FORUMS

The afternoon sessions were structured as a pair of open forums, moderated by Professor Ian Harper. Prior to the conference, Professor Harper wrote to all participants asking for their views on the topics to be covered in the forums. On the basis of the feedback received, it was decided to devote the first forum to a discussion of interchange fees and the second to access and innovation. A number of participants were asked to provide introductory remarks for each topic.

FORUM I – INTERCHANGE FEES

Introductory Speakers

1. Leigh Clapham[1]

Evidence demonstrates that five years after the Reserve Bank of Australia (RBA) regulated the payments industry, the RBA's objectives to improve efficiencies remain largely unachieved.

In fact, evidence submitted by MasterCard to the RBA's Review of payments system regulations shows that, far from reducing costs to consumers, the combination of increased annual fees, reduced benefits and the increased prevalence of surcharging at the point of sale actually means cardholders have been disadvantaged. The unintended impacts of the RBA's regulation simply underline the fact that strong competition is superior to direct price regulation.

MasterCard believes that the RBA should focus on facilitating workable competition between payment systems instead of enforcing draconian and *ad hoc* price regulation.

In relation specifically to interchange – a complex balance with numerous issues impacting the way the market establishes the rate – it is clear that any artificial, academic manipulation of those market forces will always result in a skewed system. This is best evidenced by the fact that the regulations have now placed American Express in a position of competitive advantage.

MasterCard believes strongly in vibrant and robust competition which operates on a level playing field. In our full submission MasterCard highlighted evidence that shows that the existence of payment cards, and credit cards in particular, provides tangible benefits to an economy. Benefits the regulator has so far failed to consider. For example, the value to merchants of accepting credit cards is particularly important to them in terms of sales promotion and competitive success.

1 *Executive Vice President – Australasia, MasterCard Worldwide.*

Two types of shopping behaviours are targeted by merchants in their marketing and sales efforts: (a) impulse spending which is defined as spending decisions made on the spot and not part of a planned purchase; and (b) optimistic spending defined as spending above planned purchases.

A 2007 survey by MasterCard of shoppers' impulse and optimistic spending behaviours across five cities (Sydney, Hong Kong, Singapore, Manila and Taipei) showed that both types of spending are positively correlated with credit card usage. In short, it demonstrated that credit card acceptance is critical to helping merchants increase sales and therefore adding value to merchants over and above simply being a convenient payment instrument.

Previous independent research has also shown that the presence of payment tools such as cards builds economies.

The RBA has described itself as a 'reluctant regulator' in this area. If that is truly the case, then now is the moment for the RBA to support the industry's calls to move toward a model of self-regulation which is in the broader interests of consumers and an effective, efficient market economy.

Cards – more than just a payment tool

It is fair to say that every industry and organisation involved in this process approaches the discussion of regulatory intervention with a fair amount of emotion. Regulation – by its very nature – provokes some sort of response from all parties.

From a business perspective, there is no question that the RBA's intervention in introducing a regulatory regime has damaged MasterCard's business, as has been demonstrated by the declining growth rates in payment card usage, and that of our issuing and acquiring customers.

To that end, MasterCard has invested considerable time and resources – both using our own internal, global experts and making use of outside, independent analysts – to investigate the specific impact of regulation.

Consumers have suffered

What we found reinforced our view that consumers have suffered. Five years after the regulatory intervention by the Reserve Bank – which had the specific goal of enhancing competition, improving efficiency, and benefiting consumers – available evidence suggests that the Bank's objectives have been largely unachieved. Overall, the payments market has not been made more competitive or efficient and Australian consumers are now saddled with higher costs as issuers increased annual fees and reduced benefits to compensate for the RBA-mandated reduction in interchange fees.

The detailed written submission MasterCard made to the RBA's Payments System Review describes the impacts of the regulations as supported by evidence in the Australian marketplace. Some of the intended and unintended ramifications of the regulations have included:

- higher cardholder fees and interest rates, with reduced features and benefits;
- a reduction in average merchant fees of more than 0.60 per cent since the introduction of the regulations equating to approximately A$1 billion per annum;

- no evidence of reduced consumer prices to reflect the reduced merchant cost;
- a widening in the gap between the average merchant fees of the regulated and unregulated schemes;
- a competitive advantage derived by the unregulated three-party schemes, as evidenced by growth in the collective market shares of American Express and Diners Club;
- the interchange regulations disadvantaging one regulated scheme against the other regulated scheme, simply due to the differential make-up of each scheme's portfolio;
- the surcharging of credit card transactions by merchants across all retail and non-retail segments (with some examples of price-gouging);
- no significant new entrants into the Australian market since the introduction of the regulations in 2003; and
- reduced investment and innovation in payment products (e.g. significant delay in the introduction of chip/PIN cards).

