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Dear Dr Richards

I welcome the opportunity to respond to the Review of Card Payments Regulation Consultation Paper issued in December 2015. My comments are influenced by over 26 years as both an Executive in, and consultant to, the payment cards business. My direct involvement in the credit card issuing and acquiring businesses in the years immediately preceding the 2003 regulations have no doubt played a role in forming my views but these are now offered as a relatively independent observer of the industry.

As an introduction, it may be helpful to outline some of the principles that I consider to be of material importance in approaching the regulation of payments:

- A competitive market will generally produce a more innovative set of products and processes than delivery via a prescribed approach.
- Regulation of an industry is warranted primarily where there is a clear abuse of market power to the disadvantage of common user groups.
- Regulation should be applied equitably across all participants.
- The up-front and ongoing costs of regulation should be considered alongside the anticipated financial and other consequences of those regulations.
- Any regulatory impositions should be managed to minimise associated uncertainties and provide clarity and confidence of the future operating environment.

In the order that the issues are described in Chapter 3 Reform Options, my observations and questions are as follows:

Companion Cards

Companion cards have developed since 2003 as a tactical means of leveraging the comparatively unregulated three party card scheme products. The advantage delivered to the three party card schemes was recognised soon after the 2003 regulations with the concerns acknowledged in a March 2006 address, "The Evolution & Regulation of the Payments System" by Phillip Lowe. In an extract from that address, Dr Lowe described the industry concerns as, *"The third argument about relative prices is a much more practical one: that is, the Bank's regulations have given an advantage to American Express and Diners Club. In particular, it is argued that, as a result of the Bank's reforms, American Express is able to offer its cardholders more reward points than issuers of MasterCard and Visa cards, and that this has encouraged the growth of American Express at the expense of the other schemes.*

The success of companion cards in the following years was described as follows in the 2012 Payment Systems Board Annual report: "*Since late 2009, American Express cards have also become more widespread in the personal credit card market through the issuance of 'companion' cards. Under this model, cardholders are provided an American Express card as part of the package with their primary MasterCard or Visa credit card, with both cards accessing the same line of credit. However, cardholders are offered more reward points for spending on the American Express card, creating an incentive for the cardholder to use this card more heavily. Unlike the developments related to platinum cards, the issuance of companion cards is not related to interchange fees as there are no interchange fees in a three-party card scheme; there are, however, alternative commercial arrangements in place that give financial institutions an incentive to issue companion cards. While companion American Express cards were first introduced in 2004, they have now become a standard feature on rewards credit card accounts at the four major banks; in June 2012, only three credit card products with a rewards program across the four major banks did not feature an American Express companion card.*"

The omission of the three party schemes from the RBA's initial regulation of interchange led to a rapid response when ANZ issued a Diners Club card in September 2003. One could argue that ANZ, subsequently followed by other issuers was doing no more than leveraging a regulatory approach that was inequitable in its treatment of card issuers. The four party card scheme card issuers, in conjunction with Diners Club and American Express, reacted to a possible scenario in which they would face a large scale loss of business, particularly from cardholders in the top quartile of annual card spend.

The December 2015 RBA review paper states that, " ...the possibility that the growth of companion card arrangements may indicate that the current regulatory system is not fully competitively neutral."

We consider that the decision to recognise the imbalance resulting from the exclusion of at least some of the three party card scheme products is a belated but positive response to the market distortions resulting from the RBA's 2003 reforms.

In the 12 month to December 2003, the three party card schemes had a 14.7% share of the value of purchases. In the 12 months to November 2015 that share had increased to 18.8%. Expressed another way, the share of value of purchases attributed to the three party schemes increased by 27.9% with this representing an annual gain of $81,593 million on current total credit card purchases. Given that companion cards are positioned as a direct alternative to four party cards, we are unable to develop any logic that supports maintenance of the status quo. Many observers have questioned the competitive neutrality implications that enabled the three party card schemes to gain share and we support Option 3.

In his March 2006 address "The Evolution & Regulation of The Payments System" Dr Lowe said: "Given the different structures of the schemes, any argument that American Express should be regulated in the same way as MasterCard and Visa is tantamount to the argument that interchange fees should not be regulated. The only way in which uniform regulation could have been applied would have been for the Bank to do no more than require the removal of the no surcharge rule. While such an approach had the appeal of regulatory neutrality, we judged that, by itself, it would be unlikely to establish more appropriate price signals to cardholders within a reasonable time, particularly given the considerable customer resistance to being charged for credit cards. The approach that has been adopted is delivering significant net benefits – benefits that would have been foregone had the regulatory response been limited to just the removal of the no-surcharge rule.

