Bank of Queensland

Submission to RBA

on EFTPOS Reforms

October 2004

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1. Executive Summary

The reform process that has enveloped the Australian EFTPOS system to date has proved to be a roller coaster ride through the regulatory processes, which for a small participant in the EFTPOS has proved to be both illuminating and disillusionary. The Bank has expended considerable resources to the process with the view that the reforms proposed in the RBA/ACCC Joint Study would lead to a more equitable outcome within the EFTPOS arrangements for card issuing institutions and there customers.

Whilst the Bank does not necessarily concur with each finding of the Joint Study in isolation, we are of the firm view that for the system wide benefits advocated by the Joint Study to be effective it was necessary for the credit card reforms and the debit card reforms to be implemented concurrently. With the benefit of hindsight, it is unfortunate that different regulatory paths were taken in relation to credit cards and EFTPOS reforms.

The opposing arguments proffered by retailers in supporting the credit card reforms and then in opposing the EFTPOS reforms, simply lack credibility and need to be seriously discounted by the Reserve Bank in considering the overall impact to the payment systems in implementing EFTPOS reforms.

In cutting through the plethora of economic arguments that have been presented in one form or another during the past 4 years, there remains one inescapable question: "Where is the equity in a system that requires a card issuing institution to pay a fee indirectly to a retailer, for the retailer to accept a payment instrument that is the most cost effective, secure and efficient payment option available to the retailer, and from which they derive significant benefits". Whether there was a justification all those years ago for an interchange fee to provide the necessary incentive for retailers to adopt EFTPOS is past history. What is important is that there is no demonstrable case to support the continuation of a negative EFTPOS interchange fee arrangement going forward.

We are at the point now where the wrongs can be righted and we encourage the Reserve Bank to adopt the interchange fee reforms that it originally proposed in the Joint Study.

2. Background to RBA Designation Decision

The events that led up to the decision by the Reserve Bank of Australia (RBA) to utilise its powers provided for under the Payment Systems Regulation Act (PSRA) to designate the EFTPOS system are well understood so we do not intend to provide an expansive account of these events here. Instead we have provided the key milestones in the journey to this point:

1996: Financial System Inquiry (Wallis Committee) made a number of recommendations in relation to the efficiency and governance of the payments system, including the establishment of a new Payment Systems Board (PSB).

1998: Payments Systems Board formed and Memorandum of Understanding between Reserve Bank and Australian Competition and Consumer Commission (ACCC) published covering respective responsibilities for competition and access in the payments system.

1999: RBA and ACCC announced a joint study into interchange fees for debit and credit cards.

2000: (October) Joint Study findings published. The Joint Study broadly concluded that in the Australian credit card and debit card networks competition is not working as they should. More particularly, the Joint Study's findings in relation to EFTPOS were that:

- credit card interchange fee arrangements were encouraging credit card usage over the more efficient debit card,
- there was not clear support for an interchange fee for debit card payments, in either direction.

2001: Industry Working Group formed to develop and implement EFTPOS reforms.

2001: *(April) RBA designates Credit Card systems (Bankcard, MasterCard and Visa)*

2002: *(August) RBA releases details of cost-based standard for setting credit card interchange fees - expecting a 40% reduction in interchange fees.*

2003: *(January) RBA Standard on Merchant Pricing comes into effect allowing merchant surcharging for credit card transactions.*

2003: (February) Authorisation application for Zero EFTPOS Interchange Fee Agreement lodged by 12 applicants representing EFTPOS participants (banks, building societies and credit unions).

2003: (August) ACCC released draft determination proposing to deny the Application.

2003: (September) Predetermination conference convened by ACCC at the request of the Applicants.

2003: *(November) Credit card interchange rates reduced to nearly half their previous levels as a result of the introduction of the RBA cost-based standard. Merchants receive benefits of reduced Merchant Service Fees.*

2003: (December) ACCC released final determination authorising the Zero Interchange Fee application.

2004: (January) Retailers lodged an appeal with the Australian Competition Tribunal against the ACCC authorisation decision.

2004: (April) Australian Competition Tribunal appeal hearing.