Competition versus regulation

The experience of the past five years has merely served to reinforce the general presumption that competition is superior to direct regulation in achieving efficient outcomes. MasterCard considers that regulators should therefore focus on facilitating workable competition between payment systems rather than directly regulating interchange fees.

Such an approach by the Bank would be entirely consistent with the evidence from Australia and Europe that a merchant's ability to discourage card usage through such means as offering cash discounts, steering and surcharging means that the merchant community has the ability to effectively constrain interchange fees. Indeed, we see regular evidence of merchant behaviour discouraging card usage to the point where it is clear the balance of power lies increasingly with the merchant. Through the various tools at their disposal (including surcharging), they are well equipped to make a decision as to which payment mechanism they accept without actually blocking card acceptance.

While MasterCard believes surcharging is not consumer friendly, in the spirit of achieving a mutually acceptable outcome we believe that the merchant's ability to impose a surcharge, or just as importantly, the ability to threaten the imposition of a surcharge, is preferable (along with the various other tools available to merchants) to continuing on with what can only be described as a draconian measure of regulating price through interchange.

So, while we have seen evidence of merchant segments taking up their option to reduce card acceptance where they feel it benefits them for strategic, competitive reasons (for example acceptance of pre-paid) we also see some segments – including online retailers – rapidly growing card acceptance. Cards – and the ability to accept payments remotely – have spurred a whole new economy. Without the flexibility of card payments, there is every reason to believe that online retailers would not exist. And there remain many other retail segments where card penetration is growing rapidly – such as utilities and government payments.

It should be noted that the Australian payments landscape (and the Australian economy with it) has changed significantly over the last five years. As mentioned above, online payments have grown exponentially, as has the power of the retailer. Whether these changes can be directly attributed to the regulations is debatable, but what is clear is that this has been an historic period of substantial change. One could argue that the Australian payments system has matured and is now a lot more sophisticated than it was as recently as five years ago.

These changes are reflected in the manner in which the four-party card schemes now set interchange fees. Five years ago banks set the fees and there were only three interchange categories in operation for domestic transactions. Indeed, as has been previously documented, the schemes had the same interchange categories and the same level of fees. Today, the schemes (MasterCard and Visa) set the fees and have well over a dozen interchange categories each. The categories are not only split by transaction type, but also by product and merchant category. Some merchants have forced down their effective interchange fee to 0.30 per cent, while other merchants are prepared to pay more than double that rate. This reflects that many merchants do heavily influence the level of interchange fees, while for some other merchants it is not an important consideration in the running of their business: further evidence – if it were needed – that merchants are in as strong a position as they have ever been to make decisions as to what mechanism they choose to accept payment.

And the payments landscape in Australia still has a long way to go in its development. Many merchant segments continue to have no or very low levels of card acceptance. Urban transit systems and taxation agencies are only two examples of merchants which do not accept card payments in Australia, but enthusiastically accept cards as a cost reduction tool in other markets. Australian merchants have proven that card acceptance is an option, and not an involuntary requirement of business. They have also proven that the cost of card acceptance is not the main determinant of their decision to accept cards, but a whole range of factors inform their decisions in this regard. That example is underlined with numerous examples of countries with relatively high interchange in comparison to Australia that also have deep and strong card acceptance including, among others, Spain, Japan and Hong Kong.

MasterCard's approach

Considering the above, MasterCard has looked at this debate through the consumer's eyes – the well over 90 per cent of Australians above the age of 18 who carry and use some sort of payment card. We wanted to know how regulation has affected them. Has it changed costs? Do they think they are more or less convenient or efficient? How has it changed how they use their cards?

For the record, and in the interest of full and frank disclosure, MasterCard approaches today with the belief that – as indicated by independent research – regulatory intervention has demonstrably hurt consumers. But in the spirit of co-operation and in an attempt to reach an outcome that is acceptable to the majority of players, MasterCard has been prepared to agree to a middle ground solution.

As has been discussed above, MasterCard believes it is now clear that merchants do have and do exercise significant power when it comes to the determination of merchant fees. To this end, MasterCard has expressed to the Reserve Bank its willingness to agree to a model of co-regulation whereby the market re-assumes control for the setting of interchange fees, with the retention of regulations relating to surcharging and the 'honour all cards' rule. It should be noted, however, that MasterCard does believe that further protections need to be enshrined in Australian law or regulations which protect consumers from excessive surcharging.

