Australian Merchant Payments Forum

The Reserve Bank of Australia's 2007/08 Review of Payment System Reforms

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1. Introduction

In May 2007 the Reserve Bank of Australia (RBA) published an issues paper titled 'Reform of Australia's Payments System: Issues for the 2007/08 Review'*.* The paper raised a number of specific issues on which the Bank sought comment from interested parties.

The Australian Merchant Payments Forum (AMPF) has participated actively in the reforms to Australia's Payments System. This document is in response to the RBA's request for submissions and puts forward the views and comments of the AMPF.

The purpose of this submission is to:

- Review the progress of the RBA's reform initiatives so far;
- Outline the facts supporting the continued regulation of the system; and
- Recommend a number of changes to the current regulatory regime.

This submission will look at each of the affected areas in turn, making observations and recommendations.

2. Reforms so Far

Reforms were introduced by the RBA after investigation and analysis of the following four broad areas:

(i) the effect of interchange fees on price signals in the payments system;

(ii) the effect of restrictions placed on participants;

(iii) access arrangements for potential providers of payment services;

(iv) the availability of information about the pricing and operation of different payment systems.

A key finding made by the RBA and the Australian Competition and Consumer Commission's 'Joint Study'[1] into interchange fees and access was that relative price signals faced by many consumers for payment instruments did not reflect relative resource costs. One of the key factors that contributed to the distortion of price signals was found to be the structure of interchange fees.

After further investigation the RBA concluded that interchange fees were not subject to the normal forces of competition. In the case of scheme credit and debit card systems, the schemes interchange pricing structures were set collectively by the members of the schemes. These interchange fees were opaque and artificially increased the cost of card acceptance. The effect of these interchange fees was to provide issuers of scheme cards with a subsidy at the expense of consumers paying with other tender types.

[1] *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* October 2000, RBA and Australian Competition and Consumer Commission.

The RBA concluded that these interchange fees did not promote efficiency, rather they distorted the price signals in the Australian payments system. In addition, the RBA found that price signals were also being distorted by a number of restrictive card scheme regulations. These restrictions included the “no surcharge rule’, the ‘honour all cards rule’ and the ‘no-steering rule’. Each of these rules was found to have an adverse affect on competition and contributed to the price signal distortions in the Australian payments system.

To address these concerns the RBA, through its reforms, has sought to increase the efficiency and transparency of the Australian Payments System through greater competition and providing clearer pricing signals via more transparent fee structures.

The AMPF believes that any relaxation of these reforms risks the dilution of the gains made to date. The commercial incentives for the card schemes, and their members, that led to the introduction of interchange remain. This environment will continue to encourage inefficient pricing structures, resulting in lower overall social utility, if left unchecked.

2.1 Credit Card Interchange Reforms

It was the purpose of the RBA’s Credit Interchange reforms to provide a more efficient Payment System. This was achieved through:

- Reduction of interchange to lower (but not eliminate) the level of hidden cross-subsidisation of cardholders by consumers using other tender types as a result of inappropriate pricing signals;

- Introduction of transparency in interchange structures; and

- Compensate for the lack of competitive market forces amongst the small number of participants in the payments industry.

To meet these objectives four component costs of Interchange were identified. These were used to establish a cap below which each Scheme had to maintain its portfolio weighted average interchange.

Merchants

The resulting reductions in interchange have decreased the overall cost to acquiring institutions. This has in turn resulted in a reduction in merchant service fees. Indeed data published by the RBA suggests that average merchant service fee rates for Visa and MasterCard have decreased by more than the reduction in interchange fees, over the period of the reform.

These merchant service fee reductions have reduced the cross subsidies paid by merchants to credit card issuers via interchange. Lower merchant costs have benefited all consumers because these cost reductions are reflected in lower retail prices to all customers.

The schemes claim that there is no evidence of retail price reduction by merchants.[2] The fact is that whilst significant in aggregate, small changes in cost and price are difficult to separately identify from fluctuations in retail prices driven by macroeconomic data. However, strong competition amongst Australian merchants, and in particular retailers, has ensured

[2] Insights, First Quarter 2007, MasterCard Worldwide at page 7

that the reduction in merchants' costs has been passed on to consumers via merchants' prices.

