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Evaluation of options for EFTPOS interchange

Submission to the EFTPOS Working Group

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Executive Summary

This submission is written in response to the Discussion Paper, *Options for EFTPOS Interchange Reform*, published by the Reserve Bank of Australia (RBA) on 10 July 2002.

ANZ broadly supports the objectives for reform set out in the paper, with some modifications.

ANZ does not support the model of bilaterally negotiated interchange fees proposed in the Options paper because it is inefficient and impractical.

ANZ can see some merit in the model of multilateral interchange fees but does not support that model because of the likely immateriality of the fees that would result from a multilateral methodology. The administrative and other costs of implementing such a model would most likely outweigh its benefits.

On balance, ANZ supports interchange fees for EFTPOS transactions being set to zero. This recommendation is based on the likely practical benefits of avoiding the costs of administering a system of regulated interchange fees. There is no inconsistency between having interchange fees set at zero for EFTPOS transactions co-existing with positive interchange fees for credit card transactions. The large imbalance in the costs of credit card issuers and acquirers means that credit card interchange fees are required to support the existence of the credit card network. Without such interchange fees, credit card networks could not exist.

Any decision to set EFTPOS interchange fees to zero should however be reviewed by the industry, in consultation with the RBA, in two to three years in the light of industry developments.

EFTPOS access and switching fees are conceptually distinct from interchange fees and there is no need to regulate them, as the markets for gateway services and switching services are competitive.

Chapter One

Background

1.1 Origins of this submission

In October 2000, the Reserve Bank of Australia (RBA) and the Australian Competition and Consumer Commission (ACCC) released a Joint Study of debit and credit card schemes in Australia and their initial findings.[1] The Joint Study found, *inter alia*, that "application of formal interchange methodologies does not provide a convincing case for a debit card interchange fee, in either direction".[2]

Since the release of the Joint Study, the RBA has convened meetings of industry participants, which were held on 19 February 2002, 8 April 2002, 9 May 2002 and 10 July 2002. These meetings discussed principles and options for reform of EFTPOS interchange fees and resulted in the publication of a Discussion Paper on the RBA's web site.[3]

1.2 Purpose of this submission

The purpose of this submission is to discuss the options for reforming the EFTPOS interchange system, as discussed in the Discussion Paper, assessed against the principles for reform identified in that document.

In what follows, Chapter 2 discusses the objectives of reform and assesses reform options against those objectives. Chapter 2 also discusses other related issues, especially access to the EFTPOS system.

[1] RBA and ACCC, *Debit and Credit Card Schemes in Australia: Study of Interchange Fees and Access*, October 2000 ('Joint Study').

[2] Joint Study pg71

[3] EFTPOS Industry Working Group, *Options for EFTPOS Interchange Fee Reform*, July 2002 ('Discussion Paper')

Chapter Two

Objectives of reform and proposed models

2.1 Objectives of reform

The Discussion Paper identifies the following general objectives for possible reform of EFTPOS interchange fee arrangements:

- Flexibility – Interchange fee levels should be responsive to market conditions and the costs of providing services
- Customer acceptance – Any industry-wide changes to interchange fee arrangements should consider the impact on end-users.
- Efficiency – Reforms of interchange fees should be consistent with productive, allocative, and dynamic economic efficiency considerations. This may include use of lower cost payment systems, pricing to end-users that reflects costs, and an appropriate level of investment in improvements to the payment system given the level of public benefits.
- Competition – Interchange fee arrangements should support vigorous competition between providers of payment services and should address any Trade Practices Act issues.
- Access – Interchange fee arrangements should be consistent with fair and open access to the EFTPOS network.
- Sustainability – Interchange fees should be consistent with continued provision of EFTPOS services over the long term and investment in new technology needed to maintain and upgrade the network.
- Practicality of implementation – The up-front and ongoing administrative costs of implementing any proposed reforms to interchange fees should be considered.
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These principles are discussed in more detail in the sections below.

Flexibility

ANZ agrees with this objective.