2004: (May) Australian Competition Tribunal handed down its decision to set aside the determination of the ACCC in relation to the EFTPOS Authorisation.

2004: (June) RBA requested submissions from stakeholders following its announcement to consider designation of the EFTPOS system.

2004: (September) RBA designates EFTPOS system and invites submissions on appropriate standards to be adopted.

3. Defining the "Problem"

3.1 Joint Study conclusions

There have been many attempts since the Joint Study was released to define the problem, or from the retailers' point of view the lack of a problem, in the EFTPOS system arrangements.

The Joint Study addressed the issues not just from an EFTPOS perspective, but as a review of the credit and debit card systems operating in Australia. The conclusions of the Joint Study were the result of consideration given to the impact that changes in one system would have on the other system and vice versa. It is probably fair to say that no one organisation has singularly agreed with every element of the Joint Study, however, what we believe is beyond dispute is that the reforms proposed by the Joint Study needed, to be effective across all systems, to be implemented as a total package.

The Australian Merchant Payments Forum (AMPF) stated to the RBA in their opening paragraph of their submission dated 9 July 2004, that "*The AMPF believes there is no need for the RBA to designate the EFTPOS system as it is not "broken" and does not need "fixing"*". In arguing against designation of the EFTPOS system the AMPF submission (page 6) stated in relation to the Joint Study that *"there have been **significant structural changes*** (emphasis added) *in the payment card market since the Joint Study".*

The AMPF submission gives no details of these 'significant structural changes' or the impact that they have had. The only changes that we are aware of arose from the RBA decision to **designate the credit card systems** resulting in reductions in the level of credit card interchange fees, removal of the 'no surcharge' rules and the imposition of new access regime. There have been no 'significant structural changes' in the debit card environment. This simply reinforces our point that for the Joint Study recommended reforms to be effective, there was a need for the credit and debit reforms to be introduced concurrently.

If the Joint Study assessment of credit cards proved sufficient for the retailers to support designation of those systems, then there would appear to be little argument to oppose that the same should apply to the decision to designate the EFTPOS system.

3.2 Interchange Fees

The origins of interchange fees in EFTPOS have been commented upon by many parties, the majority of whom were not involved in the original development of the EFTPOS network and can therefore by regarded as largely speculation on their part. Some 'experts' have suggested that the fees were previously necessary in order to provide incentives to acquirers (and subsequently merchants) to install EFTPOS terminals in the initial development of the EFTPOS networks.

Accepting that this was the reason for the introduction of EFTPOS interchange fees nearly 20 years ago when the networks were being developed, it is difficult to argue that the same reasons still exist today to support the continuation of interchange fees at the same level in what is generally regarded as a "mature" system.

The Australian Retailers Association in its submission titled "Credit Card Schemes in Australia" provided to the RBA in July 2001 argued against the case for interchange in a debit card environment in Section 3.1 – Interchange Relevance where it was stated:

"We would also refute the 'balancing' argument in favour of interchange, which argues interchange fees are necessary to get a payment scheme established initially. The Canadian 'Interac' card payment scheme is a good example where there has never been any interchange fee from inception. In 1996 the Canadian competition authority issued a Consent Order to mandate open membership of Interac beyond the founding institutions. Since that time, the Interac scheme has grown dramatically, and still with no interchange fees."

The Canadian experience, so strongly supported by the ARA in July 2001, contradicts the claim by AMPF in their submission of July 2004 (Section 4 – Interchange) where they stated that:

"We believe that moving to the RBA's still preferred model of zero interchange will lead to reduced investment and, over time, degradation of the network"

These latter comments highlight the recent shift in the merchant's position now that credit card reforms have been implemented and the focus moves to the EFTPOS environment. Their position needs to be seen as the self-serving position that it is, which is not unexpected, but one that does not seriously add value to the debate.