Cardholders

From a cardholders' perspective credit card fees have increased since the RBA made its first reforms to the credit cards market. Cardholder fees are an alternate source of revenue for card issuers, and are paid for by the user of the product instead of the merchant. The largest fee increases have been made to non-recurring cardholder fees that are less likely to be considered by consumers when selecting a credit card. These fees are often referred to as 'hidden' fees because they are typically listed amongst the product's terms and conditions and may not be incurred by all cardholders.

The Bank's annual Bank Fee Survey[3] reports that total fees paid by household credit cardholders have increased from $589m in 2003, to $1,018m in 2006, representing a growth rate of 20% p.a.. Over the same period, the number of credit card accounts in Australia grew by only 7%[4]. The Bank Fee Survey also reveals large increases were realised in the following fees between 2003 and 2006: the average foreign currency conversion fee increased from 1.3% to 2.4%; the average late payment fee increased from $23 to $31; and, the average over-limit fee has increased from $25 to $30. Also between 2003 and 2006, the average ad-valorem charge for ATM cash advances increased from: 0.4% to 1.1% for own ATM's, from 0.4% to 1.4% for other banks' ATM's, and from 0.4% to 1.4% for international ATM's.

Meanwhile, the average annual fee for standard cards increased only marginally from $27 to $28 between 2003 and 2006. However, cards with a rewards program exhibited a slightly larger increase in annual fee. The average annual fee for standard rewards cards increased from $76 to $85, and from $128 to $140 for gold rewards cards.

On top of the increase in cardholder fees, the benefit to cardholders from rewards programs has fallen on average by 19bp, from 81p in 2003 to 62bp in 2007, according to Table 5 of the Bank's May 2007 *Issues for the 2007/08 Review* document. This reduction is much less than the 45bp drop in credit card interchange; this indicates that the remainder of the reduction in interchange has been offset by increased cardholder fees and/or reduced issuer profit margins.

Some market participants have argued that the increase in credit cardholder fees is evidence of the failure of the RBA's credit card reforms. Nothing could be further from the truth. The clear aim of the reforms was to reduce price distortions introduced by credit card interchange and to reduce the cross subsidisation of credit cards, which was expected to result in increases to credit cardholder fees.

The cost of programs such as credit card rewards is now being levied on the beneficiaries of these programs, and these cardholders are now receiving a reduced level of subsidy due to the reductions in credit card interchange.

That said, the AMPF believes that interchange rate reductions have resulted in benefits for some credit cardholders. The reductions in interchange have led to a renewed focus on credit cardholders who revolve debt. Increased competition for revolving cardholders has seen new product innovation in the market with the introduction of "no frills" and low rate credit cards.

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[3] RBA Bulletin, May 2007.

[4] RBA Bulletin Table C1.

Card Interchange Categories

The card schemes have responded to the Bank's Interchange standard by increasing their range of interchange categories. In particular, new interchange rates applicable only to Premium and Chip cards have been introduced.

This has decreased the transparency of cost based fee setting. For instance, the cost of funding the interest free period is incorporated in the credit card interchange benchmark. However, the number of interest free days on most Commercial Cards, which attract above average interchange fees, is lower than for many personal cards.

The variation amongst interchange categories has also provided scope for Schemes to promote high interchange products such as the new premium cards and still purport to be within the required average interchange cap.

It is not clear to the AMPF how the card Schemes are ensuing their compliance with the interchange benchmark since the interchange fee for both premium and EMV cards is much higher than the benchmark, and many issuers have recently introduced new premium and EMV cards and are actively promoting these products.

The AMPF requests greater transparency in the reporting process through which the card Schemes demonstrate their compliance with the RBA's interchange benchmark.

Whilst the recent introduction of new interchange rates applicable only to larger merchants and specified categories of merchants has reduced the cost of card acceptance for merchants receiving these rates, it does also call into question the justification and basis for setting credit card interchange fees.

As the AMPF represents all sizes and types of merchants, we are concerned that the reduction of specified categories significantly below the interchange cap, may result in an increase on the interchange fees for SME merchants thereby causing an increase in their merchant service fees.

