



AUSTRALIAN SETTLEMENTS LIMITED

ABN 14 087 822 491

RESPONSE TO THE RBA'S PRELIMINARY CONCLUSIONS OF THE 2007/08 REVIEW

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1. INTRODUCTION

ASL is pleased to have the opportunity to respond to the Reserve Bank's *"Reform of Australia's Payments System, Preliminary Conclusions of the 2007/08 Review, April 2008"*.

Review and reforms of Australia's payments system go back to the Wallis Report and the PSRA (98) with considerable change taking place since the RBA released its Joint Study in October 2000.

ASL has tried to provide useful and objective input for this process during this period, actively participating in providing its perspective on credit card, scheme debit, and EFTPOS issues. ASL represents the views of its members which are principally building societies and several credit unions.

During that period ASL has submitted (or participated in submissions) as follows:

- Responded to RBA questions on the credit card system (3 August 2001)
- Letter to the RBA regarding scheme debit (co-signed) (17 August 2001)
- Letter to the RBA regarding scheme debit (co-signed) (6 September 2001)
- Discussion Paper: Visa Debit Australia (co-author) (September 2001)
- Letter to the RBA regarding their Credit Card Consultation Document (15 March 2002)
- Discussion Paper: Options for EFTPOS Interchange Fee Reform (co-author) (July 2002)
- Comments to the RBA on the EFTPOS Discussion Paper (September 2002)
- Letter to the RBA regarding designation of the Visa debit system (31 March 2004)
- Letter to the RBA regarding designation of EFTPOS (9 July 2004)
- Letter to the RBA regarding designation of the Visa debit system (15 October 2004)
- Comments to the RBA on the RBA draft standards for Visa Debit and EFTPOS (29 April 2005)

ASL has consistently attempted through this participation in the RBA reforms to ensure that its members were properly represented and that their interests were fairly presented, consistent with the public interest principles established by the RBA for payments system reforms regarding efficiency, competition, safety and risk.

Throughout the reform history, the ASL has presented a consistent view on various issues related to the reform process. These have consisted of:

1. Reform of EFTPOS should be concurrent and consistent with scheme debit

2. Interchange fees for all card based payment products should be determined by a consistent framework across all those products
3. Continuation of the honour all cards policies of MasterCard and Visa given that the decision making of what payment option to use is best left to the consumer, assuming that the price signals to the consumer are appropriate. This is accomplished with surcharge reforms, not changes to the honour all cards rules.
4. General support for surcharging but with the recognition that this would have to be done in a logical manner such as differential end-user pricing for each payment option and the amount of the surcharge reflecting the difference in merchant costs for accepting different payment options
5. Timing of the reforms to minimise to practicable disruptions to the market
6. Sensitivity to reforms that would have an adverse impact on a financial institution for no reason other than its size.

It would not be productive to use this submission to discuss members' views on how the reforms to date have addressed the issues listed above. In summary members believe in some areas the reforms adequately reflect those issues whereas to date the reforms have not adequately taken into account other issues. The net impact is that the pricing signals provided to end-users (cardholders, merchants, and consumers) now more likely reflect relative resource costs. The impact on total payment resource costs, competition and efficiency is less clear.

Going forward members believe that Australia's consumers are best served by the following:

- Interchange fees for card-based payment options determined by applying an objective, consistent framework and methodology across all relevant products. Members believe this approach is superior to interchange fee determination by regulatory sanction
- This approach would likely resolve the current major anomaly with EFTPOS interchange (that it flows from Issuer to Acquirer), both in the context of other card-based payment products in Australia and in comparison to practices in other global markets. In doing so it would further underpin the efficiency of the payments system and contribute to enhanced transparency and confidence for all stakeholders.

After eight years of reform process and with considerable resources focused on this issue, the building societies believe such an approach exists and has provided substantial commentary on the subject in prior submissions

- No further revisions to the honour all cards / products rules as competition should be driven by the end consumer by means of the surcharge reforms
- Modifications if possible to the surcharging reforms.

The intent of the reforms was to provide better price signals to consumers. It is not clear how a reduction of 50 basis points in the credit card interchange fee (and assuming it was passed on to the merchant, which it appears it essentially was) justifies a surcharge of 1% or 2%.

This aberration in the surcharge reform may be that merchant competition in the Australian market is not as robust as assumed by the RBA. In addition, it is not clear why merchants should surcharge for one payment product such as credit cards but not differentially price for other payment options.

For this reform to work properly it would make more sense (conceptually if not practicably) to require that if a merchant surcharges any payment option, it must differentially price for all payment options that account for some (say 90%) of payment transaction volume, with the understanding that there might be surcharges on some payment options and "discounts" on others. It is possible that the problem lies not with the merchants but with their acquirers to blend interchange rates when determining pricing for merchants. For example, a number of merchants do not distinguish between scheme credit and scheme debit when surcharging notwithstanding the significant difference between interchange rates.

Within this context, ASL's members have reviewed the three options in the recent consultation document and have provided their following views:

2. OPTION 1: RETAINING THE STATUS QUO

Comments on Option 1:

- This option provides a known and relatively stable business environment
- It removes the exemption for cash-outs from the EFTPOS standard such that all EFTPOS transactions would be subject to interchange fees as specified as part of the reforms
- Costs to implement this option would be minimal for the industry
- The biggest negative is that it perpetuates the existing inconsistencies that apply to EFTPOS interchange fees, both directionally (i.e. currently passing from issuer to acquirer) as well as the cost methodology (acquirer costs rather issuer costs), and would therefore continue to undermine the EFTPOS system as a viable competitor to both scheme debit and credit cards, which restrains both investment and innovation
- Under this option, there is no logical basis for the differential between EFTPOS and scheme debit interchange.