3.3 Relative Benefits from EFTPOS

Retailers have attempted to make much of the benefits accruing from EFTPOS for card issuers yet make no mention of the benefits that merchants derive from cardholders effecting payment to merchants via an EFTPOS transaction as opposed to other payment instruments. Given the current negative interchange flow, it is perhaps understandable that merchants do not want to publicly acknowledge the significant benefits and cost reductions they achieve when consumers elect to use EFTPOS as a payment option, including:

- Guaranteed payment of funds
- Overnight settlement of funds each business day
- Effectively no fraud losses for the merchant
- Ability to integrate the payment system with merchant backend systems (eg. accounting and inventory systems)
- Elimination of cash thefts
- Reduced cash handling/clearance costs

Recently, retailers have attempted to argue that EFTPOS transactions, particularly EFTPOS cash out transactions, are in fact the merchant undertaking a 'banking transactions' on behalf of the card issuing financial institution. This simply overlooks the fact that EFTPOS transaction is the result of an agreement made between the merchant and the consumer for the purchase of goods or services, as is the method of payment required to finalise the transaction. The card issuing institution is not involved in the transaction up to this point. It is only when the merchant and the cardholder agree to settle the transaction by way of an EFTPOS transaction does the card issuing institution become involved, and then acting a party for the cardholder, not the merchant.

In our view, it is necessary to take a more balanced representation of an EFTPOS transaction, one that takes into account the role that the card issuing institution undertakes ie. providing a service to the cardholder, not the merchant. By providing the cardholder with a facility (an access card), the card issuing institution empowers the cardholder to undertake an EFTPOS transaction enabling the merchant to receive a secure, low cost payment method for goods and services.

The ARA submission to the RBA in July 2001 titled "Credit Card Schemes in Australia" the ARA provided information, based on a survey of their members, on the relative costs of the various payment tender types (ie. payment options). The table from their submission (page 20) is reproduced below:

	Cash %	Cheque %	Bank issued Credit Cards %	Non-Bank (Charge) Cards %	Debit Cards %
Retail Average	0.7	1.4	1.9	2.9	0.3

Table 4 – transaction Cost As Percentage Of Sales (July 2001)

It should be noted that this study occurred before the reduction in credit card interchange fees in November 2003. As a result of the reduction in merchant service fees since then, it would be reasonable to assume that the only real change in costs would have been in accepting credit cards where the costs would have fallen to similar levels to those for accepting a cheque.

From the study results it is clear that accepting a debit card is on average the most cost effective option for a merchant. Even with the removal of the subsidy paid to acquirers by card issuers through the current interchange fee arrangements, we would still expect EFTPOS to be the lowest cost payment option for merchants.

This supports the Joint Study position of moving away from the current negative EFTPOS interchange fee levels towards a zero EFTPOS interchange fee environment, or even possibly a positive interchange environment.

Bank of Queensland presents the view that there are no compelling reasons existing in today's EFTPOS arrangements to support the continuation of a negative interchange fee in the EFTPOS network.

3.4 EFTPOS Cashout Transactions

Whether an EFTPOS transaction involves the cardholder accessing cash as part of the transaction is determined by a business decision of the merchant based solely on their circumstances. Therefore, the claim by merchants that a cashout transaction is a service provided by the merchant on behalf of the card issuing institution, as was argued to the Australian Competition Tribunal, is simply not a defendable argument.

Merchants who elect to provide 'cash out' on an EFTPOS transaction do so at their own instigation because it suits their requirements, either to reduce their bulk cash clearance costs and/or reduce their theft risks. Merchants are under no compulsion by their acquiring financial institution to provide cash out facilities, as such card issuing institutions cannot rely upon the service being provided to their cardholders.

Statistics provided in the July 2004 RBA Bulletin "How Australians Withdraw Cash" shows that in the 12 months to March 2004 there were 167 million EFTPOS transactions involving cashout to cardholders. Of these 167 million EFTPOS cashout transactions, 91% were combined purchase/cashout transactions, as a result merchants incur no transaction costs in processing the cashout portion of the transaction.

Merchants who accumulate excess cash to their requirements are able to substantially reduce they cash handling and cash security costs by providing cashout with EFTPOS purchases. According to the RBA Bulletin, the annual value of cash provided in EFTPOS transactions was $9.283 billion (although these represent just 6.5% of total card based cash withdrawals, excluding over-the-counter branch cash withdrawals).

