

22 April 2015

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By Email to: pysubmissions@rba.gov.au

Dear Dr Richards,

Consultation on “Review of Card Payments Regulation – Issues Paper, March 2015”

The Commonwealth Bank (the Bank) appreciates the opportunity to lodge this Submission to the Reserve Bank of Australia (RBA), further to the 4 March 2015 Media Release and “Review of Card Payments Regulation” Issues Paper March 2015¹. The Bank understands that this Submission will be posted on the RBA’s website.

The Issues Paper identifies a number of specific issues for consultation (Chapter 5). These shall be addressed below. Prior to that, however, we’d like to take the opportunity to comment briefly on a few related matters, as well as some of the “Issues for the Review” raised in Chapter 4 of the Issues Paper.

The Bank believes that card payment networks exhibit high levels of innovation; they are highly competitive both between Schemes and also amongst Issuers and Acquirers. There is a strong customer value proposition for cardholders to use cards, and for merchants to accept card payments. High levels of investment are evident and we believe it is important that there is enough value in the network to justify, and indeed encourage, ongoing investment and innovation. Furthermore, it is important that regulation does not inhibit such innovation or competition, nor inhibit the movement away from less efficient forms of payment such as cheques and cash, towards more efficient channels such as cards.

The Bank believes that interchange fees, through the function they perform in balancing the relative costs on both sides of a cards payments network, play a key role in cultivating innovation. This assists a network to bring mutual benefit to participants and promotes ongoing efficiencies.

Regulatory intervention should be commensurate with the extent, if any, of market failure. After many years of regulatory intervention in card payments, we do not believe that further significant changes are warranted. As will be noted below, some incremental fine tuning of

¹ <http://www.rba.gov.au/payments-system/reforms/review-of-card-payments-regulation/review-of-card-payments-regulation-issues-paper.html>

regulation may be possible – if introduced in a practical manner which minimises market disruption. However, it is important that any regulatory response be cognisant of the size of the issue being addressed. As a principle, we believe that erring on the side of less intrusive regulation, rather than more, is a preferable outcome.

Chapter Four of the Issues Paper canvasses a range of issues to address in this review. Such topics are generally expanded upon in the specific issues for consultation listed in Chapter Five. These will be addressed below. However, a few themes warrant brief consideration before our detailed views are spelt out. Such themes include:

- Complexity / Simplification: At a number of points in the Issues Paper, concern is expressed in relation to the number, and spread, of interchange fees. While we understand this concern and agree that some simplification may be desirable, we are also mindful that simplification and rationalisation risks an adverse impact on innovation and product differentiation – and thus competition. We are also concerned that it is not the role of payments regulation to seek to specify end market pricing arrangements – that is the province of competitors seeking to provide services valued by their customers.

Simplicity should also manifest itself in any regulatory solution. Any regulatory response should be simple, practical and cost effective, in order to avoid placing unnecessary burdens on the industry and its customers.

Furthermore, we think that the more intricate regulation becomes, the more incentives participants have to seek to “game” the system. This is counter-productive, albeit commercially understandable.

- Cross Subsidisation: The impact of interchange fee hierarchies, combined with differing interchange fees for different card products, is seen to be perpetuating a cross subsidisation of costs between small and large merchants. Again, we understand this concern and agree that incremental benefit may be obtainable by addressing the extremes of these circumstances.
- Drift: Concern around the upward ‘drift’ of interchange fees between the three yearly reset periods is evident. This is able to be addressed with relatively straight forward initiatives, as outlined below.
- Efficiency: The Bank does not accept the argument that current interchange fee caps are inefficiently high. In our view, the market has settled at a level of equilibrium reflecting current interchange fee caps, and further wholesale reductions run the risk of seriously undermining cardholder value propositions for little, if any, benefit.
- Surcharging: Recent history, and the Issues Paper itself, makes it clear that surcharging for card based payments remains a contentious topic – especially in relation to some identified industries. Instances of “excessive” surcharging are best assessed, we believe, as a competition law enforcement issue. While surcharging is addressed further below, it is our view that surcharging where input costs are regulated, is not appropriate – ie, where interchange fees as an input cost are regulated, and thus restrained, it is not appropriate that merchants also retain the ability to surcharge. We do not believe that ‘two bites of the cherry’ can be justified. Surcharging in circumstances where payment input costs are unregulated should be left to the merchant’s discretion, having regard to issues of market power which should be considered the province of competition law rather than payments regulation.

Specific aspects arising from these themes, and more, are addressed below. However, it is suggested that a number of these themes can be addressed in a relatively straight forward manner with some relatively incremental modifications to existing regulation.

The Issues Paper seeks the views of stakeholders on a number of issues. These are addressed below, using the headings identified in the Issues Paper.