The removal of the requirement for cost studies every three years will, for the industry at least, be a welcome cost saving but does not justify the failure to put in place a robust, objective approach for the determination of interchange fees

3. **OPTION 2: REDUCING INTERCHANGE FEES FURTHER**

The directional change proposed with EFTPOS interchange fees (i.e. from issuer to acquirer currently to acquirer to issuer under Option 2) makes EFTPOS interchange more conceptually consistent with scheme debit and credit cards domestically, and also with PIN debit schemes throughout the rest of the world.

The major drawback of Option 2 is that it moves away from the current objective, cost based approach to interchange (albeit inconsistently applied across products) to an environment where there is no methodology other than the opinion of the RBA. In a market driven economy this does not make sense.

The building societies believe that a cost-based approach to establishing interchange fees consistently applied across all card systems, would further underpin the efficiency of the payments system and contribute to enhanced transparency and confidence for all stakeholders. As already evidenced with the reduction in the benchmark for credit cards between 2003 and 2006, such an approach could be expected to reflect efficiencies gained over time from normal market forces such as larger transaction volumes and declining technology costs.

A uniform and transparent approach to interchange fee determination would also lead to a stable business environment where investment and innovation decisions can be made with greater confidence. This is particularly pertinent to smaller issuers who do not enjoy the opportunities of scale of the large issuers/acquirers and merchants, and therefore require more environmental stability before committing to substantial investments in new products and services.

With no framework in place to estimate the proposed interchange fees it is difficult to conclusively state they are at inappropriate levels. However, the setting of the same interchange fee for EFTPOS and scheme debit suggests that the assumption made is their cost structure and benefits are similar, which is unlikely.

Likewise there is no basis provided for setting the credit card interchange fee at 30 bps.

If the objective is focused on the difference between interchange fees for debit and credit then it's not clear why the points selected are \$0.05 / 30 bps as opposed to say \$0.10 / 40 bps or some other similar difference.

Similarly it is not clear why scheme debit is decreased to \$0.05 rather than setting EFTPOS at \$0.12 and setting credit card interchange correspondingly.

The RBA has just completed a robust cost study. It would seem the Bank could aggregate the information from that to indicate why the proposed relative interchange fees levels are fair and equitable for Issuers, Acquirers, and Merchants (compared to the current fee levels) and also illustrate why the absolute levels are better than some other levels.

From the purely commercial perspective of the building societies as large net issuers of card-based payment options, the proposed change in the EFTPOS interchange fee is beneficial. The reduction in the scheme debit interchange fee is not. The net impact will vary from member to member.

While not preferring this option, if this option is implemented members believe that the interchange fees should be set at 11 or 12 cents per transaction for both EFTPOS and scheme debit, flowing from acquirer to issuer, and not less than 45 basis points for credit cards.

4. OPTION 3: REMOVING EXPLICIT INTERCHANGE REGULATION

Comments on Option 3:

- This option seeks to remove interchange fee regulation, but this is conditional upon the industry promoting EFTPOS as a major competitor with the international card schemes
- For this option to be accepted by the Payment Systems Board, a number of “conditions” would have to be met:
 - the EFTPOS system will have to address issues regarding governance and structure, specifically the replacement of bilateral arrangements, effective scheme promotion, reform of access arrangements, and the development of alternative on-line payment instruments
 - Tangible progress towards stronger competition would need to be evident
 - Other changes would be required including further relaxing the honour-all-cards rule such that merchants will be able to make independent decisions regarding each card type they will accept; greater transparency of scheme fees and average interchange fees; and greater transparency regarding fees and procedures that would be applied if a merchant bypasses scheme switches
 - If these conditions were not met (and continued over time) regulation would be re-introduced in line with either Option 1 or Option 2
- While this option entails some risk (that of making the investment of time and other resources to meet the conditions; lack of clear objectives that must be reached and maintained) it provides a “carrot” in terms of letting the industry self-regulate interchange fees
- There is also a risk to the building societies, being small financial institutions, that they won’t be able to impact the probability of a successful outcome

- ASL believes that it would be more difficult under this option to achieve the appropriate direction for EFTPOS interchange (from acquirer to issuer) and bring it into line with the other card schemes. Merchant resistance to such a move may be too great, resulting in a stifling of competition from small issuers in the payments system.
- Self-regulation of interchange would be likely to entail all EFTPOS transactions incurring the same interchange fee, a result that might meet with merchant resistance without the support of the Reserve Bank.
- Pursuing this option would more strongly appeal to the building societies if there was some assurance or acknowledgement that smaller financial institutions would have appropriate representation in the process. Further, whatever industry gains were made in terms of payment innovation, smaller financial institutions would not be unjustly excluded from reaping the rewards of their effort and investment.
- The aspect of this option that is least appealing (and appears unnecessary) relates to the relaxing of the honour-all-cards rule. As indicated above, the issues involved in this are best resolved through a clear, logical surcharge regime, leaving the decision in the hands of the consumer, where it belongs.

5. CONCLUSION

It is apparent that none of the options present a way forward that addresses all the primary issues raised by the building societies over the past eight years and that remain unresolved. However, given the options as presented, and with the trust that the Reserve Bank and Payments System Board will carefully consider the issues raised with each one, the order preference of the building societies are first – Option3; second – Option 2; and third – Option 1.

We would be pleased to meet to discuss these views in more detail.