The ARA, in its submission to the RBA in July 2001, provided details of the retail average cost of accepting cash (based on an ARA survey) as being 0.7% (Section 3.7, page 19).

By applying a portion of this figure towards the post-acceptance costs (ie. reconciliation, security, loss and clearance) of cash which is eliminated when cash is returned to customers in an EFTPOS cashout transaction, it is possible to estimate the savings that merchants generate through cashout transactions. We have conservatively estimated that 0.5% of the total cost of 0.7% could be attributed to post-acceptance costs. Applying this component to the value of EFTPOS cashout transactions means that retailers would have benefited through savings of around $46.5 million in cash handling costs. For Coles Myer the savings in reduced cash handling costs would have amounted to $15 million based on the value of $3 billion of EFTPOS cashout provided by ColesMyer to cardholders in 2003 (refer Para. 112 of David Howell's statement to the Australian Competition Tribunal). In addition to these savings, Coles Myer would have also received a rebate from the interchange fee on each cashout transaction.

3.5 Merchant investments in EFTPOS infrastructure

Merchants who have invested in establishing EFTPOS infrastructure have referred to the need for merchants to be 'rewarded' for providing this infrastructure through the sharing of interchange fees. Detailed information on the costs these merchants have incurred is difficult to source, however, Mr Howell's statement to the Australian Competition Tribunal (File No.9 of 2003) does provide some basis for analysing the level of costs vs. the level of revenue from interchange fee rebates that they receive.

ColesMyer advised the Tribunal that their total EFTPOS infrastructure investment costs (excluding some R&D costs in the late 1980's) "is in excess of $64 million" (para. 77). As an offset to this, ColesMyer have received a share of the interchange fees from National Australia Bank since mid 1991 (para. 64) and whilst no figures were provided as to the value of the revenue we can speculate on what that might have been based on the EFTPOS transaction volume data provided by ColesMyer (Para. 69).

In the 5 years 1998 to 2003, ColesMyer advised the Tribunal that it had processed 546.1 million EFTPOS transactions. By applying various estimated per item interchange sharing values it is possible to estimate the revenue that ColesMyer would have received in the past 5 years alone, to offset the "total infrastructure investment costs":

Estimated CML income per trxn	$0.10	$0.125	$0.15	$0.175	$0.20
Estimate CML I/C revenue 1998/2003	$54.61m	$68.26m	$81.9m	$95.6m	$109.2m

From this assessment it could be reasonably argued that ColesMyer has, in the last 5 years, at worst case recovered nearly all its EFTPOS infrastructure investment and at best made a significant profit on their investment.

It is accepted that this is at best an estimate based on limited available data, however, it underpins the argument that there is no valid reason to continue with negative interchange in the current EFTPOS arrangements.

4. Pass through of savings

4.1 Credit reforms vs. Debit reforms

Bank of Queensland is concerned that different treatment by regulators in relation to the potential for passing on of cost savings to consumers/cardholders when considering the reforms in credit card interchange and debit card interchange.

With RBA designation of the credit card schemes resulting in a reduction in Merchant Service Fees charged to merchants, there was no monitoring of the pass through of these savings to consumers in general price reductions by retailers – nor has there been any demonstrable evidence of a reduction in retail prices. Retailers argued that the credit card interchange costs were borne by all consumers, not just credit card holders, as the costs were reflected in retail prices across the board. The ARA submission to the RBA in July 2001 (Section 3, page 21) notes that:
"The ARA is therefore confident that retailers will pass on the benefits generated by credit card reform to the consumer, driven by the forces of competition".
We note that to date there is no evidence that this has in fact occurred.

In considering the EFTPOS Authorisation Application in 2003, the Australian Competition and Consumer Commission (ACCC) sought assurances from card issuing financial institutions as to how the cost savings would be passed on to cardholders. We understand that the ACCC received and was satisfied with the responses they received in determining their net public benefits test applying to the proposed conduct. It must be noted that the level of the cost savings to card issuers resulting from EFTPOS reforms were significantly less than those available to merchants as a result from the credit card reforms.

The Australian Competition Tribunal took a very different, and we consider an unrealistic view in relation to the pass through of savings. The Tribunal was dismissive of the information provided to the ACCC by financial institutions, details of the Tribunal's views on this issue are contained ad infinitum in the determination document.

