# EFTPOS INDUSTRY WORKING GROUP DISCUSSION PAPER

## Options for EFTPOS Interchange Fee Reform

Comments by
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## DOCUMENT OVERVIEW

As part of an industry consultation process, interested parties have been invited to submit a response to the Discussion Paper "*Options for EFTPOS Interchange Fee Reform*" that has been prepared by an Industry Working Group (of which St.George was represented) in July 2002.

This paper sets out a summary of the views of St.George Bank Limited in relation to the options and related issues described in the Discussion Paper.

St.George concludes in this document that network growth and overall payment system efficiency would be enhanced through the removal of pricing clauses from the bilateral arrangements that currently make up the EFTPOS network. In light of the new interchange pricing principles determined for credit cards, the effective zero interchange rate on EFTPOS would be part of the progression towards having a more consistent framework for interchange across all payments products.

## THE ROLE OF THE EFTPOS NETWORK

St.George is an active participant in the EFTPOS network from both a transaction acquiring and card issuing perspective. Over many years of operation, the EFTPOS network has proved to be an extremely reliable and efficient payment system. The system shows few technical faults, has a high level of customer and merchant acceptance and relatively minimal experience of compromise through fraud.

Hence, St.George believes that the fundamental efficiency of the EFTPOS network as a payment option justifies efforts to ensure that the network continues to prosper. The network should be positioned as one of the options to continue to make payments more efficient for retailers and consumers. In particular, there remains a large pool of cash transactions that if migrated to EFTPOS, or other electronic payment channels, would generate net benefits for the economy as a whole in St.George's view.

## INHIBITORS TO THE GROWTH OF EFTPOS

Recent data on the volume of EFTPOS transactions relative to other payment mechanisms would imply that the network is operating below its potential. Between the 2000 and 2002 financial years, the value of EFTPOS transactions have increased by 21.5%. Over the same period, there has been a growth of 13.9% in retail sales across the economy, an increase of 16.4% in the value of cash circulating, and a rise in credit card purchases of 51.8%.[1]

St.George believes that the current interchange arrangements are the main cause of the below potential growth in EFTPOS activity. For a payments network to expand, there must be incentives for both retailers and cardholders to participate. Currently, there would not appear to be any lack of willingness or incentives for retailers to participate in the EFTPOS network. According to the Australian Retailers Association, EFTPOS represents the cheapest payment mechanism available for merchants.[2] This is no doubt one of the reasons

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[1] Reserve Bank of Australia *Bulletin August 2002*. Tables G7, C3 and D3.
[2] Australian Retailers Association *Submission to the Reserve Bank of Australia, Credit Card Schemes in Australia* July 2001

for the continued growth in the number of merchants who decide to accept EFTPOS transactions. Terminals have grown by 37 %[3] in number over the past two years.

For cardholders, however, there is less evidence that incentives to participate are optimal. With EFTPOS interchange flowing from the card issuer to the merchant acquirer, the card issuer costs in supporting EFTPOS transactions are typically passed onto the consumer in some form. As a result, most consumers have available to them cheaper alternatives for payment that do not involve these fees. For example, it can be argued that where one cash withdrawal can cover multiple purchases, cash will represent a cheaper alternative for consumers.

Hence, St.George believes that the current flow of interchange payments from card issuer to merchant acquirer leads to price signals for the consumer that discourages usage and growth of the EFTPOS network.

## INEFFICIENCIES IN THE CURRENT INTERCHANGE ARRANGEMENTS

The fact that existing interchange arrangements may be restricting growth in EFTPOS transactions is not necessarily a problem if it was leading to a more optimal use of the overall payments system. However, given the underlying efficiency of the EFTPOS system this is unlikely to be the case. Rather, St.George believes that the combination of the existing flow of interchange fees and the nature of bilateral agreements between issuers and acquirers leads to a sub-optimal outcome.

### *The Direction of Interchange Fees*

There are various economic methodologies that could potentially be applied to assess the correct direction and size of interchange flows between acquirers and card issuers for EFTPOS. However, with the lack of any specific theoretical guidance on debit interchange methodology in Australia, it is reasonable to be influenced by overseas norms and the apparent costs and benefits of the EFTPOS network participants, in determining whether the existing structure is appropriate. The inconsistency of the current flow of fees from the issuer to the acquirer with international models is well documented in the Working Group's Discussion Paper. Additionally, existing interchange flows also have obvious inconsistencies with the ways in which the card schemes operate in Australia for both debit and credit transactions. The standard on interchange pricing set out by the Reserve Bank in its designation of the credit card schemes[4] sets a framework whereby interchange flows from the acquirer to the issuer in order to redress "imbalances between the costs and revenues of issuers and acquirers." Now that this framework has been set, other payment systems in Australia should not be based on methodologies that are inconsistent with this approach, otherwise pricing signals to consumers and merchants will result in a distorted and inefficient use of the overall payments system.

The issue to be addressed therefore is to determine the nature of imbalance in cost and revenue of acquirers and issuers. Acquirers make considerable ongoing investments in the network and a return on these investments is required in some form if incentives are to exist to continue participating. However in terms of the relative size of the costs incurred, the

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[3] Reserve Bank of Australia *Bulletin August 2002*. Tables C5
[4] Reserve Bank of Australia *Reform of Credit Card Schemes in Australia IV* August 2002

Joint Study of "*Debit and Credit Card Schemes in Australia"* by the Reserve Bank and the Australian Competition and Consumer Commission (ACCC) in October 2000, suggested that there was minimal difference in the costs of processing transactions between issuers and acquirers. This was after allowing for depreciation expenses on infrastructure.