Interchange Benchmark Cost Components

It is apparent that overall merchant service fees have declined and competition within the acquiring industry has increased. Pricing signals now better reflect underlying costs, and consequently the extent of cross-subsidisation has decreased. However, the rationale for the retention of credit card interchange, at any level, remains unclear.

Looking at each of the remaining cost components of the interchange benchmark:

- **Processing and Authorisation** costs cover benefits gained by both the cardholder and merchant. While the merchant benefits from a guarantee of payment, this is no different to payment by cash. The cardholder also benefits from the ability to make a purchase without carrying cash, and the potential to use credit funds. The AMPF proposes the removal of the processing and authorisation cost component from the interchange benchmark

- The **Interest Free Period** allows the cardholder to make purchases on delayed payment terms. Card Schemes and issuers argue that this increases the volume of sales experienced by merchants. AMPF contends that while this may bring forward some purchases, it is not likely to impact upon a cardholder's propensity to consume because purchases must be paid for within the interest free period otherwise significant interest charges are payable. The AMPF proposes the removal of the interest free component from the interchange benchmark.

- AMPF contends that **Fraud Costs** should rest with the party most responsible for its control. Vigilance in Credit Card issuance as well as the security features of these cards, are elements out of the control of merchants. It is primarily the responsibility of issuers and acquirers to address card fraud through revised processes and use of fraud mitigating technology. So long as merchants continue to bear the burden of the cost of fraud via interchange, the parties capable of combating fraud do not have the appropriate incentives to address this issue with the urgency that might otherwise be the case. In Australia we have seen examples of failed or stalled attempts by issuers and acquirers to reduce fraud as the result of a weak business case for these projects. This includes the continually delayed roll out of such security initiatives as PIN authorisation of Credit Card transactions. Where the cause of fraud does lie with the merchant, the existing chargeback framework ensures that the costs are correctly allocated. The AMPF proposes the removal of the fraud component from the interchange benchmark.

The RBA has stated that its choice of these particular cost categories as the basis for constructing the Interchange benchmark does not indicate that these costs are necessary components of interchange.

The AMPF acknowledges the benefits realised to date from reductions to interchange rates, and supports the continuation of reforms to further reduce interchange to zero. The AMPF does not believe that there is adequate justification for the existence of credit card interchange, as it perpetuates a model whereby non credit card cardholders are subsidising the costs of credit card issuers. As shown in the accompanying paper by Alan Frankel, there is no economic rationale for this, particularly in a mature market such as Australia.

2.1.1 Three Party Card Systems

Subsequent to the decision to exclude American Express and Diners Club from regulation, American Express has commenced issuing products with two major banks. While American Express continues to be the acquirer of these cards, the cards are issued by the banks, who provide credit management, authorisation, processing and customer statements. In return the issuing bank receives a payment based on card usage. The basis and level of this payment is unclear, however for want of any better label, this is an interchange payment and should be subject to the same transparency and scrutiny as that of MasterCard or Visa interchange fees. Otherwise the opportunity exists for Visa and MasterCard to make minor changes to their operations to emulate the American Express model in an attempt to bypass the RBA's reforms.

Notwithstanding the anomaly created by these *quasi* four party arrangements, data published by the RBA shows that both American Express and Diners merchant service fees have come under competitive downward pressure following the reforms to four party cards.

The AMPF believes that maintenance of the RBA's regulations will continue to stimulate competition amongst four party merchant service fees, and this will ensure three party merchant service fees are also subject to similar competitive pressures.

2.2 Debit Interchange

The Bank's interchange reforms have reduced the size, but not the existence, of the interchange differential between EFTPOS debit and Scheme debit.

However, despite the narrowing of the interchange differential, the number of Scheme debit cards on issue and the level of marketing of these cards has increased considerably in recent months.

The AMPF believes that the differential between Scheme debit interchange and EFTPOS interchange provides an unwarranted incentive for the issuance of Scheme debit. If this differential is not removed, the marketing of Scheme debit products and the instances of banks issuing new Scheme debit products or converting their entire EFTPOS debit card base to Scheme debit will continue to increase until Scheme debit cards replace EFTPOS cards entirely. Evidence of this is become apparent with the Westpac Bank force issuing its Scheme Debit Card as a replacement for its existing EFTPOS card.

