

3 February 2016

Dr Tony Richards
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SYDNEY NSW 2001

Review of Card Payments Regulation - Consultation Paper, December 2015

Dear Dr Richards

We welcome the opportunity to participate in the **Review of Card Payments Regulation (the Review)** and in particular the reform options outlined in the Consultation Paper issued in December 2015 (the Paper).

We support PSB's role in enhancing competition and efficiency in the payments system and agree with many of the preliminary views outlined in the Paper. This response to the Paper will focus on the areas where we have concerns.

Executive Summary

We remain concerned that the direction of regulation appears to be increasingly complex and has increasing risk of unintended consequences. In particular, the potential for an adverse impact on competition at issuer level in the rewards and commercial cards markets needs to be considered from a public interest perspective. The risk of reducing competition in these markets, and possibly moving them towards monopoly structures, should be carefully considered against any gains in efficiency. Our view is that the Paper does not adequately consider the impact on public interest, as defined in the Payments System Regulation Act (PSRA), in its consideration of the standards relating to companion cards or commercial cards. We suggest that these aspects are explicitly considered during the consultation phase and in the conclusions of the Review.

Other aspects, while increasingly complex, are less contentious from a public interest perspective. In particular, the public interest is served by making prices more transparent to the relevant participants (see the moves to enhance surcharging) in terms of efficiency and competition.

We note that some of the changes are correctly noted as significant. If significant changes are made, it will be reasonable for long timelines to be allowed.

Lastly, while the Paper makes its case against deregulating interchange fee regulation for now, we think that an aspiration to remove interchange regulation would be useful to keep in consideration as technology continues to evolve.

The following section discusses the issues we see arising from the preliminary views on the options considered in chapter 3 of the Paper.

We look forward to a broad consultation in the next phase of the Review.

Sincerely

Chris Campbell
Head of Payments Policy and Strategy

Westpac Group response to the RBA
Review of Card Payments Regulation – Consultation Paper

Reform Options

This section considers the Reform Options as set out in chapter 3 of the Paper.

Companion Cards – Option 3 – Regulate companion cards

Key issues for further consideration;

- the effectiveness of surcharging and acceptance decisions re companion cards
- Companion cards are, by product definition, not “must-take” cards
- Competition in the rewards cards market is likely to be materially decreased at the Issuer level
- No efficiency benefit – public interest test

Option 3 (the proposal to include companion cards in Standard 1) “would represent a significant change from the status quo for the current companion card issuance model”¹. Accordingly, RBA needs to consider the impacts very carefully. Our view is that the Consideration justifying RBA’s preliminary view (pp13-14 in the Paper) appears to miss, or at least not fully consider, two important public interest aspects of companion cards. Those aspects are;

- (i) The effectiveness of surcharging and acceptance on American Express Cards² is such that there is no justification in terms of benefits to economic efficiency for such a significant intervention, and
 - (ii) Option 3 is likely to significantly reduce competition in the rewards card issuance market.
- (i) Surcharging and acceptance:
- American Express cards are clearly visible to all merchants and pricing to merchants for American Express acceptance does not vary by type of American Express Card – hence a merchant’s ability to know the marginal cost of acceptance is complete.
 - Similarly, the decision to accept or not accept American Express is a simple decision, where a merchant can weigh up the pros and cons.
 - Companion cards are, by product definition, not “must-take”. In all cases the cardholder also has a Visa or Mastercard credit card.
 - The Paper notes that “...*American Express has a strong presence in specific sectors, such as the corporate card market. It is therefore likely to be considered a must-take card in industries where there is significant corporate card expenditure, such as travel and entertainment. This is also likely to be the case for some retailers that cater to higher-income individuals or international visitors*”. This example is helpful to work through to understand the economic efficiency of current arrangements. In the travel and entertainment example given, merchants frequently surcharge. When faced with a surcharge, holders of corporate American Express proprietary cards are likely to accept the surcharge³. On the other hand the companion card holder has a choice to pay the surcharge or use their other credit or debit card. In both cases, each party has choices and transparency of prices.
 - The surcharging environment is to be enhanced under the surcharging proposal set out in the Paper.
 - The effectiveness of merchants’ legal and practical ability to surcharge, steer and make acceptance decisions negates any impact on equity⁴ in the case of companion cards.