(1) Publishing thresholds for which payment system providers will be subject to interchange or related regulation

The Bank does not support an approach to payment systems regulation that is based on an arbitrary determination of size or significance. Instead, assuming the persistence of the RBA's regulatory powers, it is our view that price regulation should be targeted only at multi-lateral prices – interchange fees – that are not the result of bilateral, commercial, negotiations. This enables a clear understanding of when such regulation will apply and avoids any debate about significance – and also ensures competitive neutrality between networks utilising an interchange fee arrangement.

For the sake of abundant clarity, and to address one specific, but topical, example, we do not see a need for regulation of American Express cards or transactions. Further, we see no need to distinguish between “companion” card arrangements and the more traditional American Express card. Comments further below in relation to surcharging are, however, germane.

(2) Broadening interchange fee caps to include other payments between schemes and issuers.

Further to Issue (1) above, non interchange payments between Schemes and their members are the outcome of bilateral, contractual, negotiations between counterparties and it is our view that RBA should not intervene in such relationships. As stated above, if regulation is to persist, this should be restricted to regulation of multi-lateral interchange fees in light of their unique nature. To stray beyond that principle is an unreasonable intervention in bilateral commercial relationships.

(3) Making changes to the interchange benchmark system to reduce the upward ‘drift’ in average interchange rates inherent in the current three-year reset cycle.

We believe that a more frequent reset period, in conjunction with other initiatives, will address the concerns currently arising from the ‘drift’ in interchange fees between the three yearly reset periods. An appropriate “cap and collar approach” – discussed further below – combined with annual resets, would address ‘drift’, while still allowing competitive pressures, and innovation, to persist.

(4) Lowering interchange caps.

The Bank does not accept that there is any basis for the suggestion that interchange fees are currently too high. We believe that the market has, in recent years, found equilibrium and to move away from such a position will be disruptive for participants, with the consequences of such disruption falling disproportionately on cardholders.

The expectation of lower product prices following a reduction in merchant cost of card acceptance does not, in our view, stand up to scrutiny.

In our response to issue (3) above, we endorse the possibility of transitioning to an annual reset period (away from the current three year interval). A practical implication of such a relatively minor change is to remove the incentive and ability for issuers to exploit the opportunity for ‘drift’ – effectively introducing considerable downward pressure on each Scheme's weighted average interchange fees. In conjunction with the “cap and collar approach” discussed below, this removes the need for a blunt, and draconian, reduction in current caps.

(5) Replacing weighted-average interchange caps with hard caps.

Complementing the above discussion, we encourage the RBA to further explore the introduction of “caps and collars”. We would envisage separate caps and collars for credit card interchange fees, and debit card interchange fees, based around the current weighted average rates. To be more specific, we suggest consideration of a model involving:

- Retain current weighted average interchange caps to apply separately for credit card and debit card interchange fees.
- Introduction of a “cap and a collar” (separately for both debit and credit products) either side of the weighted average cap. Setting an interchange rate above the hard cap, or below the hard collar, would not be permitted.
- This would have the effect of moving interchange fees to within a band around the current weighted average. Such a band should be narrow enough to address concerns around ‘drift’ and cross subsidisation, while also being broad enough to encourage issuer innovation, differentiation and competition.
- We would support retention of the current preferential rate applied to Charity transactions as an “exception” to this model.
- For clarity, we would see this applying to “cash out” debit transactions (against which a “negative” interchange fee is currently applied). This should be re-aligned to a positive number within the “cap and collar”.
- We do, however, suggest that Commercial, or Corporate, cards (both credit and debit) should be removed from this regulated regime given their fundamentally different nature when compared to consumer cards. (Commercial cards invariably “transact” rather than “revolve”, incur costs from customisation, and capturing and delivering enhanced data and management reports, and deliver considerable working capital and productivity benefits to the employer / sponsor organisation.)
- Similarly, Commercial prepaid cards should, in our view, be exempt from regulation under interchange fee caps. (Further below, we suggest that consumer prepaid cards should be treated the same as debit cards – refer Issue (7) below.)
- We also suggest, as discussed in (6) below that consideration be given to expressing both credit and debit card interchange fees on an ad-valorem basis.
- Combined with more frequent reset periods, we believe that such a model would address the vast majority of concerns expressed in the RBA Issue paper.

A complementary reduction in the number of interchange fee categories would further assist with this simplified approach.

The main challenge in such a model as this is, of course, striking the appropriate level of the respective cap and collar. We would be happy to engage with the RBA in such an exercise but would anticipate a compression of Interchange Fees (both in number and quantum) from those which are presented on page 27 of the Issues Paper².

This model, in conjunction with reduced opportunity, or incentive, for ‘drift’ is, we believe, a compelling proposition where incremental fine tuning can be implemented with less risk of market disruption than more quantum, or extreme, measures.

