Australian Retailers Association

Working for Retail

Australian Retailers Association

Submission to the Reserve Bank of Australia & Australian Competition and Consumers Commission

Debit and Credit Card Schemes in Australia A Study of Interchange Fees and Access

January 2001

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(i) The Australian Retailers Association

The Australian Retailers Association ("ARA") is the nationwide voice of the Australian retail industry. In December 1998 the ARA was registered as the organization under the Federal Workplace Relations Act 1996 with coverage of the retail industry across Australia. The ARA has state Divisions in New South Wales, Victoria, South Australia and Tasmania, and affiliations with the Retailers Association of Queensland, the Retail Traders Association of Western Australia, the Northern Territory Retailers Council and the ACT Chamber of Commerce.

The Association's mission is:

"To be the pre-eminent, cohesive, nationwide organisation which is recognised as representing the diverse interests of all retailers and is the most effective provider of quality information and services to members which fosters an environment conducive to their business success."

The Rules of the ARA include the first objective (Rule 3.0 (a)):-

"To protect, promote and advance the interests of retailers on all issues affecting or likely to affect the retail industry."

The ARA's membership comprises approximately 11,000 retail businesses which transact an estimated 75% of the nation's retail sales and employ around three quarters of the retail workforce.
ARA members operate around 40,000 retail outlets across the nation.
Approximately 10,000 or 95% of the Association's members are small businesses (i.e. employing less than 20 staff) operating in only one State.

It is on this basis that we write as a voice of retailers, both large and small, on the issue of the interchange fees charged between the banks and the resultant Merchant Service Fees ("MSFs") imposed on retailers. Whilst these views represent those of the ARA and various retailers, the close link between retailers and customers is important.

(ii) Executive Summary

The ARA:

- welcomes the opportunity to respond to the study conducted by the Reserve Bank of Australia ("RBA") and the Australia Competition and Consumer Commission ("ACCC"). On behalf of its members the ARA wishes to voice its concerns about the current interchange regime and its impact on retailers and consumers.
- believes that there is insufficient recognition of the role and contribution retailers make in the electronic payments arena in the RBA / ACCC study. The study focuses on the recovery of bank costs, acknowledging that banks incur costs in the provision of electronic payment to consumers, and that these costs should be recovered from participants in the system (ie retailers and consumers). What the study does not seem to acknowledge is that retailers are significant contributors to the payments system, and, among other things, facilitate much of the payment transaction between customers and financial institutions.
- concurs with the RBA / ACCC study in relation to the "hidden" costs associated with an interchange regime. Merchant Service Fees ("MSFs"), based on interchange fees, add to the price of goods and services, payable by <u>all</u> consumers at the point of sale. Many consumers are unaware of these additional costs.

- notes that there are inconsistencies in credit card arrangements that require redress.
- notes that many smaller retailers appear not to have the ability to negotiate a fair and lower merchant service fee with banks. Most rates appear to be set by banks without an option to negotiate.
- is concerned that the base credit card interchange fee which was set prior to the advent of the networked world has not been reviewed for banks or merchants large or small since it's inception. It is apparent that there is no efficient pricing mechanism in place to allow the benefits of technological advancement to be passed onto all participants of the credit card system. This is a cause of concern.

A possible solution would be the adoption of a "user pays" system similar to the debit card network is a possible solution to the current credit card scheme. Such a "user pays" network structure ensures those who utilise the network pay the owner of the network an access fee. Adoption of this approach would be prefaced on a network structure that has efficient pricing mechanisms and/or a review process of the base fee in place.

As discussed in the study, there would appear to be a lack of access to the credit card issuing and card acquiring schemes, which have rules that restrict membership. The result is that those with access to the schemes determine the pricing, operations and the development agenda are also the main beneficiaries from the associations. To promote competition and efficiency, membership of the card associations needs to be reviewed.

In contrast to credit cards, the ARA believes that the current fee structure associated with the EFTPOS network promotes an efficient and secure network. This is primarily due to the fact that the fee structure is based on a "user pays" system, where the supplier or owner of the network is paid a fee, and the EFTPOS fee structure can recognise the role that retailers play in the transaction process.

This submission will expand on the role of retailers in the transaction process and offer an alternative arrangement to the current interchange regime that acknowledges the input of all parties in a payment transaction.

1. Introduction

The recent trend in payment services has been towards electronic delivery methods of payment. Whether it be through the use of ATMs, or EFTPOS facilities in retail outlets including supermarkets, the method of transacting has undergone significant change. Transactions involving the use of debit cards and credit cards have increased in number rapidly, whilst the traditional forms of payment such as cash and cheques have diminished in use relative to the other forms of payment. In an age of electronic delivery and settlement, it is expected that this trend will continue.