¹ RBA, December 2015, p15.

² RBA, Issues Paper, Mar 2015, p33

³ With corporate cards, usage of the card is generally required as company policy.

⁴ The Paper (p14) referred to an equity benefit in regulating companion cards, which is not present unless merchants have no power to refuse, steer away from or surcharge companion cards (or if companion cards are regarded as “must-take”).

The Paper notes increased issuance of companion card products (p13) yet recent RBA data show a decreasing American Express market share⁵. We also note the decreasing Merchant Service Fee of American Express⁶. These data present strong evidence of the effectiveness of merchants' ability to trade-off cost and value in American Express acceptance conditions.

Overall, given that the price signals are clear and there is no "must-take" argument, there is **no efficiency justification** for such a significant intervention in the commercial arrangements underpinning companion cards.

(ii) Competitive Neutrality:

- The Paper notes that Visa and Mastercard's market shares have been increasing (see above).
- RBA's data (chart 4 in the Issues Paper) shows that this has been at the expense of American Express.
- The Paper (p14) notes that some banks may cease offering companion cards if option 3 were implemented. We agree that this would be a very likely outcome.
- However, while the supply of such products may contract to one issuer, the proposed changes are unlikely to dull the demand for rewards products (which includes companion cards).
- While we understand the desire of 4-party schemes to seek regulatory advantage vis-à-vis their competitors, Option 3 is acknowledged in the Paper to be at expense of Australian ADIs and competition at the issuer level.

Overall, our view is that there is **no net benefit to competitiveness** arising from Option 3. That is, any benefit to competition (at scheme level) from Option 3 is more than offset by reducing competitive neutrality (at issuer level).

In many ways, companion cards are well suited to the Australian market. In our market where;

- Surcharging is permitted and is noted as effective in the Issues Paper,
- steering is permitted,
- cardholders have multiple cards (which by definition includes companion card holders), and
- merchant pricing is straightforward (as with American Express),

companion cards allow greater degrees of choice and competition for all participants with no cost to efficiency.

In summary, regarding companion cards, it seems that;

- *if there is a competitive neutrality issue, it isn't material*: The Paper (p25) states that Visa and Mastercard are expanding market share,
- *regulatory arrangements are working*: The Issues Paper presents the view that surcharging and acceptance decisions are effective, and the Paper presents examples which support the effectiveness of existing regulatory arrangements,
- *Option 3 is a material change*: The Paper states that the Option 3 will have a "significant change" on existing business models,
- *Option 3 will decrease competitiveness*: The Paper acknowledges that some ADIs may stop issuing companion cards, possibly moving towards a monopoly in the rewards cards market,
- *We suggest that the impact on public interest, in terms of competition and efficiency, is explicitly considered in the next phase of the Review.*

Alternative Consideration: Companion cards are, by product design, rewards cards. It is likely that the four-party schemes will set their rewards cards rates at the maximum individual rate. If, despite the lack of any identified efficiency, competitive or equity benefits, RBA decides to intervene, setting the

⁵ RBA, Issues Paper, Mar 2015, p16

⁶ RBA, Issues Paper, Mar 2015, p22

companion card rate equal to the maximum individual rate (rather than the weighted average cap) would decrease the adverse impact on competition to some extent.

Interchange Fees / Coverage / Commercial Cards – Option 2, keep commercial cards within the weighted average

Key issues for further consideration;
- Note impacts on competition

If commercial cards are kept within the weighted average, the level of the maximum individual rate must be carefully considered. In particular, the impact on competition in the commercial card market is likely to be material.

Discussion on the cap on individual interchange rates is below.

Interchange Fees / Coverage / Foreign-issued cards acquired in Australia – Option 2, regulate foreign-issued cards

Key issues for further consideration;
- A material change
- Another option should be considered

This matter was not included in the Issues Paper and would represent a material departure from existing practice. On this basis, we think the PSB needs to develop a better understanding of the impact of including foreign-issued cards under its interchange standard.