MasterCard is open-minded to the call by other industry participants for the replacement of the interchange regulations with a set of agreed principles. Obviously MasterCard cannot commit to such an arrangement until it becomes privy to the details, and would want assurance that such an arrangement does not create the opportunity for prosecution under competition law, whether it be by the ACCC or a private litigant.

Finally, MasterCard would point out that if the Bank is genuinely serious about promoting competition in the payments market in Australia, then all payment vehicles should be put on the same footing for consideration; which would include not only four-party schemes, but three-party schemes, two-party payment cards, as well as cash and cheques. While MasterCard has some serious reservations about the cost research undertaken by the Bank and discussed in detail today, we do note that payment cards when compared to most other payment instruments deliver higher average transaction sizes, and are cheaper to merchants as a proportion of the transaction size than most other forms of payment. The research demonstrates that payment cards deliver significant advantages to merchants – even when understated in the manner done in this research.

From this perspective, the key consideration should not be the prices at which each of these vehicles are available to the market, but the values delivered to the end users (the consumers) by these competing payment vehicles. Only consumers and merchants, moreover, are in a position to decide what value is being delivered to them. More often than not consumers' perceptions of such value are highly sensitive to where and when they need to make a payment, and for what purposes. No regulatory authority can hope to understand what the needs of millions of consumers may be at any given time and how their needs may change over any period. Only the consumers themselves know, and hence only they are in a position to decide what values are being delivered to them by each product or service.

This is no different from the pricing of two similar personal fashion accessories, one with a designer brand and the other without. Their costs of production may be similar; and yet consumers perceive vastly different values between them, and consequently are willing to pay a much higher price for the former than for the latter.

Focusing exclusively on interchange is equivalent to a government regulatory authority aiming to regulate the pricing of personal fashion accessories and deciding that the branded goods should be priced the same as the unbranded if their production costs are similar – an absurd conclusion. Such a stance is also against the broader interests of consumers and an effective market economy.

2. Paul Rickard[2]

The Commonwealth Bank appreciates the opportunity to offer these introductory comments on interchange fees at the Reserve Bank of Australia's (RBA's) Payments System Review Conference.

2 *Executive General Manager, Premium Business Services, Commonwealth Bank of Australia.*

Our recent submission to the Reserve Bank made the following key points in relation to interchange fees:

- Interchange fees should be transparent, simple, and relatively stable;
- Interchange fees may change over time to maintain or further develop a market;
- Direct pricing in end-markets is a key complement to interchange fees;
- Network owners and participants should be able to self-manage, with transparency in approach and review;
- While costs are an important consideration, a focus only on costs for setting interchange fees is an unduly narrow approach; and
- Regulatory intervention should only occur when there has been a demonstrated, or there is a perceived risk of, market failure.

The introductory comments presented below discuss these, and related, issues. In addressing the suggested scope for these comments and questions posed by Professor Harper, we offer the opinion that the opportunity now exists for the Reserve Bank to step back from regulation of interchange fees in favour of a principles-based approach to self-regulation.

The role for interchange fees

Interchange fees play an important role in developing, maintaining, operating and enhancing many networks, including payment systems. That role can go beyond the role of 'encourag[ing] the growth of payment networks by redistributing revenues between participants to induce them to join'.[3] Interchange fees also provide an effective mechanism to maximise the benefit to each group of customers in many two-sided markets.

There may be some markets where zero interchange is the right answer. This is not the case for credit cards, nor for many other payment systems. To arbitrarily set interchange fees at zero for all payment systems would be to ignore a useful tool for facilitating efficient use of resources to meet the needs of business and personal consumers.

Interchange fees should be *simple* and *relatively stable* over time. They can (but may not need to) change over time to maintain/further develop a network or in response to competitive pressures in light of changes to the market.

Questions for discussion

In suggesting the scope of the discussion regarding interchange fees, Professor Harper reported that he's received feedback which suggested 'particular interest in a number of issues relevant to interchange fees, including:

1. whether changes such as removal of the no-surcharge rule and honour-all-cards rule have themselves adequately addressed concerns about competition;
2. the prospects of self-regulation of interchange fees; and
3. to the extent that competitive issues remain how should they be addressed?'

3 *'Debit and Credit Card Schemes in Australia', RBA and ACCC Joint Study, October 2000.*

I will return to those issues shortly, but to help set the context for those questions, it is worth recalling the reasons behind the current regulatory regime, as stated by the Payments System Board at the time of their decision to designate card systems. The Board's concerns were set out in the Payments System Board's Media Release of 12 April 2001, quoting from the previous RBA/ACCC Joint Study:

A. 'interchange fees are not reviewed regularly by system members on the basis of any formal methodologies;

B. interchange fees are higher than can be justified by costs, and system members lack clear incentives to bring these fees into line with costs;

C. price signals are encouraging the growth of credit card usage at the expense of other payment instruments, particularly debit cards and direct debits, that consume fewer resources; and

D. restrictions by credit card systems on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed'.

If these concerns were the reason for the Payments System Board imposing regulation of interchange fees, the corollary is that interchange regulation is no longer required once these concerns have been resolved. I will address these concerns in order.