The retail industry is a progressive and competitive industry sector. The Productivity Commission Staff Research Paper "Productivity in Australia's Wholesale and Retail Trade", October 2000, found that the wholesale and retail sector "appears to be, on the basis of industry profit margins, highly competitive" and that the percentage of operating income available as operating profit was 3.4% in the retail industry. The retail industry has generally embraced technological change such as scanning and computerisation, and changed management systems all of which has lead to enhanced retail productivity. The Productivity Commission Paper noted that the retail industry has pursued productivity improvements, "with competition as the catalyst and technology the enabler".

The Annual Retail Turnover is approximately $148,975 million (ABS – Retail Trade 8501.0).

A survey of members conducted by the ARA has shown that card transactions (both debit cards and credit cards) now account for over 50% of total sales (51.3%). Cash and cheques account for fewer than 50% of sales (48.7%).

Although the use of credit cards as a means of payment has grown rapidly recently, the pricing regime between banks themselves, and banks and retailers, has remained largely static since the inception of the credit card, despite the credit card product itself undergoing significant change. The credit card is no longer mainly a source of short-term credit. Statistics showing the extent of cardholders using revolving credit reveal that many credit card balances are being repaid when due, so that short-term credit provision is not the sole function of credit cards. This emphasises the use of the credit card as a payment card to take advantage of offers such as loyalty points.

The ARA is calling for immediate action to resolve the current inequities and inefficiencies within the credit card system. This submission will highlight the current issues that are preventing the payments system from operating more efficiently, and will offer alternative solutions.

2. Current Issues – Credit Cards

2.1 The Role of Retailers

The RBA / ACCC study focuses primarily on the role of banks, and the costs that they incur in the provision of electronic banking services. The study, however, does not consider the role that retailers play in the provision of electronic payments, and the costs that retailers subsequently incur. The sole consideration when analysing MSFs and interchange should not be the recovery of bank costs, but should include an analysis of the contribution of all participants.

The role that retailers play in the payments system varies greatly amongst retailers, however the provision of card processing facilities is no longer an option but a necessity for most retailers.

All retailers conduct the transaction with the customer, however many large retailers own and operate their equipment, and in fact perform many functions that would otherwise be performed by the banks. Generally terminal hardware will be rented by the smaller retailer from a financial institution, for which a rental payment will be required. The ARA survey found that this fee averaged $300 annually, but could be as high as $960 (ARA National Survey (October 2000) - Appendix A).

The delivery of electronic payments services, and in particular the retailer's role in the delivery of such services, has developed to such an extent that the banking sector has been able to substantially reduce their branch network, thereby reducing a major fixed cost. However this reduction in costs has not translated into lower MSFs for retailers to reflect the retailer's contribution, nor, it would appear, in lower bank charges for consumers.

The results of the ARA survey indicates that retailers, on average, transact more than 50% of business via credit and debit cards, with some 29.4% of retail transactions by way of bank issued credit cards.

The RBA's own statistics highlight the changing nature of the payments system and points of access for card transactions. In 1994 there were 8,583 Bank Branches with 12.5 million accounts. In 2000 there were 6,716 Bank Branches with 17 9 million accounts. With 1867 fewer branches, banks are now able to service an extra 5.4 million accounts and they are able to do this through EFTPOS. In 1994 there were 30,582 EFTPOS terminals transacting 17 million transactions per month and now there are some 266,000 EFTPOS terminals transacting 53 million transactions per month. Banks, through EFTPOS have effectively outsourced 36 million transactions every month to merchants, many of whom are retailers.

It must be acknowledged that the network of retailers has replaced many of the functions previously performed by the branch network. Retailers are part of the process of funds passing from customers to the issuing bank and are involved in processing, authorising and collecting payments on behalf of the bank, and also, in the case of debit cards, for dispensing cash to customers. For these important functions of the payments system, retailers do not receive recognition, and are instead required to pay MSFs. The interchange regime does not compensate the retailer for the costs they may incur in facilitating the payments process and for the banking functions that they perform.

In view of the expanding role of retailers in electronic payments, the existing system of interchange should be abolished and replaced with a “user-pays” system, where the level and flow of fees is dependant upon the contribution of the party to the transaction process. This system would reflect the contribution of all parties to the transaction.