The driver for this intervention is described as “... *an increased possibility of circumvention of the interchange standards through the use of such cards ...*” using virtual cards. Our understanding is that the schemes can address this via their rules and enforce it via their systems. This would appear to be a more efficient option to be considered for what is now only a theoretical issue.

We also note that higher scheme fees assessed on international transactions would offset much of any financial incentive to issue such cards.

Interchange Fees / Coverage / Benchmark compliance – Option 2, Quarterly Compliance

Key issues for further consideration;
- Quarterly cycles are likely to infer unnecessary extra costs
- Annual changes should be considered as an option

Our advice is that quarterly changes to interchange rates are expected to be challenging from an operational perspective. Given this, the key question is how much will be gained over less frequent resets. We note that quarterly resets would increase the number of resets by 1200%, and presumably costs by a similar amount. Whereas annual resets would only triple of current reset costs. On this basis, it seems to be a reasonable approach that annual resets should be the preferred option. If the desired policy outcome is not achieved then more frequent resets could be implemented.

Interchange benchmarks and ceilings, Option 3b, individual rate caps and debit weighted average reduction

Key issues for further consideration;

- Impact on Commercial card competition at an issuer level
- Impact of scheme debit interchange fee reduction

Individual Rate Caps

The 80bps cap on individual credit card rates is likely to have an adverse impact on ADIs' commercial card portfolios to the competitive benefit of American Express' commercial cards. We have seen analysis that shows American Express commercial cards already have comfortably the largest market share in the commercial cards market. The proposed individual rate cap would further skew this dominance towards American Express in this market.

Overall while competitive neutrality between schemes is important, competitive neutrality between issuers in Australia (here the Australian ADIs and American Express) is at least equally important. Our understanding of the Payments systems (Regulation) Act, 1998 is that the impact on competition must be considered when determining standards. On this basis, the extent to which the draft standard will distort the competitive tension in this market must be understood and explicitly considered before deciding on the standard.

A lighter touch solution, that would keep the 50bps weighted average cap, would be to set a separate cap for commercial cards within the weighted average. We have recommended a level that was previously acceptable to RBA, such where they were set immediately following the 2003 reforms (around 110bps) until at least the 2007/8 Review of Cards Reforms. This would both allow effective competition between ADI issued commercial cards, and those issued by 3-party schemes which currently dominate this market.

Debit Card Weighted Average Fee Cap Reduction

We agree that adding regulatory changes during a period when mandatory industry initiatives are in play is challenging for existing participants⁷. Decreasing the debit card weighted average at such a time by a largely arbitrary⁸ and large percentage (33%) is very much an unwanted disruption. It is unclear what impact that this will have on NPP and eHub, however it is unlikely to be favourable. Further, we note the final justification for the preferred option in regard to debit card interchange is that "It would also bring interchange fees in the international scheme debit systems and the eftpos system closer together". We query whether it is appropriate for a regulator to favour one company's business strategy over another.

⁷ Issues Paper, p26

⁸ While average transaction sizes have reduced by a commensurate amount, it can be equally argued that the cost to drive that reduction in transaction sizes (ie the roll-out and continued support of contactless cards) has been considerable.

Surcharging, Option 3

Key issues for further consideration;

- Implementation Date
- Further detail required

This broad package seems to be an acceptable one, balancing the relatively low level of excessive surcharging and the difficulty in enforcing current standards. The key issue will be making the changes to merchant statementing (including customer communications, staff training, and technical changes).

Further, there are a number of details that will need to be worked through. These include; clarifying which costs are included in determining the average cost of acceptance (ie regular fees and incident-type fees), what process should be followed where there is insufficient data (eg, a new customer with insufficient history), and a view on how quickly should a merchant should adjust their surcharge rate given changing regular fee rates. Changing surcharge rates each month will likely be operationally challenging and confusing for merchants' customers, so consideration should be given to a buffer to smooth out the ups/downs each month.

Timelines

Finally, we offer a general comment regarding timelines.

Depending which options are finally settled upon, the implementation timelines will need to be carefully considered, given competing efforts in the payments industry. Where there is a material change to business models, it would be reasonable to consult broadly on timelines, once decisions are finalised. Our view is that 18 months from the date the new rules are published would be required for the more material changes.