A. Regular reviews

The first concern is perhaps the easiest to address, because it can be entirely within the control of the industry, or of each scheme or payment system operator. If it was true that interchange fee regulation was required because of the lack of regular review based on formal methodologies, then that reason for regulation is removed once the relevant scheme or payment system operator commits to regular reviews on the basis of formal methodologies.

B. Costs

The second concern was that interchange fees were higher than can be justified by costs, and system members lacked clear incentives to bring these fees into line with costs. We should be very clear about what it means for interchange fees to be justified on the basis of costs. To focus *solely* on costs as the basis for interchange is too narrow.

Cost is certainly one necessary factor to consider, but other factors are also very important. These include the competitive environment (payment systems should compete with each other) and the provision of incentives to participants for innovation. The latter is critical if the industry is going to evolve and meet the needs of end-users. Restricting interchange to cost alone would impede the ability of the payment system to respond to competitive pressures and to provide important incentives to participants.

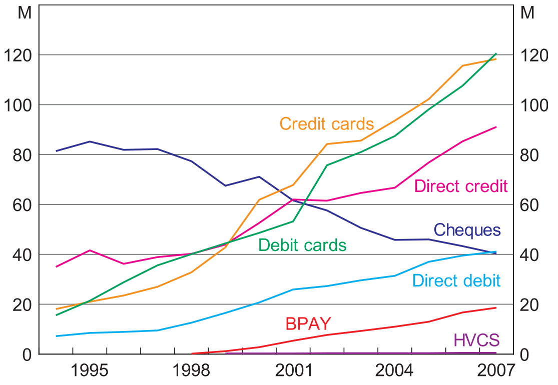
C. Pricing signals and the growth of credit card transactions

The third concern was that inappropriate price signals were encouraging the disproportionate growth of credit cards. To evaluate the current state of that concern we need to consider the current growth of EFTPOS and credit card transactions, changes to the pricing of EFTPOS and credit cards, and the effect of changes to the no-surcharge rule and the honour all cards rule.

Graph 1

Payment Volumes

May each year



Sources: APCA; RBA

Credit card transactions are no longer growing faster than debit transactions

Data published by the RBA and APCA (which admittedly includes scheme debit with EFTPOS) show that debit transactions have grown faster than credit transactions (Graph 1). Our own merchant acquiring data indicate that EFTPOS growth (i.e. with scheme debit transactions excluded) is higher than the growth of credit card transactions, by a significant multiple. These data indicate that the growth of credit card transactions is not disproportionate.

Changes to the consumer price for EFTPOS and credit cards

Since the reforms commenced, financial institutions have made substantial changes to the pricing of transaction accounts with EFTPOS capability, to effectively eliminate discrete fees associated with EFTPOS transactions. This, along with devalued loyalty schemes for the use of credit cards, has resulted in the cost of an EFTPOS transaction and a credit card transaction being now much more closely aligned than when the reforms commenced.

While some institutions have acknowledged that those transaction account fee structures were introduced in the expectation of zero EFTPOS interchange, other institutions adopted fixed price accounts well after the current EFTPOS Interchange Standard had been set, and did so in response to strong forces of competition.

Surcharging and the honour all cards rule

Since the abolition of the no-surcharge rule and the honour all cards rule, merchants now have complete freedom to determine which cards they will accept, and the price to the consumer at which the merchant will accept each type of card. While many merchants do not surcharge, data presented by the RBA Issues Paper in May this year show a substantial minority of merchants do surcharge, and the number is growing rapidly. There are even examples of merchants charging prices well above the cost of their merchant service fees. In addition to those that explicitly surcharge, many others achieve the same effective result by offering discounts for alternative payment methods such as cash.

By choosing the amount to surcharge, at zero or otherwise, and by alternative pricing signals which achieve the same result, merchants now play an important part in determining the end consumer price of alternative transaction methods. If a large proportion of merchants choose not to surcharge, then clearly the benefit of accepting the cards and absorbing the merchant service fees is of greater value to the merchant than refusing the cards.