2.2 Impact on Prices

The most significant effect of MSFs is that they form part of the cost of doing business of all retailers and as such is an element in determining selling prices of merchandise and also lowering returns to owners. As a result, consumers who purchase goods and services using payment methods other than credit cards, are actually subsidising credit card users.
In this way MSFs are said to be “hidden” fees, since many consumers are unaware that retail prices are inflated to enable retailers to recover these additional costs incurred in the process of offering consumers a choice of payment methods.

In fact those consumers who purchase goods using credit cards can in fact incur a negative cost. Where loyalty points can be redeemed for rewards and prompt settlement means no transaction fees on a credit card purchase, this allows the consumer to be rewarded for using the credit card. To the extent that the cost of loyalty programs is being recouped through a MSF leads to distortions in the payments process. Loyalty programs funded by merchant service fees are not a cost that should be funded by the retailer, as the banks derive the benefit of such schemes.
Abolition of the interchange regime and the introduction of a “user-pays” fee regime would ensure that only consumers using their credit card pay for the service. The cost of loyalty programs would be levied only on credit card users. Openness and transparency means that non-users of credit cards would no longer be required to subsidise the cost of credit cards users.

The RBA / ACCC study suggested the abolition of the “no-surcharging” rule, as a means of increasing transparency, and increasing the awareness of the consumer. Surcharging would also in theory ensure that only those using their credit card to purchase goods would pay for the service.

Surcharging, however, is not a realistic option. Competitive forces amongst retailers would most likely not realistically result in achieving the required transparency unless the surcharge was mandated. However retailers should also not be imposed with the burden of recovering bank-imposed fees from their customers as it only condones the current inequitable MSF procedure.

Retailers recognise that there is a cost to handling cash. Card transactions reduce the risks of handling cash for staff and retail businesses. The ARA survey did not identify the cost to retailers of handling cash, however indicative figures suggest that the security collection costs for retailers is of the order 0.01% to 0.06% of cash handled. This is significantly less than even the lowest merchant service fee reported in the ARA National Survey.

The costs of handling cash is an area for a possible future research project.

2.3 Anomalies in the Credit Card System

Card not present transactions

Within the interchange regime are some examples of anomalies. One such anomaly exists in MOTO (card not present) transactions. In MOTO transactions the retailer is unable to verify the signature of the cardholder, and therefore is exposed to greater risk of fraud. However despite the increased risk of fraud that is borne by the retailer, the retailer is required to pay a MSF that is higher than if the transaction was one where the card was present.

Visa Debit Cards

Another example of an anomaly in the system is the Visa branded debit card. A debit card is issued to access transactional accounts, but is labelled with a Visa badge and the banks encourage their customers press the "CR" button on the EFTPOS system. That way (it is advertised by some banks) the cardholder does not pay transactional fees, and the bank earns MSFs on the transaction, payable by the retailer.

2.4 "Double Dipping"

As discussed in the study, financial institutions charge consumers fees on accounts, and maintain wide interest rate margins on lending products. These fees are commonly justified as being levied to recover the bank's costs associated with maintaining the accounts, and providing credit services. However it would seem from the RBA/ACCC study that these same costs are also recovered from retailers through the imposition of the MSFs. If these same costs are recovered from two sources then the banks would be "double dipping".

2.5 Inability of Retailers to Negotiate Lower MSFs

Of particular concern to ARA members is the way in which the level of MSFs are dictated to retailers. This often results in inequitable dealings between retailers and the banks supplying the card facilities.

The results of the ARA survey indicate that smaller retailers with lower turnover have a lesser ability to negotiate lower MSFs. However the results of the survey did indicate that a few retailers with high turnover still paid high MSFs. This may be the result of a lack of knowledge on the part of the retailer, or a belief by the retailer that the fee is non-negotiable.

The issue of the interchange fee setting a floor under the MSF is the subject of a separate action between the ACCC and the National Australia Bank. The results of the ARA survey identified that all MSFs payable by ARA members are above the 0.8% interchange rate, indicating that the interchange fees payable between the banks does set a floor under the MSF.

The ARA is concerned that the base credit card interchange fee which was set prior to the advent of the networked world has not been reviewed for banks or merchants large or small since it's inception. It seems that there is no efficient pricing mechanism in place to allow the benefits of technological advancement to be passed onto all participants of the credit card system. This is a cause of concern.

2.6 Limited Access

The "high barriers to entry" of the card associations protect the current members. Those parties unable to gain equitable access to the card associations have no means of influencing the activities of the card associations.