Retailers' costs of debit card acceptance will increase substantially if EFTPOS cards disappear entirely because of the existence of Scheme fees. EFTPOS debit is an efficient, secure and low cost method of payment for merchants and cardholders. The AMPF considers the survival of EFTPOS debit to be essential to ensure the competitiveness and efficiency of the Australian payments system.

AMPF believes that the removal of interchange on Scheme and proprietary Debit will eliminate the competitive disparity between these products and allow issuers to promote debit card products based on their features and true underlying costs, rather than on a cost base distorted by interchange.

2.3 Scheme Regulation Reforms

2.3.1 Honour All Cards

In a mature market, the Card Schemes have openly declared their pursuit to expand their market penetration through the issuing of additional card types, such as Scheme Debit Cards and Prepaid Cards. Introduction of these card types can be good for competition with the existing EFTPOS Debit network only if their acceptance by merchants is based on choice, rather than being a requirement of Credit Card acceptance, setting aside the relative pricing of these payment instruments.

Tying acceptance of such cards to that of existing Credit Cards removes the opportunity to establish natural market forces. Continued prohibition of such anti-competitive regulations as the Honour All Cards rule is therefore necessary to ensure an efficient marketplace, where merchants are able to select which tender types they will accept based purely on the merits and pricing of each payment method.

Further regulation and clarification of the Honour All Cards rule to allow merchants to reject certain categories of cards within a Scheme (such as Premium Cards or Corporate Cards) would increase the opportunity for merchants to control their costs. As stated earlier, Visa and MasterCard are increasing the differential in Interchange between a number of their card categories (eg basic consumer vs business). Merchants rightfully should be able to choose whether they will accept each category of card transactions with its own interchange rate. The AMPF proposes that the RBA's regulation of the Honour All Cards rule be amended to reflect this.

Ultimately, this situation only serves to further illustrate the benefits of the AMPF's preferred option of no interchange.

2.3.2 No Steering and No Surcharging Rules

In order to enable merchants to provide correct pricing signals to consumers, the anti-competitive rules that prevented surcharging and steering of customers towards alternative tender types were removed. Preventing surcharging of certain card types meant that there was a cross subsidisation of consumers paying with more costly tender methods by other customers.

The removal of no-surcharge rules has seen a number of merchants, particularly in narrow margin businesses, introduce a fee on some cards, particularly those from the more expensive three party systems. However, the RBA has been proven correct in assuming that other competitive pressures would prevent surcharging becoming status quo.

The effect of surcharging on customers of retailers, who have yet to finalise their purchase, is different to the effect of surcharging on customers of billers, who have already consumed the good or service and are obliged to make a payment. Retailers are most likely to receive an adverse customer reaction to surcharging, and hence are least likely to surcharge. Merchants with higher average transaction values are more likely to surcharge, in particular billers because they receive payments in arrears and the transaction cannot be cancelled.

The risk facing a retailer that surcharges is that a customer may choose to cancel their purchase or, more likely, to shop at a competing retailer for future purchases. And because most customers perceive a merchant as being indifferent between different payment methods, the credit card surcharge is typically perceived to be a tax. By introducing a surcharge, a retailer weakens its competitive position. This makes the decision to surcharge particularly difficult for a retailer. A retailer would only be likely to implement a surcharge if their average transaction size is high, which makes the price of credit cards high relative to other payment methods, or if their profit margins are thin.

For billers, surcharging is a lower risk option because the customer is obligated to make the payment. Furthermore, the payment is unlikely to be made at the biller's premises, so offering a wide variety of payment options adds to the convenience of making a payment, even if some of these payment methods attract a surcharge. For some customers the convenience of making a payment by credit card outweighs the cost of the surcharge.

Amongst billers, those providing an essential service to customers on an ongoing basis are most likely to surcharge, for instance utilities and councils. This is because it is difficult for customers of these billers to change to an alternative provider as a result of a surcharge.

But whereas some participants have suggested that the lack of widespread surcharging has represented a failure of the reforms; this is not the case. It is the ability to surcharge that has driven much of the increased competition, and the resulting decrease in overall merchant service fees has reduced the need to apply a surcharge. For this reason, the maintenance of the current reforms on surcharging and steering is considered necessary.