Each of the developments described above has modified the pricing signals to customers, diminishing the extent to which credit card transactions are encouraged in preference to debit transactions. Altered pricing signals have changed the relative rates of growth of credit card and EFTPOS transactions. For each of these reasons, the previous concern that pricing signals were encouraging the growth of credit card usage at the expense of debit transactions is no longer relevant. We maintain that the current arrangements which prevent previous restrictions around surcharging and honouring all cards are sufficient, and that ongoing restrictions on wholesale pricing or interchange fees are unnecessary.

D. Access

Of the four concerns quoted, the first three are core to the question of whether interchange regulation is still required. The fourth issue of 'access' will be discussed separately at this conference. For the purposes of this discussion it is sufficient to note that former restrictions on access have been removed, or could be removed if any remain.

Having addressed the original concerns cited by the Payments System Board as its reasons for regulating, I return now to the three questions posed by Professor Harper.

1. Have changes such as removal of the no-surcharge rule and honour all cards rule themselves adequately addressed concerns about competition?

The abolition of those two rules has definitely addressed the issue of pricing signals to end-consumers, but other developments described above have also helped. Most importantly, if interchange fees were deregulated and rose, then the mechanism now exists through which a future pricing change could be immediately passed on to consumers. The existence of that mechanism means that competitive forces do, and will continue to, apply downward pressure on interchange fees.

It also follows from this that there is no fixed 'correct' level of surcharging in the market. As in any multiple-variable equilibrium system, the number of merchants who surcharge will rise and fall over time in response to changes to other variables. If interchange fees are relatively low, then the level of surcharging should be expected to be low too. It is important that the public policy objective should be to achieve the *ability* of merchants to surcharge, as the Reserve Bank has already done, and not to achieve any specific *level* of surcharging.

2. What are the prospects for self-regulation of interchange fees?

Perhaps an unintended consequence of the current arrangements, whereby the RBA has set a limit on the weighted average interchange fee, and the schemes have determined individual category interchange fees, is that it fails the key tests of being simple, transparent and stable. While the myriad of individual interchange fees are transparent, the methodology being applied by the schemes to determine these fees is not transparent. Further, the frequency of change is providing uncertainty to participants, which is not conducive in an environment where participants face major investment decisions to upgrade and re-invest in their technology.

Noting the Reserve Bank's view of itself as a 'reluctant regulator', a self-regulatory arrangement which achieves the principles outlined above is clearly preferable to the current situation. Self-regulation exists now in the Australian market, and works well in the BPAY scheme.

In BPAY, interchange fees known as 'Capture Reimbursement Fees' are reviewed regularly on the basis of a formal methodology. The methodology includes costs as an important component. BPAY's Capture Reimbursement Fees have been thoroughly investigated by the ACCC and the Reserve Bank, and have withstood scrutiny. Interchange fees are now published by BPAY to achieve the Reserve Bank's objective of transparency.

Self-regulation is already working very well for BPAY, and could work equally well for any scheme or payment system.

3. To the extent that competitive issues remain, how should they be addressed?

The reforms to date, especially the removal of the no-surcharge rule and elements of the honour all cards rule, have effectively addressed the issues of competition which were previously identified by the Joint Study. The only issue remaining is that the design of interchange fees is now driven largely by imposed regulation rather than through transparent self-regulation. That issue should be addressed by each scheme or payment system individually demonstrating that it is capable of self-regulation of interchange fees.

The way forward

Moving to a lighter regulatory touch is the preferred way forward. The industry, including the RBA as regulator, now has this opportunity.

Work is already under way within APCA to explore ways in which a principles-based approach to industry self-regulation could be implemented, and we support that work. Alternatively, the card schemes could establish and publish a methodology for self-regulation of their own interchange fees, based on sound principles. They could also commit to have interchange fees reviewed regularly in line with their published methodologies, with reviews conducted in line with published time-frames, and by suitable independent experts.

This process should commence as soon as each scheme, payment system or industry body is ready, and does not require the whole industry to move at the pace of the slowest participant.

Conclusion

To sum up, I'd like to reiterate the following key points. Interchange is an important tool for achieving efficient outcomes in many payment systems. The removal of the no-surcharge rule and elements of the honour all cards rule has addressed important concerns regarding price signals to consumers, while other factors such as re-pricing of transaction accounts and credit cards have also resulted in closer alignment of consumer prices for credit card and debit transactions. Access issues will be addressed at another point in the conference, but access to issuing and acquiring markets has been liberalised.

The industry, or the operator of any card scheme or payment system, should now be able to establish a methodology for self-regulation of their own interchange fees, based on sound principles, and subject to review by an appropriately qualified independent expert. This process should commence as soon as any scheme or payment system is ready, and does not require the whole industry to move at the pace of the slowest participant.