We do not believe that the absence of interchange fees in the three party scheme model should continue to form a platform supporting the logic outlined above. We ask why the current logic leading to the regulation of companion cards is not extended to cards issued directly by three party scheme issuers? The self-acquiring model of three party card schemes does not require the presence of interchange but we do not believe that this structural issue should preclude the establishment of a competitively neutral environment. If the RBA is able to introduce a maximum interchange rate for four party scheme issuers, we suggest that a quasi interchange rate could be established to deliver a market place that would then offer no inherent advantages or disadvantages to specific issuers? This becomes particularly relevant for commercial cards where American Express has a disproportionately high market share, given that the RBA proposals will limit the interchange on such four party scheme cards to 80 basis points.

Interchange

The RBA has questioned whether commercial cards should be exempted from interchange regulation or retained within the scope of interchange standards. The Board's preliminary conclusion is to continue to include commercial cards within the assessable interchange framework.

Our view is that there is no compelling argument to exclude commercial cards from the regulated weighted interchange assessment. We are however concerned with their inclusion within a framework that restricts the maximum interchange rate to eighty basis points. Commercial cards are not an entirely homogenous group and are quite different to the personal credit card market. Commercial cards are by definition directed at the commercial market for use by them as procurement, travel and entertainment expense tools and general cash management products. As such, they typically require differing product characteristics including more detailed management information systems and control features; they typically have very different usage and balance metrics; and accordingly, very different financial models to personal credit and charge cards. Our view is that commercial cards do warrant a higher interchange rate and suggest a level around one hundred and twenty basis points would be more appropriate.

It is proposed that interchange from internationally issued cards used at Australian merchants be included in the assessment of the actual weighted interchange.

We question the inclusion of foreign issued cards as a means of preventing offshore issuers leveraging any differential in interchange rates. Our understanding is that the card scheme rules already include regulations to manage cross-border issuing and we therefore regard this regulation as adding unnecessary complexity.

The RBA estimates that foreign transactions comprise 3% of domestically acquired transactions and concludes that the impact on average interchange fees would therefore be relatively low. We note that in the New Zealand market, foreign cards accounted for 11.7% of total card spend in that country in the twelve months to November 2015. The RBA historically published information on acquired transactions and when available, it indicated that the share of foreign card use in Australia was just a little below that of New Zealand. We caution any moves in this area without verification of the scale of foreign transactions and of the subsequent financial impact.

It is proposed to move from a three yearly to a quarterly review of the weighted interchange rates.

The need for a more frequent review of ongoing interchange is accepted but we question whether the costs associated with the proposed frequency are commensurate with the expected benefit of incremental changes? Moving from one review to twelve each three years is a major change; we would have thought that an annual review would have been closer to an optimal process. A three monthly cycle will necessitate an ongoing assessment and potential reset process that could impose considerable administrative burdens upon the payment card industry.

The RBA paper indicates that the Bank plans to leave the weighted-average benchmark at 50 basis points with a maximum interchange fee to be capped at 80 basis points.

We support the retention of the current weighted interchange as we do not believe there is a compelling basis in the current market to reduce this further. We point out that the introduction of a quite low maximum cap on credit card interchange will adversely impact the ability of card issuers to deliver differentiated products to specific cardholder segments. In particular, the capacity of card issuers to offer value add features such as insurance cover, concierge services and reward programs will be restricted.

The RBA paper states, "However, the Bank is proposing to reduce the weighted -average benchmark for debit cards from 12 cents to 8 cents consistent with the fall in average transaction values since the debit benchmark was introduced." In addition, a cap of 15 cents or 20 basis points is being proposed.

The proposed reduction in the weighted-average benchmark is therefore 33.3%. This appears to be significantly greater than the fall in the average transaction value. The average debit purchase transaction value in the twelve months to April 2006 when the benchmark was introduced was $59.53. The average debit purchase transaction value in the twelve months to November 2015 was $53.65. This represents a decline of 9.9%. We note that the RBA paper states, *"In the case of debit cards, a reduction in the benchmark to 8 cents would unwind the effective increase in percentage terms in the benchmark that has resulted from the fall in average transaction size since 2006."*

The proposed 33.3% reduction in the weighted-average benchmark for debit appears to be a considerably greater reduction than indicated by the fall in the average transaction value. There may be arguments to support a reduced debit interchange rate such as a lower fee to accelerate penetration of low value transactions but this should be the stated logic rather than indicating it is based on the historical movement in average transaction values. Using the logic outlined by the RBA, the weighted-average debit interchange should be reduced from $0.12 to $0.108.

The RBA paper states that "Contrary to predictions by the international schemes at the time of the initial regulations, the Australian cards market has continued to grow very strongly since then and innovation has thrived."