Customer acceptance

ANZ believes that this objective requires clarification. While end-users ought to be able to understand the impact of changes in interchange fees, customer acceptance will be reflected in the market for EFTPOS payments, provided both ends of the market — the sale of EFTPOS payment services by acquirers to merchants and by issuers to cardholders — are competitive. Customer acceptance should occur if end-users are confident that interchange fees have been determined in a pro-competitive manner.

ANZ suggests that this objective be rewritten as:

Customer acceptance – The process for determining interchange fees should be such that end-users are confident that they have been determined in a pro-competitive manner.

Efficiency

ANZ agrees with this objective. However, ANZ submits that "use of lower cost payment systems" is not in itself efficient if end-users desire to use higher cost, but higher quality, payments systems.

ANZ suggests that this objective be rewritten as:

Efficiency – Promotion of economically efficient outcomes, including use of lower cost payment systems (other things being equal), pricing to end-users that reflects costs and an appropriate level of investment in the payment system given the benefits (including network effects) to society.

Competition

ANZ agrees with this objective.

Access

ANZ supports open access to the EFTPOS system. However, ANZ believes that the terms and conditions of access should be considered separately from interchange fees. This is particularly so with smaller providers who may wish to enter the EFTPOS system via gateway arrangements. Gateway services can be provided by any of several participants (for example, any of the major banks) and potential entrants can choose amongst several alternative suppliers for the best gateway deals. Thus the market for gateway services should be presumed to be competitive. There is no reason for gateway fees to be regulated and consideration of access issues in general should be kept separate from the reform of interchange fees *per se*.

Sustainability

ANZ agrees with this objective.

Practicality of implementation

ANZ agrees with this objective.

2.2 Proposed models of reform

Option 1: Bilateral interchange arrangements

This option is structured in several parts:

- a "circuit breaker" comprised of an initial percentage reduction in interchange fees, followed by an agreed percentage reduction in interchange fees over a number of years, or a movement to zero interchange fees; and
- a "long term" approach, comprising an agreed methodology between bilateral partners for setting interchange fees, with an associated time frame for such reductions; or contractual requirements which allow for re-negotiations, with independent arbitration if no agreement can be reached.

Although ANZ supports the principle that commercial arrangements between parties should be negotiated bilaterally wherever possible, ANZ does not support this model of bilateral interchange arrangements. The model has the following defects:

- it is manifestly anticompetitive. Agreements to set bilateral interchange fees, as described above, would breach s.45 of the *Trade Practices Act* (TPA). ANZ is not confident that the ACCC would agree to authorise such arrangements;
- it would not be practical to devise an agreed methodology for setting bilateral interchange fees. Such a methodology would almost certainly be based on each financial institution's relevant costs. This would necessarily imply that each financial institution reveals its costs to each of its competitors. ANZ would not be prepared to do this, for obvious reasons, and doubts that any other issuers or acquirers of debit cards would be prepared to either. Furthermore, revelation of costs could be interpreted by the ACCC as a breach of s.45 of the TPA;
- this model is not consistent with efficiency as it would encourage cost-padding, or cost-shifting, in an attempt to raise interchange fees; and
- the model would also fail the transparency and customer acceptance tests.

Option 2: Multilateral interchange fees

2a Standard multilateral interchange fee

Multilateral interchange fees, possibly varying by type of transaction, could be determined in the same way that multilateral interchange fees are likely to be determined for credit card transactions. In terms of the objectives of transparency and customer acceptance, there is something to be said for using the same methodology (in broad terms) for determining interchange fees for both credit card and EFTPOS transactions. In principle, such interchange fees could be made reasonably consistent with the objectives of reform set out above. This would depend on whether a suitable methodology (assuming that it is cost-based) could be devised which includes all the relevant costs.

However, as noted in the Joint Study, unlike with credit card interchange fees, if a cost-based methodology is to be adopted it is not obvious whether interchange fees should flow from issuers to acquirers (the present situation) based on acquirers' costs; from acquirers to issuers based on issuers' costs; or whether the flow should be based on the difference between issuers' and acquirers' costs. While it might be argued that consistency with credit card interchange would necessitate a flow of interchange fees from acquirers to issuers, this would be a very shallow interpretation of consistency. Credit cards are a quite different payment instrument, compared with debit cards, both in terms of functionality and operations. With credit cards, acquirers pay interchange fees to issuers because the nature of the service is such that issuers' costs per transaction are much larger than acquirers' costs ($1.93 versus $0.43, according to the Joint Study). This is because issuers' costs include items like charge backs, fraud costs, the interest-free period and credit losses.

