Credit Union Services Corporation

REFORM OF EFTPOS INTERCHANGE

SUBMISSION BY CUSCAL

EFTPOS INDUSTRY WORKING GROUP

September 2002

INTRODUCTION

This submission to the EFTPOS Industry Working Group sets out the view of Credit Union Services Corporation (Australia) Limited (CUSCAL) on EFTPOS interchange fee reform.

CUSCAL is the peak industry and service organisation for Australia's credit unions, representing 173 credit unions, with around $21 billion in assets and 3.1 million members.

CUSCAL provides credit unions with treasury and funds management services, transaction services, various wholesale and retail banking products, insurance products, data processing and communications, technology, public affairs, compliance, staff training, research, marketing, and other business services.

CUSCAL holds an exchange settlement account with the Reserve Bank of Australia and is a member of the Australian Payments Clearing Association (APCA).

Credit unions:

- are mutuals, where members own the credit union in which they are customers;
- have 3.5 million members nationwide, offering a vital competitive alternative to major banks in the Australian marketplace;
- are not-for-profit, with a focus on delivering member benefit;
- have total combined assets of $26 billion, with individual credit union asset sizes ranging from less than $100,000 to over $1 billion; and
- have a strong customer focus, which is reflected in the high satisfaction ratings recorded by members of credit unions.[1]

These distinguishing features are important factors in the different perspective credit unions can bring to regulatory and reform issues. Unlike other institutions that operate as both card acquirers and issuers, credit unions are primarily issuers.

In our submission on the RBA's credit card reform Consultation Document, we argued that reform processes for individual payment instruments must not occur in isolation from each other. A coordinated approach is required to avoid the creation of further inefficiencies or distortions in the payments system, inconsistency in treatment of individual payment instruments, or serious damage to the viability of

---

[1] In 2001 a survey by Eureka Market Research, *Consumer Relationships in the Retail Financial Services Industry* found 8 out of 10 credit union members rated their satisfaction with their institution highly, compared with 3 in 10 bank customers.

financial institutions (particularly smaller institutions).

We proposed a number of further principles that must underpin reform across payment instruments:

1) uniform pricing principles must be applied across different payment products;
2) reform of different payment products must take effect concurrently; and
3) reform must take account of industry diversity.

A consistent efficient pricing framework should be used for all card-based payment products. However, the underlying cost structures of the different card-based payment products will vary. This will result in different underlying interchange costs. Therefore, a consistent interchange methodology can be applied across all card-based payment products and the inherent differences in cost structures (and functionality) of these products will result in interchange fees appropriate to each card-based payment product.

Application of consistent interchange methodology across unique card products with differing functionalities will result in a spectrum of interchange rates, appropriate to each. Any other approach will create new distortions.

Card-based payment products include credit cards, signature-based card scheme payment cards, and PIN-based payment cards. A credit card has additional functionality compared to a Visa Debit card and a Visa Debit card has additional functionality compared to a PIN-based debit card.

For example, a Visa Debit card may have a line of credit attached to the underlying transaction account but will not feature the interest free period which typically distinguishes a credit card. However, a Visa Debit card has the acceptability features of a credit card, i.e. global acceptance, telephone and internet acceptance. A PIN-based debit card will pose much less fraud risk than a credit card or a Visa Debit card.

PROBLEMS WITH EFTPOS INTERCHANGE FEES

Problems with EFTPOS interchange fee arrangements have been obvious for some time, and were discussed in the Prices Surveillance Authority's June 1995 Inquiry into bank fees.[2]

Problems with EFTPOS interchange arrangements were identified long before the RBA/ACCC's report.

The PSA found, seven years ago, that interchange fees had not changed over time and were not based on costs. Nothing has changed since then.

[2] Report No.65 by the Prices Surveillance Authority *Inquiry into fees and charges imposed on retail accounts by banks and other financial institutions and by retailers on EFTPOS transactions* June 1995, p268.

"The strong growth in the number of EFTPOS transactions over recent years, and the relatively high incidence of fixed costs in the system, suggest that unit costs would have fallen over time and that incremental costs are very low," the PSA said.

"Consequently, the retention of interchange fees negotiated in the late 1980s has meant that the cost burden of system operations has tended to fall increasingly on the institutions that are predominantly card issuers.

Smaller issuers are increasingly bearing EFTPOS system costs.

"Those financial institutions which have not established an EFTPOS network, but issue cards to customer, are clearly losers."