The average annual growth in value of credit purchases over the five year period (1999-2003) preceding regulation was 27.3%. (We note there was a series break in 2002.) The average annual growth in the five years from 2003 was 9.7% and in the last five years to 2015, an average of 5.2%.

The average annual growth in value of debit purchases over the five year period up to 2002 was 19.8%. The average annual growth in the five years from 2003 was 10.6% and then in the last five years to 2015, an average of 11.0%.

We do not believe that it is reasonable to describe the card market as having experienced very strong growth since the regulatory changes of 2003. Credit card growth rates in spend have markedly declined whilst balances have struggled to deliver any growth of late with the current average annual balance being just 2.1% above the level of three years ago. Whilst debit card growth remains strong, it is below the levels preceding regulation.

The RBA is proposing to regulate payments from schemes to issuers (less the fees paid by issuers to the schemes) with the objective of blocking any potential attempt to use such payments as a quasi interchange income stream.

We see no logical basis upon which to disagree with this proposal if it is established that the intent of such payments is indeed the circumvention of interchange benchmarks. However, any such regulation should be framed so that legitimate payments to issuers to support activities such as compliance, fraud prevention, education and market development should be considered outside scope.

Surcharging

The removal of the no-surcharge rule in 2003 without any reference to the costs of card acceptance or the costs of alternative payment options enabled merchants with market power to unduly leverage the change of rules. A narrower and clearer definition of what constitutes card acceptance costs is required, as is an effective and workable monitoring and enforcement mechanism.

There will be a requirement on Acquirers to provide sufficient information for merchants to assess the percentage acceptance costs by payment product category.

We agree that it would now be inappropriate to prohibit surcharging but safeguards continue to be required to prevent opportunistic exploitation of cardholders. The proposed changes are an overdue step in the right direction; we believe a narrow interpretation of costs to the merchant service fee is appropriate but do not believe that terminal costs (albeit relatively small) should be factored in. For example, were the costs of cash registers included in the RBA's 2007 payment cost study when determining the cost of cash payments to merchants? In addition, the increasing use of online & mobile based purchases will reduce the proportion of transactions in which a card terminal is required.

We support transparency in segmented merchant pricing as a positive step but note that this is likely to involve up-front and ongoing costs to acquirers.

Given that all payment options entail associated costs to merchants, we would ideally like to see surcharges limited to the costs of card acceptance less the average costs of other available payment products such as cash, cheques and accounts. This is particularly relevant in situations in which a merchant chooses to apply a surcharge for payment by card but does not apply a surcharge for any other payment product. We believe this occurs because a) the cost of card acceptance is readily assessable from the acquiring bank's statement, b) the RBA's decision to prohibit the no-surcharge rule was seen as an endorsement to surcharge by some merchants, and c) many merchants are unaware of the costs of accepting payment by means other than a card. We agree that using a differential costs entails additional complexity but in doing so, the RBA would be delivering a message to merchants that all payment options incur a cost. It should be practicable for the RBA to assess an overall cost of alternative payments that could then be debited from the merchant service fee for card acceptance.

The RBA has sought feedback on the issue of chargebacks and their exclusion from the narrower definition of card acceptance costs to merchants. Chargebacks are typically sought when a cardholder disputes a transaction or a merchant has made an error such as processing an expired card. According to ANZ's website, the top 10 chargeback reasons are:

1. Unauthorised Mail/Telephone Transaction
2. Requested Item Not Received
3. Duplicate Processing
4. Invalid Account Number
5. Transaction Exceeds Floor Limit
6. Sales Voucher Not Imprinted with Card
7. Invalid Transaction
8. Merchandise Not Received by Purchaser
9. Credit Voucher Not Processed
10. Posting Direct Debits

The fundamental objective of a chargeback therefore appears to be to provide a purchaser using a payment card with protection against occurrences such as fraud, error or insolvency.

We have difficulty in developing a logic that would support a merchant (or agent) including chargeback costs in the allowable card acceptance costs for the purposes of surcharging. The overwhelming role of chargebacks is to provide cardholders with a financial recovery tool in the event that the debit to their card account has not been matched by a corresponding receipt of a good or service. Part of the margin determined by an acquirer when calculating a margin above interchange cost for a merchant service fee is an assessment of risk. Our view is that this is where any cost for high risk industries should reside. When dealing with industries where goods and services may not be delivered until some future date, an acquirer should establish what risks are entailed and seek to counter these through an additional margin, an escrow account or other means. We do not believe that a surcharge is the appropriate means of addressing this issue. It would in effect enable a merchant to pass on the costs of their own shortcomings to cardholders.

I trust that these views are of assistance in your further deliberations on the review of payment card regulations.

Yours sincerely

Michael Ebstein
Director