3. Douglas Swansson[4]

Good afternoon. My name is Douglas Swansson. I am the Group Manager for Payment Services for the Coles Group. I would like to thank the Reserve Bank of Australia (RBA) for this opportunity to address you all today, and to be able to provide a retailer's perspective on payments reform and, more specifically, on the issue of interchange fees.

Let me start by saying that we fully support the underlying principles that have been at the heart of the RBA's reform agenda, namely transparency, efficiency and competition. These principles we believe are key to ensuring that we have a payments system that ensures low cost, efficient payment instruments thrive at the expense of less efficient ones.

Fundamentally this boils down to the issue of price signals and the relative pricing of payment instruments. Which brings me to today's topic of discussion – interchange fees.

Interchange fees have been the subject of much debate the world over; they have been the subject of litigation both here and overseas and have attracted the interest of central banks and competition authorities.

The reason is simple in our view. Interchange fees are a subsidy that distorts the pricing of payment instruments and in turn their usage and acceptance costs for merchants.

In our view interchange fees are an unnecessary distortion and lead to inefficiencies – or, as Alan Frankel has explained, '…exploit externalities rather than solve them'.

We support the Australian Merchant Payments Forum's (AMPF) position that there is no justification for interchange fees and that they should be abolished. I appreciate that this is not a position that we have always held, at least with respect to EFTPOS debit, and to be clear we would not support the removal of EFTPOS debit card interchange fees in isolation.

It is with an opportunity to reflect over the past few years, and with a view to the fundamental principles outlined in the RBA's May 2007 *Issues Paper,* that we have come to this position.

The key question for us is what justification do we have for interchange fees being used to subsidise one party's costs over another's. In relation to scheme cards why are issuers' costs for authorisation, processing, interest-free periods and fraud subsidised by merchants via an interchange fee?

These are not costs that merchants can influence or control and ultimately these costs are borne by all consumers not just the scheme cardholders as they are passed on in the pricing of goods and services.

We would argue that the principle of user pays should apply; otherwise it is difficult to see how consumers can be presented with clear pricing signals for these payment instruments.

4 *Group Manager, Payment Services, Coles Group.*

In our view looking forward, what is needed is a simple and transparent system where these hidden cross-subsidies are removed.

It is argued by some that card payment systems will not survive without interchange, that there is something inherently different about card payment systems from other payment instruments that have and continue to operate without the need of interchange fees.

Further it was claimed that the mandated reductions in credit card interchange fees introduced as part of the RBA's reforms in 2003 would lead to a 'death spiral'. Clearly this has not been our experience.

That said, the reduction of this cross-subsidy has obviously led to increased fees for credit cardholders, but this is exactly the point. A greater proportion of the costs of providing these payment instruments is now priced into the products that issuers offer to their customers.

It has also been argued that reduced interchange fees would hinder innovation; again this has not been our experience. We have seen, for example, significant developments in prepaid and gift cards, low interest rate credit card products, MasterCard scheme debit, contactless, PIN on credit, Triple-DES, near field communications, and chip cards.

I understand that the issue of innovation will be discussed in more detail later this afternoon.

Another issue relevant to interchange fees that has been raised is the question of whether changes such as the removal of the no-surcharge rule and the 'honour all cards' rule have themselves adequately addressed our concerns.

To be clear the no-surcharge rule and the honour all cards rule we believe were unjustified commercial restrictions on our business that restricted competition. We supported their removal and continue to do so.

As to whether these reforms alone are sufficient to address our concerns regarding interchange fees our answer is clearly no.

It is somewhat ironic that those who argued that the no-surcharge rule should not be removed, now offer it as a potential solution to the concerns we have expressed about interchange fees and their impact on pricing signals.

Whilst the adoption of surcharging has increased since the removal of the no-surcharge rule, it is by no means widespread and we believe there will always be barriers to its adoption by some merchants for a number of valid reasons, such as the costs to develop systems and processes to collect these surcharges and competitive pressures within the retailing industry.

But why should merchants be expected to address these hidden cross-subsidies – is this not a case of treating the symptoms not the cause? We feel that this is a distraction from the key issue, namely what is the justification for interchange fees in the first place.

To summarise then, we advocate a move to eliminate interchange fees to remove unnecessary and unjustified cross-subsidies. We support a continuation of the abolition of the no-surcharge rule and the honour all cards rule.

Overall we believe that the RBA's intervention on interchange fees has been beneficial to the Australian public and we urge that it continues moving forward with its reforms.

Thank you.

Discussion

The discussion in this session covered five broad themes. These were: the effects of the reforms; the rationale for interchange fees; the regulation of interchange fees; the no-surcharge and 'honour all cards' rules; and transparency.