The PSA identified this class of "losers" as including regional banks, building societies and credit unions.

In 1996, *European Card Review* examined Australia's EFTPOS arrangements and concluded that that powerful retail groups had taken control of the payments supply chain.

Large and powerful retailers are the dominant partners in EFTPOS interchange arrangements.

"Banking relationships in Australia have been managed in such a way that the retailers are the dominant partners in the plastic card payment systems supply chain, largely thanks to their superior negotiating skills,"[3] the magazine reported. "Past absence of strategic vision among their acquirers about the increasingly card-centric delivery of financial services and the lack of recognition within bank hierarchies for the payment card managers, have provided a 'corridor of indifference' to plastic payment cards, which the large Australian retailers have been able to exploit."

In October 2000, the RBA/ACCC Joint Study found that the "direction of debit card interchange fee payments in Australia is unique."[4]

"In other countries the payment is to the card issuer, or there are no interchange fees at all. None of the participants in the Australian debit card network could provide a formal methodology or empirical evidence to support either the existing direction and level of interchange fees, or a change in these arrangements."

"Access to the debit card network through a series of bilateral agreements can put both new issuers and acquirers at a competitive disadvantage, because they may need to use more expensive gateway arrangements," the RBA concluded.

---

[3] *Role Reversal,* European Card Review May/June 1996, p25

[4] *Debit and Credit Card Schemes in Australia – A study of interchange fees and access*, RBA/ACCC, October 2000, p66

REFORM OF EFTPOS INTERCHANGE FEES

The *Payments Systems (Regulation) Act 1998* means Australia now has an active payments system regulator with a brief to ensure payments systems are efficient and competitive.

The regulator has concluded that debit cards in relation to credit cards are:

- potentially a strong competitor,[5]
- in many circumstances, a close substitute.[6]

EFTPOS provides clear benefits to merchants.

The Reserve Bank has rejected the proposition that card issuers do not provide payment services to merchants. The credit card interchange standard gives regulatory recognition to these payment services provided by issuers to merchants.

> "From the viewpoint of the merchant, a debit card also provides a guaranteed, pre-authorised payment,[7]" the RBA says.

The Australian Retailers Association (ARA) unsuccessfully argued that issuers should pay a "fee for service" to acquirers or merchants.

> "The underlying logic of this proposal is that the providers of the network infrastructure (acquirers and sometimes merchants) ensure cardholders and merchants have access to a payment system and that providers should be recompensed for this. The same logic implies that card issuers do not provide payment services for which merchants are the main beneficiary, hence eschewing the need for an interchange fee," says the RBA's December 2001 Consultation Document.

> "The ARA proposal has strong similarities with the justification for the flow of interchange fees from issuers to acquirers (and some merchants) in Australia's debit card system. The proposal would represent a major departure from long-established credit card arrangements, for which there is no precedent in any country," the RBA said.

[5] *Reform of credit card schemes in Australia, A Consultation Document,* RBA December 2001, p38

[6] *Reform of credit card schemes in Australia, Final Reforms and Regulation Impact Statement* August 2002, p3

[7] *Reform of credit card schemes in Australia, A Consultation Document*, Op.Cit, p38

If there is to be regulatory intervention into payment systems, the outcome should be consistent across payment products which are competitors and substitutes.

Credit card issuers will continue to receive compensation in the form of an interchange fee for the costs involved in providing benefits to merchants. It follows that debit card issuers should also be compensated for providing identical benefits.

The Reserve Bank's credit card standard provides the basis for determining EFTPOS interchange.

If debit card issuers are not compensated by merchants, through acquirers, for these costs, these costs will have to be recovered from cardholders. This will perpetuate the bias in favour of credit cards - a higher cost payment instrument (albeit one with greater functionality and more features) against a lower cost payment instrument.

Cardholders should not have to pay for benefits provided to merchants.

The credit card interchange fee standard sets the benchmark for a new debit card interchange fee.

The debit card interchange fee should be based on objective, transparent and cost-based methodology that is subject to review.

A multilateral interchange fee for debit card issuers based on relevant issuer costs would:

- lower barriers to entry to the issuing market and increase contestability - a competitive market will drive efficiency and cost reduction, keeping downward pressure on the interchange fee; and
- be transparent to merchants, putting pressure on merchant service fees.

The RBA's October 2002 Joint Study arrived at a figure of $0.07 to the issuer for an interchange fee based on this approach.