We are concerned that the Tribunal's position on this issue was an important component of their determination, when in fact what had been provided by financial institutions in relation to the pass through of savings in EFTPOS far exceeded what was required of retailers in the credit card reforms, where there was a total absence of any requirement from the RBA, or commitment from retailers, to pass on the savings, even in part, to consumers. In fact, the only monitoring undertaken by RBA of credit card interchange reforms was to ensure that acquirers passed on the savings to merchants through reduced merchant service fees.

The different processes adopted by the RBA and the Tribunal in relation to pass through of savings from credit and debit reforms were far from equitable.

4.2 BoQ Response to ACCC

In assessing the Authorisation Applications for Zero EFTPOS Interchange, the ACCC requested information from financial institutions as to issues relating to the pass through of savings to cardholders if the Authorisations were granted. The Bank provided information to the ACCC on a confidential basis, as the information included details of costs and revenues as well as information on pricing strategies that the Bank would look to adopt in a zero EFTPOS interchange environment.

Without some greater degree of certainty around the outcome of the EFTPOS reform process, the Bank has not been able to devote resources to develop detailed plans for new products or to reprice existing products to cater for a zero EFTPOS interchange environment. The reform outcomes have simply been too uncertain to this point. However, the Bank is still committed to the concept of product/pricing reforms that were conveyed to the ACCC, and a copy of the response is provided as a **confidential** attachment for the benefit of the Reserve Bank's consideration of this matter.

Also provided in a **confidential** attachment are up-to-date details of the Bank's EFTPOS transaction volumes, processing costs and interchange income/expense.

5. Access

It is well accepted that EFTPOS access reforms are an integral part of increasing competition in EFTPOS issuing and acquiring, Bank of Queensland supports the development of an appropriate access regime for the EFTPOS environment.

The work being undertaken by Australian Payments Clearing Association in developing an access regime, which is now nearing completion, has been developed with wide consultation across many EFTPOS stakeholders.

It is the view of Bank of Queensland that it is necessary to have some form of regulated Interchange Fee arrangements, either through a fixed fee or a default fee, to ensure that the proposed Access Regime can operate effectively. It seems to us incongruous that through an access regime a new EFTPOS participant would be afforded rights (and obligations) regarding access to the system, only to find that they could not negotiate an equitable interchange fee with existing EFTPSO participants. Bank of Queensland is well aware of the fact that smaller participants in the network are price takers, and not price setters, given their limited negotiating positions.

The critical question is "what is the appropriate level for a regulated fee?". Apart from the zero interchange fee conclusions provided by the RBA/ACCC Joint Study and subsequent work undertaken by the EFTPOS Interchange Working Group which also supported a move to zero interchange we need to look to international experience that is most closely aligned to the Australian environment and that is the Canadian Interac system. As noted previously, Interac has a zero default interchange fee.

6. International Experience – Canadian Interac System

The Australian Competition Tribunal, in handing down its decision on the EFTPOS Appeal, was dismissive of the relevance of overseas experiences (para 81) in deciding to uphold the EFTPOS appeal. We believe that the Tribunal erred in not examining the experiences in similar systems overseas, particularly the Canadian experience.

The Canadian Interac system has been studied in some detail by APCA in looking to develop the most appropriate EFTPOS Access arrangements for the Australian environment.

It is recognised that the work undertaken to date by APCA, and its advisers, has been heavily influenced by the Canadian model as it appears to most closely match the

Australian system. In developing an access model which will be closely aligned to Interac's arrangements, it is imperative that other components of the successful Canadian system are also considered in detail, including the role that the default zero EFTPOS interchange fee plays in the system.

We have already noted that the ARA strongly supported the Canadian Interac arrangements, particularly the role of zero interchange fees, in its submission to the RBA in July 2001.

We believe that the Canadian system provides valuable insight into how the Australian EFTPOS system might evolve in the future under a new access regime and with a regulated zero interchange fee arrangement. It also may provide valuable lessons in consideration to a possible move away from the current EFTPOS network architecture to a more open communications architecture.