



**AUSTRALIAN BANKERS' ASSOCIATION INC.**

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Ms Michele Bullock  
Head of Payments Policy  
Reserve Bank of Australia  
65 Martin Place  
Sydney NSW 2000

Dear Michele,

**Australian Bankers' Association's submission  
on the Reserve Bank of Australia's preliminary  
conclusions of the 2007/08 Review**

The Australian Bankers' Association (ABA) welcomes the opportunity to make a submission responding to the Reserve Bank's preliminary conclusions document from its 2007/08 payment policy review.

The ABA's main objective is for the payments system to be deregulated and for policy concerns to be addressed through competitive market solutions or, where necessary, industry self-regulation.

In terms of the future direction of payment regulation, the ABA supports option 3 as outlined in the preliminary conclusions document that was publicly released in April 2008, although we recommend against further watering down of international scheme honour all cards rules.

Option 3 has the Reserve Bank stepping back from interchange fee regulation so long as, inter alia, the industry is able to reform the operation of the Electronic Funds Transfer at Point of Sale (EFTPOS) system to position EFTPOS as a more effective competitor to the international card schemes.

The ABA strongly supports the establishment of a scheme for EFTPOS. The Australian Payments Clearing Association (APCA) is overseeing a process to develop the scheme.

A second proposed condition outlined in order for the Reserve Bank to step back from interchange fee regulation and one ABA strongly opposes, is the requirement that international card schemes change their operating rules to allow merchants to refuse to accept varieties of credit and debit cards, for example, premium credit cards.

### **Argument against further modification to the honour all cards standard**

In the ABA's view, this further proposed watering down of the honour all cards rule, in which merchants could refuse to accept certain cards is too intrusive into the business model of the international card schemes.

Card issuers should be able to offer payment products that are simple to understand and be widely accepted. There is a great simplicity in informing a customer that their card is accepted where the card scheme's logo appears.

Similarly, it is not unreasonable that Visa and MasterCard should be free to advertise their products as having universal acceptance as this unambiguously is an attractive feature of these payment instruments for customers.

The current regulation allowing merchants to refuse debit cards issued by the international credit card schemes already undermines the ability of these schemes to advertise universal card acceptance where their logos appear. By extending the principle to allow merchants to refuse varieties of credit and/or debit cards is, in the ABA's view, an unreasonable undermining of this product.

In terms of practical difficulties for customers - it is unclear how further modifications to the honour all cards standard would apply to international cards used in Australia, or to Australian cards used overseas. From the customer's perspective, it could lead to embarrassing moments when their card is refused even though their account is in order. In attempting to avoid these situations, consumers will be inconvenienced.

The ABA acknowledges that a stated objective of the Reserve Bank is the ability of retailers to exert downward pressure<sup>1</sup> on interchange fees. We believe that the incremental benefits to competition of allowing merchants to refuse certain varieties of card are limited, particularly given retailers are already able to surcharge without restriction.

It has been argued by others that differential surcharging is not practical because it requires the retailer's staff to recognise different cards and inform the customer of the applicable surcharge, but this practical problem also exists in terms of card acceptance. The retailer's staff will still need to identify those cards that are not accepted in the store.

Another argument against differential surcharging as an alternative to the capacity of retailers to refuse certain cards is that terminal card readers cannot identify those cards where a higher interchange fee is applicable. The ABA understands that a technological solution to this problem has been found and that these readers are now commercially available.

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<sup>1</sup> By refusing to accept certain credit cards, merchants will be given an additional negotiating tool to put downward pressure on interchange fees. This tool will be available even to those merchants that currently receive a blended interchange rate i.e. one rate for each card in the scheme.

Finally, it is argued that the fact most banks offer merchants 'blended' merchant service fees (MSFs) – i.e. one merchant service fees payable regardless of the interchange fee applying to the transaction – means that there is no incentive for merchants to differentially surcharge and, therefore, little value in putting downward pressure on interchange fees. We do not agree with this argument.

The ability of the merchant to surcharge without restriction gives the merchant very similar bargaining power over interchange. The freedom of a merchant to apply a very high surcharge to a transaction will generate downward pressure on interchange fees, but is preferable because consumer choice is still maintained. And, it also allows the banks and card schemes to continue advertising universal access where the card scheme's logo appears.

### **ABA comments on the other options**

Option 1 is described as the "Status quo" option whereby all existing rules and interchange fee methodologies remain in place. This would provide ongoing business certainty, but is inconsistent with the ABA's longstanding view that interchange fees should be deregulated in favour of a more competitive system and one that promotes innovation.

Option 2 also provides business certainty for the banks as interchange fees would be fixed in perpetuity, although at different rates than currently apply for credit cards and EFTPOS. Once again, however, having interchange fees set by regulation is inconsistent with the ABA's view that, where feasible, competition rather than government regulation should govern markets.