With EFTPOS transactions, the costs to issuers and acquirers are much more closely aligned because there are no interest-free period costs or credit losses for issuers and other costs, like fraud, are lower. EFTPOS interchange fees could flow in either direction and still be consistent with the credit card interchange fee methodology. But perhaps more importantly, EFTPOS interchange fees would not be large, either way. According to the Joint Study's cost data, EFTPOS interchange fees, which are based on costs, could be $0.07 to issuers, or $0.15 to acquirers.

ANZ does not endorse the data used in the Joint Study or the choice of relevant cost items used in it to determine indicative EFTPOS interchange fees. However, ANZ agrees that the interchange fees that are the result of a rigorous examination of EFTPOS costs would most likely be small — much smaller than credit card interchange fees. In the circumstances, ANZ questions whether the benefits of adopting a methodology that yielded such small payments would exceed the costs of setting up and complying with the regulatory apparatus needed for its implementation.

2b Bilateral fee agreements with multilateral default rate

This option would retain bilateral fee agreements but a "default" interchange fee would prevail if no agreement could be reached. The bilateral agreements could either be unconstrained (i.e. the result of commercial negotiation) or be constrained (i.e. there would be upper and lower bounds on the bilateral fees).

According to the Discussion Paper this model would retain the advantages of competitive bargaining and the flexibility of existing bilateral relationships. However, ANZ does not believe that such a model could be made to work in practice. If a multilateral default interchange rate exists, there would be no incentive for any party to negotiate a bilateral interchange rate that was worse from its point of view. If the multilateral rate was a payment from issuers to acquirers, then financial institutions that are net acquirers would be very unlikely to agree to a bilateral interchange rate that was less than the multilateral rate, and financial institutions that are net issuers would likewise be very unlikely to agree to a bilateral interchange rate that was more than the multilateral rate. If the multilateral rate was a payment from acquirers to issuers, the reverse would be true, but either way, the negotiated bilateral rate would soon converge to the default multilateral rate. Indeed, since both net issuers and net acquirers would realise this from the outset, negotiation might immediately move to the multilateral rate. This being the case, the bilateral negotiation part of the model would soon become redundant.

Option 3: No interchange fees

The Discussion Paper presents two variants of this model: one where interchange fee *clauses* of bilateral contracts are eliminated, the other where bilateral interchange fee *agreements* are eliminated. While these variants may be different from a legal perspective ANZ views these variants as being substantively the same in terms of assessment against reform objectives.

The principal argument in favour of no interchange fees is simplicity. If there are no EFTPOS interchange fees:

- there would be no need to set up a complex administrative and regulatory apparatus that would be required in the case of multilateral interchange fees;
- there would be no need to determine whether interchange fees should be paid by issuers to acquirers, or *vice versa*;
- there would be no need to determine whether different interchange fees would apply to different EFTPOS transactions;
- there would be no disputes about which cost categories should be included in the determination of interchange fees; and
- the complex task of measuring industry-wide costs would not be required.

In ANZ's view, these arguments are compelling, and point to a policy of setting interchange fees at zero. ANZ also believes that setting interchange fees at zero would be consistent with the objectives of EFTPOS interchange reform, including. customer acceptance, competition, efficiency and sustainability.

In terms of competition, setting interchange fees at zero would most likely result in a rebalancing by financial institutions of EFTPOS charges, in particular an increase in merchant fees charged by acquirers (since acquirers would no longer receive interchange fees). The extent to which merchant charges would increase would be limited by competition in acquiring. Competition in acquiring services is already very strong and there are, in any case, no barriers to entry to the industry — even for small players who can negotiate access through gateway arrangements. Likewise, competition by issuers is also very strong. EFTPOS interchange fees set at zero will not affect the existing strong competition for EFTPOS services to merchants and cardholders.

Competition will in turn ensure that EFTPOS services are efficiently provided, as long as there are no regulatory barriers to cost recovery at both ends of the market (and none has been proposed).