(6) Applying caps as the lesser of a fixed amount and a fixed percentage of transaction values.

The Bank does not support the setting of interchange fees as the lesser of *either* a flat fee *or* an ad-valorem fee. We think that such a model would be confusing for merchants, and confusing for cardholders in the event that surcharging were to be permitted (see below). This model would also be difficult for an acquirer to implement – necessitating a sizeable lead time (as foreshadowed in the Issues Paper) and involving considerable expense.

² Ibid

It is important to note that a number of the costs that are traditionally re-couped by way of credit card interchange fees vary according to the size of the transaction. Thus, ad-valorem recovery, rather than flat cents per transaction, is appropriate. Such cost categories include issuer costs in respect of fraud, issuer costs incurred in funding the interest free period on credit card transactions, and cost of capital.

The Reserve Bank may wish to give consideration to transitioning all interchange fees to an ad-valorem approach, in lieu of the proposed “lesser of” approach. This would, we believe, assist in the acceptance of low value card transactions. An appropriate transition period would likely be necessary under such an approach.

(7) Including prepaid cards within the caps for debit cards.

The Bank has always been of the view that debit card regulation applied also to prepaid cards. To the extent that clarification is required, and we are surprised that this may be the case, then confirmation of the existing approach may be beneficial.

(8) Allowing for ‘buying groups’ for smaller merchants to group together to negotiate to receive the lower interchange rates that are accessible to larger merchants.

The Bank is of the view that allowing for such buying groups is an artificial construct that seeks to bring together retailers that otherwise have no common interest – other than aggregating purchasing power for a single purpose.

While we appreciate the objective here – to reduce disparity between the favourable rates enjoyed by large merchants and the rates otherwise charged to smaller enterprises – we believe that such an objective could be addressed by other initiatives discussed above – such as under Issue (5) above.

In a practical sense, we also question whether such buying groups would generate enough volume so as to be meaningful in terms of qualifying for more strategic rates – and we also anticipate a considerable implementation challenge for acquirers across disparate merchants if this were to be implemented.

(9) A tiered surcharging system, perhaps

- (a) Allowing low-cost system providers to prevent merchants from surcharging, to encourage consumers to use low-cost payment methods.**
- (b) Allowing medium-cost providers to limit surcharges to limits set by the Board**
- (c) Allowing high-cost providers to limit surcharges to the reasonable cost of acceptance**

The Bank believes that a tiered system of surcharging is likely to prove confusing for cardholders, bureaucratic, and difficult to implement for retailers and acquirers. Such an approach is thus unlikely to be adopted. An alternative, and preferable model in our view, would be to ban surcharging for those instruments subject to interchange fee regulation, while allowing merchant discretion for setting of surcharges, if any, for otherwise unregulated payments channels.

This approach should be considered in conjunction with, and complementary to, the above suggestion for a “cap and collar” around a weighted average interchange fee outcome, with annual reset periods. With regulation, and effective lowering of interchange fees for regulated networks via the elimination of ‘drift’, the need for surcharging is significantly reduced –

especially in relation to what might (formerly) have been seen as high cost cards to non-strategic merchants.

With regulation (price capping) of an input cost, it is unnecessary, and arguably inequitable, to also allow surcharging. We believe that “two bites at the cherry” is inappropriate.

(10) Targeted changes to reduce particular cases of excessive surcharging.

The Bank is strongly of the view that cases of “excessive” surcharging are indicative of market structure and price setting powers, and are best addressed under competition law, rather than seeking to do so under the regulation of payments systems.

(11) Any other changes to enforcement procedures and disclosure practices.

The Bank endorses the importance of timely and fulsome disclosure of surcharging intent and also encourages the provision of non surcharged payment channels – helping cardholders to make informed choices while also promoting competition.

(12) Strengthened transparency over the cost of payments to merchants and cardholders.

There are a number of aspects to this issue, viz:

- Electronic identification of debit versus credit cards is conceptually desirable but has proven to be challenging to implement. Keeping an expanding range of card numbers up to date, and able to be interrogated at the Point of Sale, is onerous and arguably unnecessary if other, incremental, initiatives discussed elsewhere are implemented.
- It is even more difficult to electronically distinguish different categories (colours) of cards – and keep card number ranges up to date, without significant imposition on acquirers and merchants. This is exacerbated when ranges of card numbers are “migrated” to different categories, without any visual change to the cards in question. Visual differentiation of already crowded card “real estate” raises further challenges. Again, this is onerous and arguably unnecessary if other, incremental, initiatives discussed elsewhere are implemented.
- The provision by acquirers of merchant pricing details that separately shows interchange fee and merchant service fees applying to different card types is a competitive matter and regulation thereof cannot be justified. Providing additional pricing and statement detail (and complexity) also overlooks the simplicity (such as blended pricing or pricing that includes monthly card turnover) that, in our experience, many merchants value highly. For clarity, we believe that provision of “interchange plus” pricing should remain a competitive matter – offered by some, but not necessarily all, acquirers and likely accepted by some, but not all, merchants.