> "The fee would be much lower than the indicative interchange for credit cards under this approach because there is no interest-free period and no credit losses, fraud is very small and processing and authorisation are electronic," the RBA said. "Furthermore, since most of the issuing costs are unrelated to the value of the transaction, the interchange fee would be flat rather than ad valorem."

Merchants stand to benefit from the RBA's reforms of credit card schemes by up to $400 million, assuming acquirers pass through reduced credit card interchange fees to merchant service fees. According to the RBA, "each 0.1 percentage point reduction in merchant service fees would involve a reduction of around $100 million in the size of the transfer from the community to financial institutions."[8]

By contrast, Westpac has estimated that $60 million flows to major retailers as their share of the current "negative" EFTPOS interchange fee.[9]

EFTPOS/ATMs Proposals to abolish interchange fees in ATM networks (as canvassed by the RBA's 2000 Joint Study and recommended by a Federal Parliamentary in 2001) should not be directly compared to EFTPOS. ATMs fundamentally provide cash – with three parties involved: card issuer, cardholder and ATM operator. EFTPOS is a payment service provided to merchants and cardholders by acquirers and issuers. Cash-out at EFTPOS transactions is a separate and additional service to the payment service. Merchants can (and do) choose whether or not to provide, and whether or not to charge for, this additional service.

DESIRED REFORM OBJECTIVES

- *Flexibility – Interchange fee levels should be responsive to market conditions and the costs of providing services.*

This objective would be met by moving a multilateral interchange fee based on relevant issuer costs and subject to regular review, instead of the current rigid bilateral arrangements.

- *Customer acceptance – Any industry-wide changes to interchange fee arrangements should consider the impact on end-users.*

Cardholders are likely to benefit from lower transaction costs. Merchants may pay more in EFTPOS merchant service fees, but the interchange fee element in merchant service fees will be transparent, cost-based and subject to regular review. Reform to EFTPOS interchange, in concert with the removal of the no-surcharge rule in credit card schemes, is likely to encourage the use of EFTPOS debit cards over credit cards. This will benefit merchants.

- *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*

[8] *Reform of credit card schemes in Australia, Final Reforms and Regulation Impact Statement*, Op.Cit, p22
[9] Westpac's Initial Response to the RBA and ACCC Joint Study, November 2000, p31

level of investment in improvements to the payment system given the level of public benefits.

Transparent, cost-based pricing will encourage the use of lower cost payment instruments.

- *Competition – Interchange fee arrangements should support vigorous competition between providers of payment services and should address any Trade Practices Act issues.*

Current interchange fee arrangements disadvantage smaller card issuers and harm competition.

- *Access – Interchange fee arrangements should be consistent with fair and open access to the EFTPOS network.*

A multilateral interchange fee will improve access to debit card issuing by making it easier to enter into interchange arrangements. Currently, direct network access is linked to successful negotiation of an interchange fee with each counterparty issuer or acquirer.

- *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.*

Efficient pricing for EFTPOS payments, combined with the effect of reforms to credit cards, will encourage the use of EFTPOS services.

- *Practicality of implementation – The up-front and ongoing administrative costs of implementing any proposed reforms to interchange fees should be considered.*

Moving to a multilateral interchange fee based on relevant issuer costs would involve greater up-front and ongoing administrative costs than some of the alternative reform options. However, these costs are justified by the wider efficiency and competition benefits of our preferred option. Up-front and ongoing costs of calculating and reviewing a multilateral interchange fee would depend on the methodology and number of issuers involved in the data gathering and analysis process.

CONCLUSION

CUSCAL's position is that current EFTPOS interchange arrangements are rigid, uncompetitive, and unrelated to costs. The losers from the current arrangements are smaller issuers and their cardholders.

EFTPOS reform should be implemented concurrently with reforms to credit cards to ensure that the benefits and impacts of reform are distributed fairly and to ensure that the costs of implementation are minimised.

CUSCAL supports EIWG Discussion Paper Option 2a, 'Standard multilateral interchange fee.' This mutilateral interchange fee should be based on issuer costs that benefit merchants, as specified in the RBA's credit card interchange fee standard.

Contact CUSCAL Public Affairs for further information:

Luke Lawler
Senior Advisor, Policy and Public Affairs
(02) 6232 6666 or 0418 213 025
llawler@cuscal.com.au

Adrian Lovney
General Manager, Public Affairs and Compliance
(02) 9333 7258 or 0411 641 340
alovney@cuscal.com.au