It might be argued that interchange fees for EFTPOS transactions set at zero would be inconsistent with positive interchange fees for credit card transactions. However, there exists a powerful case for positive interchange fees for credit card payments in order to support the existence of the network. The different nature of credit card transactions, and the associated implications for the costs incurred by credit card issuers, means that significant credit card interchange will almost certainly always be required. However, because the costs of issuing and acquiring EFTPOS transactions are relatively close, there is less need for interchange fees to support the EFTPOS network.

ANZ submits that a policy of no interchange fees would be best implemented if interchange fees for EFTPOS were set at zero, rather than explicitly abolished. This is because, at some time in the future, there might be a good reason for non-zero EFTPOS interchange fees.

ANZ is also wary of international comparisons that have been used to support no EFTPOS interchange fees. The fact that these fees do not exist in other countries means very little in itself because this could be a highly inefficient outcome in those cases. In the absence of a full understanding of how EFTPOS interchange fees have been determined overseas, strong conclusions based on international comparisons should be avoided.

On balance, ANZ believes that the arguments in favour of interchange fees set at zero for EFTPOS are powerful, at least at the present time, given the alternative of multilateral interchange fees, which would most likely be small anyway. For the purposes of the RBA's current reform program ANZ recommends that EFTPOS interchange fees should be set at zero. However, advances in payments technologies and other innovations mean that, in the future, interchange fees for EFTPOS transactions might be justified. ANZ recommends that the issue be revisited by the industry, in consultation with the RBA, in two to three years time in light of such developments.

2.3 Access pricing and other issues

As noted in Chapter 1, ANZ believes that the terms and conditions of access to the EFTPOS system are quite distinct issues from interchange fees. ANZ submits that the market for access services is competitive as prospective entrants can choose amongst several different suppliers to act as gateways to the EFTPOS system. As such, there is no need to regulate access fees nor, for the same reasons, is there a need to regulate switching fees when third parties provide switching.

In this regard, the arrangements that apply to Interac Association in Canada may be a useful guide.[4] Interac Association is a network of financial institutions and other institutions, which links automatic teller machines and the electronic debit payment system. There are basically two types of members of Interac Association:

- *Direct Connectors*, who are connected directly to each other via physical links; and
- *Indirect Connectors*, who access the Interac network by connecting through a Direct Connector.

Each member of Interac Association is authorised to carry out at least one of four basic network functions:

- *Issuers* maintain eligible demand accounts and issue cards. Only deposit-taking financial institutions can be Issuers.
- *Acquirers* operate card-accepting devices, such as ATMs and EFTPOS terminals, capturing and submitting relevant data to Issuers to undertake a transaction.
- *Connection Service Providers* are Direct Connectors who provide Indirect Connectors with access to the Interac network.
- *Settlement Agents* are Direct or Group Clearers in the Canadian Payments Association who settle the obligations of other members.

There are no interchange fees in the Interac Direct Payment (i.e. EFTPOS) service. However, members pay "switch" fees per transaction. Interac Association does not levy fees on end-users of the system (cardholders and merchants) but its members are free to do so. Interac Association rules ensure that these fees are properly disclosed but they are not otherwise regulated.

Thus, in the Canadian EFTPOS system, the absence of interchange fees has not precluded other fees, which have been used to recover operating and capital costs. This has not hindered the growth of the system — in fact Canada leads the world in terms of EFTPOS transactions *per capita*.

Likewise, if EFTPOS interchange fees were to be set at zero in Australia, this should have no bearing on the existence or size of switching fees, access fees, user fees or other fees which members of the EFTPOS network may choose to levy on each other or on their customers. Competition will keep these fees aligned with the costs of producing the associated services.

[4] See http://www.interac.ca/pdfs/backgrounder_en.pdf

Finally, the Joint Study noted that restrictions on access to credit card acquiring implied restrictions on debit card acquiring as potential acquirers who could not enter the credit card schemes could not then offer full acquiring service to merchants. Since the RBA, through its designation process, has announced plans to liberalise access to credit card acquiring, presumably its related concerns with respect to debit card acquiring will now be put to rest.