In effect, the above discussed “cap and collar” with regulated weighted average interchange fees renders this issue redundant.

(13) Further easing of ‘honour-all-cards’ rules to allow merchants to decline to accept cards with high interchange fees.

The “Honour All Cards” rule is a central tenet of individual card payment networks. The Bank does not support any easing of existing rules in this respect. Consumer confidence that their “Scheme X” card, regardless of colour or features, will be accepted wherever they see the sign stating “Scheme X Cards Accepted Here”, is vital. A watering down of this proposition to the effect that only “Some Scheme X Cards Accepted Here” is a significant weakening of the cardholder value proposition. This would be a backward step in terms of promoting card usage and the ongoing migration to more efficient forms of payment.

Again, the above discussed “cap and collar” with regulated weighted average interchange fees reduces the need to challenge this tenet of card payment networks.

(14) Facilitation of differential surcharging by merchants.

Differential surcharging for otherwise unregulated payments networks is really, in our view, a matter of merchant choice. Competitive pressures would we believe, in conjunction with no surcharging for regulated networks, act to exert downward pressure on surcharging levels.

However, we do not believe that it would be good market practice for merchants to be required to inform customers of their cost of card acceptance. Again, this is a matter of merchant choice and should be considered in the same context as a merchant considers disclosure of any input cost.

(15) Ensuring that merchants have the ability to choose to route their transactions via lower-cost networks or processors.

The Bank does not support allowing merchants the ability to route transactions via alternate networks. Apart from the technical challenges inherent in this proposal, and the technical inefficiencies it would introduce, such an option overrides cardholder selection of card brand and card features – and potentially negates the benefit that drove a cardholder to select a certain card in the first place – such as the provision of insurance protection which would be jeopardised if an alternate network were to be selected by the merchant at the point of sale.

(16) Clarifying arrangements for competing payment options within a single device or application.

In August 2013, RBA announced that agreement had been reached between the three debit card networks over dual-network debit cards. These agreements have been kept confidential between the RBA and the respective network. If these agreements are now found to be wanting, then clarification through greater transparency and more rigorous enforcement may be required.

A central element of this issue is, to our view, the ability for card issuers to have the right to select which application is “Priority One”, rather than have that dictated by a card network. Clarification and confirmation of this would be a welcome development.

(17) Stakeholder views on the appropriate regulatory arrangements for prepaid cards

Further to Issue 7 above, the Bank believes that debit card regulation should encompass prepaid cards. We understand that this is currently the case; confirmation of the existing approach may be beneficial.

(18) Other issues concerning card payments and their role in the broader retail payments system

Earlier in this Submission, the Bank made comment on a number of principles and themes. We repeat the view that competition, investment and innovation is evident in the market for card payments, while acknowledging that light-handed regulation can play an important role in promoting the movement away from less efficient forms of payment such as cheques and cash. We take this opportunity to urge further RBA action in support of such a migration.

It is also important to stress the two sided nature of the cards payments network. In our opinion, the current debate has tended to overlook the importance of, and potential impact on, cardholders. The above discussion has deliberately sought to re-balance this debate.

Interchange fees have been shown to be an important component of network growth and efficiency and while some incremental fine tuning of regulation may be possible – introduced with a view to minimising market disruption – it is important that any regulatory response be cognisant of the size of the issue being addressed. Erring on the side of less intrusive regulation, rather than more, is to be preferred.

(19) Additional measures that the Bank should consider in a review of the regulatory framework

We will happily expand further on any of the above, or related matters, when we meet to discuss this Submission.

In the meantime, the above discussion canvasses a range of issues and responses thereto. At a high level, and by way of summary, we see merit in further exploring a “solutions package” that might include the following:

- Restrict price regulation to those instances where a genuine multi-lateral interchange fee is in place;
- Introduce a “cap and collar” approach (separately for debit and for credit networks) around the current weighted average interchange fee;
- Introduce annual reset periods; and
- Permit surcharging for unregulated networks only.

In our view, such a model, further embellished with points of detail discussed above, will address the vast majority of issues articulated in the RBA’s Issues Paper. We believe that this approach would result in less market disruption than a more interventionist approach, minimising adverse cardholder impacts, and significantly simplifying merchant pricing.

Thank you again for the opportunity to lodge this Submission. We look forward to discussing the above, and related, matters with you and to that end we ask that you contact the undersigned to arrange a suitable opportunity.

Yours sincerely

[Signed]

Stuart Woodward
General Manager
Representation