that the federal government** intervene to impose a regulatory framework for credit card network operators, in order to ensure the fairness and transparency of the credit card payment system and end the abuses observed therein.

Among the aspects that should be considered and studied when developing that regulatory framework, Union des consommateurs recommends that special attention be paid to the following:

1. The appropriateness of authorizing merchants to impose a surcharge on consumers paying by credit card, to cover only the fees that their use entails for merchants;
2. Capping the average interchange rate for all cards of the same network, and capping the interchange rate per transaction;
3. Regular and frequent reviews of the caps;
4. Adopting measures requiring the publication of interchange fees, to improve the network's transparency;
5. Prohibiting, in network operators' contracts, any clause that dictates or prohibits merchants' business practices and that could have anticompetitive aims or effects;
6. Ensuring, for the regulatory authorities' eventual mandate to monitor and apply those regulatory frameworks, that those authorities will have the necessary powers and resources for implementing and enforcing compliance with the regulations;

7. The appropriateness of concertation with the provincial governments to ensure the adoption of a uniform framework offering consumers the highest possible level of protection;

**Union des consommateurs recommends that the federal government** study the relevance of establishing an independent body, such as an *Interchange Regulatory Board*, that would be responsible, notably, for setting interchange fees and monitoring the sector in order to guarantee its fairness and transparency.

**Union des consommateurs recommends that governments** change the rules requiring the display of full prices, to indicate clearly that the advertised price must be the cash price, and that governments provide methods for disclosing the payment fees imposed on merchants applying a surcharge related to the payment method.

**Union des consommateurs recommends** the development and dissemination of a major information campaign addressed to consumers, with regard to the costs and inequities of interchange fees and loyalty programs, and to the distortions of the market and decision-making power entailed by those practices;

Such a campaign should be developed in concert by the governments, governmental consumer protection organizations and community organizations defending consumer rights;

Financial resources should be provided to ensure adequate participation by consumer groups and very wide dissemination of the information campaign.

---

Version française disponible.

Union des consommateurs received funding under Industry Canada's Contributions Program for Non-Profit Consumer and Voluntary Organizations. The views expressed in this report are not necessarily those of Industry Canada or the Government of Canada.