Rules of the credit card associations restrict admittance to the functions of credit card issuer and acquirer. Initially, the stability of the payments system was paramount to the determinants of who could issue and acquire cards. Although the integrity of the payments system is still of equal importance today, the market has grown and developed to such an extent, that the rules precluding others from admittance to the card associations can no longer be justified.

The rules require review to ensure that the payments system continues to grow and develop with innovations. There is no valid reason why those retailers who have the financial capacity and expertise to perform the functions of card issuers and card acquirers should not have access to the card systems. This raises the question as to the suitability of the existing rules of membership of the card associations.

2.7 Possible Solution

Adoption of a "user pays" system similar to the debit card network is a possible solution to the current credit card scheme. Such a "user pays" network structure ensures those who utilise the network pay the owner of the network an access fee.

Adoption of this approach would be contingent on a network structure that has efficient pricing mechanisms and/or a review process of the base fee in place.

3. Current Issues – Debit Cards

RBA statistics show a greater than 1,600% growth in the number of EFTPOS facilities since 1990 compared with 66% growth in retail trade generally. In 1990 the number of EFTPOS units was 15,500. In 1999 that figure had grown to 265,000. The growth in the use of the debit card can in part be attributed to the willingness of retailers to offer consumers greater payment choices, and the willingness of retailers to expand their range of services offered to their customers. This range of service now extends to the provision of consumer banking services that would otherwise be provided through the bank branch network, enabling banks to move their operational focus to the electronic delivery of services.

It has generally been acknowledged that Australia has a world class EFTPOS network, and this has occurred primarily because of the efficient fee structure, which encourages investment in, and development of the network.

3.1 "User Pays"

The current fee structure of the debit card network is in fact partly representative of a "user pays" network. Those utilising the network pay the owner of the network an access fee. This ensures the continued maintenance and development of the network. As with credit cards, some larger retailers have invested substantially in the development of the EFTPOS network, and generally perform many of the functions that would otherwise be performed by the banks. The value of this to the payments process is reflected by the current structure allowing compensation to flow to the network providers, be they banks, retailers or other service providers. This model also encourages the ongoing integrity of the EFTPOS network is maintained.

Under a "user pays" regime, it would seem reasonable that those retailers and businesses who do not invest in EFTPOS infrastructure and its development contribute to the costs incurred by the parties whose networks they access.

3.2 Representative Fees

The fees charged for debit card transactions are based on a flat fee. A flat fee structure is more representative of the costs involved in processing transactions. Credit card fees (MSFs) on the other hand are percentage based, which has little relevance to the processing costs of the transactions.

3.3 Security

The EFTPOS network operates in an environment that requires the encryption and de-encryption and subsequent acceptance of customer PINs to authorise a transaction, increasing the security of the card and the transaction. As a result the level of fraud on debit cards is negligible, unlike credit cards where security remains a main concern of cardholders, especially for Internet and other such "card-not-present" transactions.

4. Conclusion

The ARA fully supports the need to reform the payments system as identified by the RBA / ACCC, and feel that appropriate action should be taken to create an equitable payments system for all parties involved. The ARA considers that greater attention should be paid to the role retailers play in the provision of payment services within the community, and also to the costs that retailers incur in the provision of those services. The ARA does not suggest that electronic payment services should be provided free of charge, but is instead suggesting a "user pays" system where participants incur fees / and are paid fees according to their contribution to the payments system.

Appendix A:

RESULTS

ARA National Survey of Members
October 2000

	Mean MSF (%)	Median MSF (%)	Min. (%)	Max. (%)
Bank Issued Credit Cards	1.89	1.75	0.9	4.0

	Mean ($ pa)	Median ($ pa)	Min. ($ pa)	Max. ($ pa)
Terminal Rental	311.69	300.00	0.00	960.00

Transaction Type	% of Retail Sales
Total Cards (debit & credit)	51.3
Bank Issued Credit Cards	29.4
Cash	39.7
Cheques	9.00

Annual Turnover ($m)*	MSF Range (%)		
	Average	Minimum	Maximum
0.10	2.53	1.36	4.00
0.25	2.30	1.25	4.00
0.50	2.10	0.90	4.00
1.00	1.75	1.00	4.00
2.50	1.68	1.00	3.00
5.00	1.53	1.19	3.25
10.00	1.51	0.90	3.00
25.00	1.47	1.00	3.00
50.00	1.38	1.25	1.50
100.00	1.35	1.25	3.00
500.00	1.30	1.00	3.00

* Survey results indicated that there was a strong relationship between Annual Turnover and the rate of the %MSF. i.e. the larger the turnover the less the MSF % rate.