In terms of revenue, the ability of issuers and acquirers to earn revenue is driven by the underlying benefit of the network to the cardholder and merchant respectively. The benefits presented by the EFTPOS network would appear to be more weighted to the merchant rather than the cardholder. Whilst the cardholder benefits from having point of sale access to their transaction banking account, this convenience can be replicated by other payment options (and given the proliferation of ATMs, cash is a close substitute in terms of consumer convenience). For merchants however, EFTPOS provides a cost reduction opportunity relative to other forms of payment. In particular, merchants would appear to stand to benefit considerably from a shift away from cash handling to a system that offers guaranteed payments directly into their bank account. The recent study undertaken by Price Waterhouse Coopers [5] suggests that for the participants in the study, cash costs were equivalent to 2.3% of the value of a transaction. Whilst the nature of cash makes it expensive to handle for both Banks and retailers, bank costs are contained by the consumers' tendency to make one cash withdrawal to cover multiple purchases. For merchants however, cash handling costs are incurred each time a purchase is made. Hence it follows that the benefits of moving from cash to an electronic payments system such as EFTPOS are weighted heavily in favour of the merchant.

In summary, given international norms, the principles being adopted for domestic credit card interchange and the apparent higher weighting of benefits available to retailers from the EFTPOS network, St.George believes the current flow of interchange from card issuer to acquirer is inappropriate.

***The Structure of Bilateral Arrangements***

Interchange arrangements are currently set on a bilateral basis between card issuers and acquirers. St.George holds the view that the nature of bilateral pricing arrangements for network participation is inherently inefficient. This is because there is a lack of a market force to influence the interchange rate to an optimal level. Within any bilateral arrangement, one participant has an interest in reducing interchange whilst the other has an interest in increasing it. This position is determined by whether the participant is a net payer or receiver of interchange. This creates a stalemate in the price setting process with the outcome being that interchange rates are set at levels that have prevailed historically.

Further cementing the "price stickiness" in bilateral networks is the lack of any transparency in customer pricing to reflect differences that may exist in the underlying interchange rates. That is, each card issuer charges its own customers the same EFTPOS fee regardless of whom the acquirer of the transaction was. The result is that there is no relationship between interchange price and transaction volume. Under an efficient model, a mechanism should exist for a lower interchange fee chargeable to card issuers to generate higher volumes and vice versa.

[5] PricewaterhouseCoopers, *Cost to Business of Accepting Cash as a Means of Payment* June 2002

St.George also agrees with the conclusion reached in the abovementioned Reserve Bank/ACCC Joint Study that “relatively smaller issuers are at a disadvantage” under the bilateral arrangements. This is because they have a lack of bargaining power relative to the larger acquirers.

## PREFERRED OPTION

Based on the reckoning outlined above, St.George has concluded that any changes to the interchange regime for the EFTPOS network must: -

1. move away from bilateral interchange pricing
2. remove the payment flow from issuer to acquirer

Whilst St.George believes that the weight of reasoning supports a reversal of interchange flow so that acquirers pay card issuers, it acknowledges that the theoretical basis for this is not indisputable. St.George is also aware of the risks inherent in radically changing the nature of an established payments system.

As such, the preferred option is to eliminate interchange fee clauses in existing bilateral contracts (option 3a in the Discussion Paper). This would appear to be a pragmatic, easily implementable solution that is consistent with some overseas models such as that currently prevailing in Canada. St.George is not necessarily advocating the permanent removal of interchange from the EFTPOS network. Rather, a move to effectively a zero rate would be a step towards the removal of the existing inappropriate pricing structure. Hence, if after a period of review, it was agreed that interchange flows should be re-established, then steps would need to commence to develop some form of multilateral based pricing, rather than re-initiate pricing clauses in bilateral contracts.

The elimination of interchange fee clauses in existing bilateral contracts, also simplifies the process of reform. As the Industry’s Discussion Paper suggests, this option is likely to have the least concerns in terms of the Trade Practices Act and potentially removes the need for ACCC authorisation. The option therefore has the advantage of generating an improvement within a shorter time frame, and importantly, it would be feasible to synchronise these changes with those taking place under the credit card scheme designation.

## SUMMARY OF BENEFITS OF CHANGE

The removal of the interchange flow from the card issuer to the acquirer would reduce the inconsistencies in the way in which interchange is set on EFTPOS relative to the framework established for the credit card schemes. A more consistent approach to pricing across all payment instruments will ultimately lead to a more efficient use of payment system resources, including the encouragement of a move away from the use of cash. The proposed removal of EFTPOS interchange pricing would also increase competitive neutrality between small and large card issuers by removing an existing bargaining bias.

**NOTE ON VISA DEBIT**

It is St.George’s view that it is inappropriate to draw any conclusions from the EFTPOS interchange review that apply to the Visa debit product. St.George is supportive of a review of Visa debit interchange whereby the framework, principles and timing applied are consistent with that of the credit card and EFTPOS reform. The principle of avoiding the risks of radical change to existing successful payment systems is also of paramount importance in all three areas of reform.

Visa debit is a unique product that combines aspects of a typical debit card and of a typical credit card. More specifically, the majority of the cost items that form the basis of the revised credit card interchange formula are common to Visa debit. Hence, Visa debit’s cost structure and methods of use are different from EFTPOS debit and therefore its interchange requires separate consideration. As such, a separate group of industry participants are reviewing reform of Visa debit interchange.