Effects of the Payments System Reforms

There were divergent views on the effects of the Reserve Bank's reforms. There was some support for the view that the reforms have not achieved their objectives and have had unintended consequences. There was, however, also support for the view that the reforms have been broadly successful and, in fact, should go further.

There was some discussion of the widening gap between merchant service fees on American Express and Diners Club cards and those on MasterCard and Visa cards. It was argued that the three-party schemes have been given a competitive advantage over MasterCard and Visa. It was conceded, however, that the market share of the three-party schemes has risen only slightly since the reforms were introduced.

A number of participants commented that merchants now have greater bargaining power in negotiations with acquirers. This arises from their ability to impose surcharges on credit card payments, offer discounts for cash, 'steer' customers and threaten to reject some types of cards. One merchant commented that it no longer felt 'bullied' now that the Reserve Bank regulates interchange fees. It was also noted that the reforms provide merchants with more freedom to negotiate lower fees with American Express or impose surcharges on American Express transactions.

There was considerable debate about whether the regulation of interchange fees had discouraged innovation in the payments system. One view was that the implementation of chip technology had been delayed because of the reduction in interchange fees. An alternative view was that interchange fee regulation has not hindered innovation and examples such as the development of pre-paid and low-rate cards, and the move to PIN on credit cards were cited as evidence. Furthermore, it was noted that innovation has taken place overseas in the absence of interchange fees, including the development of electronic cheque presentment in the United States, and innovation in the Canadian debit network. The subject of innovation was also addressed in the second open forum.

Finally, there was some discussion about whether the access reforms had been successful in promoting competition. It was noted that there have been only a limited number of new entrants despite the Reserve Bank's access reforms. On the card issuing side, it was suggested that this is a result of interchange regulation decreasing the attractiveness of issuing cards. On the acquiring side, however, it was argued that the reforms have made it easier for new entrants. It was argued, for example, that the Reserve Bank's regulation of interchange fees has made it easier for pure acquirers to enter the market, since they not only enjoy lower interchange fees but also greater certainty.

Rationale for Interchange Fees

There was considerable discussion on the rationale for interchange fees with a broad range of views expressed. One view, mainly held by merchants, was that interchange fees are unnecessary and even detrimental to economic efficiency. It was suggested, for example, that interchange fees lead to a cross-subsidy from those who pay by cash to those who pay by card and that a user-pays system would be more appropriate. Others argued that interchange fees are necessary for the development, maintenance and operation of a payment system, and that they help fund innovation.

The user-pays argument was also used to *support* the view that interchange fees are a necessary feature of credit card systems. In particular, it was argued that the benefit to a merchant of a payment by credit card may be above that for payment by cash, since the availability of credit may allow additional or higher value purchases. It was suggested that the merchant should be prepared to pay for this benefit through an interchange fee levied by the issuer of the card. This suggestion met with resistance from merchants who questioned whether the benefits of the credit function accrue entirely to merchants.

Should Interchange Fees Be Regulated?

The discussion highlighted three broad perspectives on interchange fee regulation.

The first – held mainly by merchants – called for interchange fees to be abolished in all payment systems. The main argument for this position was that interchange fees create inefficient outcomes because they result in a deviation from a user-pays arrangement. It was noted that, consistent with this stance, merchants are no longer arguing in favour of interchange being paid to acquirers in the EFTPOS system.

The second perspective was that, if interchange fees are not abolished, they should continue to be regulated by the Reserve Bank. The basis for this view was that the card schemes and financial institutions will set interchange fees taking into account their own commercial interests, which will inevitably result in their being set higher than optimal – and possibly even higher than their levels prior to regulation. It was argued that the Reserve Bank is a neutral party that looks to the interests of all stakeholders in the payments system, and is therefore the most appropriate regulator of interchange fees. Furthermore, the Reserve Bank can be held accountable for its decisions through public reporting and consultations in a way that industry cannot.

The third perspective was that interchange fee regulation should be removed. There were a number of variations on this theme. One view was that there is no market failure and therefore no need for any regulation, including those removing restrictions on merchants. It was suggested that interchange fees set by card schemes in the absence of regulation would produce a superior outcome as card schemes would be able to compete more effectively with one another. This assertion was challenged, however, with some arguing that interchange fees would rise to at least their former levels if the Reserve Bank were to remove its regulations, and that this would not be an efficient outcome.

An alternative view acknowledged that the removal of restrictions on merchants has improved competition and argued that there is, therefore, no need to continue regulating interchange fees. It was also suggested that the Bank's focus going forward should be on promoting competition, including by removing further impediments to competition. In this context, it was argued that the formation of an EFTPOS scheme to coordinate business strategy for EFTPOS might provide some competition to the established schemes and hence some confidence that unregulated interchange fees would not rise too far.