Furthermore, a mandated reduction in the credit card interchange fee to 0.3% would be another significant transfer in credit card system costs towards cardholders and away from merchants in addition to the redistribution that occurred in 2002. Moving to this option would result in another period of disruption in the credit card market as card issuers adapt their business models.

Lastly, by fixing interchange fees in perpetuity, the incentives for developing new payment products would be diminished, particularly given there appears little in the way of objective formula or rationale cited to arrive at the 0.3% figure. This would leave payments system innovators having to guess at what arbitrary interchange fee would be potentially imposed upon their new payment system.

### **Welfare gains and the Reserve Bank's intention to closely supervise the payments system**

In the Reserve Bank's preliminary conclusions paper, it is asserted that the reforms have improved overall resource allocation and contributed to substantial welfare gains to the community. Welfare analysis typically ignores distributional issues (i.e. which groups win or lose) and attempts to estimate how society overall is better off.

To do this, the Reserve Bank uses what's called a "revealed preference" model as its welfare assessment tool which requires an understanding of how consumer preferences have changed as a consequence of the reforms. To populate this model, the RBA does not observe actual changes in preferences, but makes assumptions. It assumes that the reforms have increased use of EFTPOS by 5% in preference to credit cards. Because credit cards have been found to use more resources per transaction, the Reserve Bank derives a cost savings benefit to the community and presents this as a welfare gain.

This analysis doesn't recognise any loss of consumer benefits in this assumed shift to EFTPOS usage. Nor does the estimate reflect policy reform costs such as economic and legal costs, interchange cost-studies and staff time.

There is one transfer amount that the ABA believes should be subtracted from any estimated welfare gains – this is the transfer of credit card user benefits into the profit base of merchants i.e. those merchants that because of market power have retained some or all of the interchange fee reductions rather than lowered prices of goods and services. For all of the reasons above, the ABA submits that it has not been demonstrated that the reforms have resulted in net welfare gains.

From a qualitative perspective, the ABA believes the reforms to payments system access and the removal of the no-surcharge<sup>2</sup> prohibitions have been pro-competitive and will benefit the payments system long-term.

### **Close supervision to continue**

In the Reserve Bank's preliminary conclusions paper, it is argued that continued close supervision of the payments system is warranted given the nature of competition is such that merchants are prepared to collectively pay more for accepting credit cards than the benefit they receive.

The ABA does not take issue with the Reserve Bank continuing to pay close attention to payments system particularly with respect to questions of efficiency, competition, safety and innovation.

### **Merchant card acceptance is rational**

However, we find the argument that merchants pay more for credit cards than the value they derive difficult to accept. The origin of the credit card product is that of store credit where the merchant provided their customers with a capacity to buy goods today and then pay for them later. Under this system, the merchant accepted all the costs of account keeping and transaction processing, the interest-free period and credit losses.

Credit cards today simply provide an efficient outsourced store credit/payment service to merchants. Given merchants' historical willingness to pay all the costs of providing store credit, it seems unreasonable to suggest they no longer should be required to cover these costs. Of course, large retailers continue to provide their customers with store credit facilities through issuing their own payment cards and products.

### **The future regulatory framework**

The ABA believes the ideal situation is that the Reserve Bank withdraws all its payments system designations and pursues regulatory objectives through industry self-regulatory mechanisms. But we recognize there are a number of constraints to this ideal:

1. International payment schemes have a strong business objective to harmonise operating rules throughout all the jurisdictions in which they operate and will typically only change their rules if compelled by local laws and regulations.

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<sup>2</sup> The ABA still recognises that there are legitimate arguments supporting the right of card schemes to prohibit surcharging. This includes the concern that a growing number of merchants are now surcharging above the MSFs.

2. The structure of Australia's legal system governing payments systems is that any industry agreement regarding interchange fees requires that participants are afforded legal protection under the Trade Practices Act 1974 or by Reserve Bank designation.

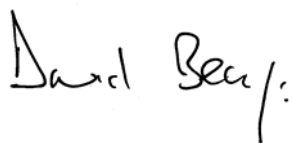
The ABA believes this is a wholly unsatisfactory situation. Either the industry is destined for continual government intervention under designation or must alternatively undertake highly uncertain authorisation applications that are, in any case, still subject to periodic review.

The unsatisfactory nature of authorisation is evidenced by the Australian Competition and Consumer Commission (ACCC) at one time opposing the first industry application for zero EFTPOS interchange fees and, when the ACCC gave authorisation, the Australian Competition Tribunal (ACT) then overturned the decision.

3. The nature of payments systems as two-sided markets means there are often zero-sum outcomes in setting interchange fees and imposing other rules. This means that incentives are often misaligned, creating difficulties in achieving consensus changes.

It is not obvious to the ABA how these constraints to industry self-regulation can be overcome under the current arrangements. In the short term, ABA would support the establishment of an industry group, resourced through the Australian Payments Clearing Association (APCA), to facilitate discussion with the RBA on advancing the recommended form of Option 3.

Yours sincerely



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**David Bell**