3. Scheme Fees

The AMPF is concerned about the recent trend of increases in Scheme fees charged to acquirers. Acquirers must pay Scheme fees if they want to act as an acquirer for a particular Scheme, which they pass on to their merchants via the merchant service fee.

Just as the RBA was concerned that interchange fees were not subject to the normal forces of competition, and that they were having a significant effect on price signals and the efficiency of the payments system, the AMPF is concerned about the impact of scheme fees on the payments system.

The possibility exists for card schemes to inflate acquiring scheme fees and use these fees to fund marketing incentives to card issuers, effectively replicating interchange while avoiding the Bank's interchange standard. In fact, marketing incentive payments are commonly paid by the card Schemes to card issuers to persuade them to issue a particular product.

By increasing acquiring Scheme fees such that they are significantly greater than issuing Scheme fees, the burden of funding the card Schemes' existence and their profitability will fall upon merchants instead of card Scheme members and their cardholders. If scheme members are both issuers and acquirers, they can pass on the cost of acquiring scheme fees to their merchant customers, while the cost of their issuing scheme fees can be partially or fully offset by marketing incentive payments from the Schemes. The end result is that consumers paying by non-Scheme cards cross-subsidise the card Scheme networks used by Scheme cardholders.

One option to prevent acquirers' Scheme fees from continual increases is to expose these fees to greater competition. This can be achieved by allowing acquirers and self-acquirers to choose which network is used to process their card payments. This decision is rightfully the acquirer's because they, through their customers, fund the cost of these payments being processed by the card Schemes via the acquiring scheme fee. The AMPF encourages the Bank to introduce a standard to permit acquirers to choose their card processing network. If this were introduced, it is feasible that the low-cost, bilateral interbank EFTPOS/ATM network could be used to process credit card transactions.

At present, a Scheme transaction must be processed by the network whose logo is displayed on the card. This encourages the schemes to compete to attract issuers to launch new products because they will collect scheme fees on every transaction made by cards with their branding for so long as these cards are on issue, but leaves acquiring scheme fees completely immune from competition.

4. Self Regulation

The AMPF acknowledges that matters dealing with operational and technical standards are best determined and managed by the industry without direct regulatory intervention. Organisations such as the Australian Payments Clearing Association, play an important role in ensuring the industry works co-operatively to set appropriate standards and implement new payment initiatives such as triple DES.

The AMPF believes that whilst operational and technical matters are best determined and managed by the industry without direct regulatory intervention, this is not the case for the setting of interchange fees.

The prospects of self regulation of interchange fees leading to a beneficial outcome for payment systems users are remote. Interchange fees are not subject to normal competitive forces in an unregulated environment, and consequently result in significant distortions to price signals facing users of payments instruments.

There has been insufficient change to the structure of the four party card Schemes since the commencement of the reforms to suggest that the RBA's interchange regulations could be relaxed without a recurrence of the original pricing distortions.

This view is further reinforced by the interest and intervention of regulatory and competition bodies around the world since the introduction of the RBA's reforms in Australia. Regulatory and competition bodies in many other overseas markets have implemented similar policies to alleviate the damaging effects of interchange and restrictive Scheme rules, as documented in Table 2 of the Bank's *Issues for the 2007/08 Review* paper released in May 2007.

The RBA's intervention in the cards market reduced the extent of cross-subsidisation amongst payment instruments and more closely aligned payment instrument price signals with the underlying costs. Without the right incentives and competitive pressures to set interchange fees at a socially optimal level, we cannot expect the card schemes to deliver such an outcome under a self regulatory model.

5. No Interchange

The card schemes and their members have yet to provide a justification for the necessity of the continuation of card interchange fees. Given the nature of competition in the card payments market, and the distortions to payment instrument price signals caused by interchange, the AMPF considers a no-interchange scenario to be in the best interests of all payments systems users. The AMPF endorses Dr Alan Frankel's no-interchange proposal.

AMPF members include:

Australia Post
Australian Retailers Association (representing some 12,000 retailers Australia wide)
BP
Bunnings
Caltex
Coles Group
Mitre 10
Spark's Shoes Pty Ltd
Woolworths Limited