The possibility of self-regulation was again raised. It was argued that experience in a number of industries, including telecommunications, suggests that in the long term cost-based regulation is ineffective and causes distortions. The BPAY Capture Reimbursement Fee was cited as a good example of interchange fees being set by the industry in a way that has satisfied public policy concerns. It was also recognised, however, that the industry has not yet provided a concrete proposal on self-regulation that would meet the Reserve Bank's public policy objectives for card payment systems.

No-surcharge and 'Honour All Cards' Rules

There was some discussion of the effect on merchant power of the removal of the no-surcharge rule. It was noted, for example, that surcharging enables merchants to price discriminate, gives them more bargaining power with respect to acquirers, and allows some merchants to have a lower advertised price for their goods than would have been possible without surcharging.

Some concern was expressed about these effects. One card scheme representative, for example, argued that surcharging is doing substantial damage to the scheme brand, particularly where merchants surcharge at a higher rate than their merchant service fee. A number of others supported the view that surcharging is often excessive and has been used by merchants in an opportunistic way, and called for the Reserve Bank to impose a cap on surcharges.

On the other hand, there was also substantial support for surcharging, particularly from merchants. It was argued that merchants should be entitled to impose a surcharge if they wish, just as they can, in principle, recover the costs of any other inputs by imposing a surcharge. It was suggested that excessive surcharging is not common and is an issue only in specific industries which are characterised by a lack of competition.

The discussion also highlighted concerns about the modification of the 'honour all cards' rule. It was argued that the ubiquity of card acceptance is a major driver of card use, and that further modification of the schemes' 'honour all cards' rules could lead to less acceptance, confusion among consumers and, therefore, greater use of less efficient payment methods, including cash. It was also suggested that further modifications to the 'honour all cards' rule would involve a very substantial effort in re-educating customers and would result in damage to scheme brands.

The merchants held a contrasting view. They questioned the basis for the rule, arguing that a merchant should not be obliged to accept all products from a scheme just because it wishes to accept one of them. It was argued that this is not the case for any other goods stocked by a retailer. Furthermore, it was noted that card schemes overseas promote each of their general cards (e.g. credit, debit, prepaid) as a separate brand, rather than promoting a single brand representing the entire scheme.

Finally, there was debate over whether the regulation of interchange fees is necessary now that surcharging is permitted and separate acceptance decisions are possible for scheme debit and credit cards. On this view, the removal of these restrictions has allowed competition to put downward pressure on interchange fees, removing the need for interchange regulation. There was support from some card schemes and financial institutions for retaining the no-surcharge and 'honour all cards' Standards if this meant that interchange fee regulations could be removed. It was noted that surcharging does not actually need to take place for the no-surcharge Standard to be effective – the threat of surcharging is enough.

The contrasting view was that the removal of the no-surcharge rule and modification of the 'honour all cards' rule have not been sufficient, by themselves, to improve competition. Merchants highlighted the difficulties of refusing to accept particular cards and of imposing surcharges. Nonetheless, the merchants remained supportive of the removal of those restrictions and some called for further modification of the 'honour all cards' rule. It was acknowledged, however, that the 'honour all issuers' aspect of the schemes' rules is important.

Transparency

The discussion of transparency focused on interchange fees and scheme fees. There was debate about whether the current process of setting interchange fees (under the Reserve Bank's Standards) is sufficiently simple and transparent. Some argued that it is, and questioned how the industry would determine interchange fees in a transparent manner if the Reserve Bank were to step back from regulation. Others argued that it is not, but the discussion did not clarify what methodology might be adopted in order to address this concern.

There was some discussion of the move by the credit card schemes to create a substantially expanded schedule of interchange categories. It was argued that this has resulted in more complexity and therefore less transparency in interchange fees. It was also suggested that this is a direct result of the Reserve Bank's cap on the weighted average of interchange fees combined with ongoing market pressure for higher interchange fees.

A number of financial institutions noted that interchange fees are still not fully transparent to merchants. It was argued that, apart from a small number of large merchants on interchange-plus contracts, merchants typically face one merchant service fee regardless of the transaction type. These merchants therefore do not face different price signals for different types of cards, and therefore have no incentive to discriminate between cards and impose competitive discipline on interchange fees.

Finally, there was some discussion of scheme fees. It was argued, particularly by merchants, that scheme fees are not disclosed and greater transparency is required. In particular, there was concern that card schemes could use scheme fees to circumvent interchange regulation in a way that would not be apparent unless scheme fees were transparent.