Submission to Reserve Bank of Australia's Review of Merchant Card Payments Costs and Surcharging - Block, Inc.

Thank you for the opportunity to provide a submission to the Reserve Bank of Australia's (RBA) Review of Merchant Card Payment Costs and Surcharging. Block, Inc. (ASX: SQ2) is a financial services and digital payments company that provides payment and software solutions to merchants through our brand Square, and buy now pay later services through our brand Afterpay.

Square's arrival in Australia in 2016 provided access to card payments to a whole new category of small and micro businesses. Many of these businesses had previously been underserved or entirely unserved by the incumbent banks which historically dominated the merchant acquiring market. Square's market entry has fundamentally expanded the total addressable market for digital payments and helped make the Payments Service Provider (PSP) sector the most competitive and diverse in the retail payments system.

A number of the reform ideas in the RBA's Issues Paper stand to make the payments system less competitive than it is today. If implemented, these proposals will leave small businesses worse off overall and reduce innovation and efficiency. The most concerning of which includes mandatory unblended pricing and a ban on debit surcharging, which will prevent small businesses from choosing their preferred simple pricing models for which they have demonstrated a clear preference.

In this submission, we have responded to the specific questions raised by the RBA. However, it is critically important that these questions are considered in light of an overarching threshold matter: will any proposed policy changes adversely impact the innovation, choice and competition generated by fintechs in the payment system? Consistent with this, our recommendations below are framed towards:

- Reducing costs and maintaining choice of payment providers for small businesses
- Promoting competition in the PSP/merchant acquiring market
- Encouraging competition in card issuing
- Increasing uptake of new forms of payments (including account-to-account)

In addition to this submission, we have also supplied independent research and survey data from Mandala Partners and The Initiatives Group which should be considered alongside our answers to the consultation questions.

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Interchange and card issuing

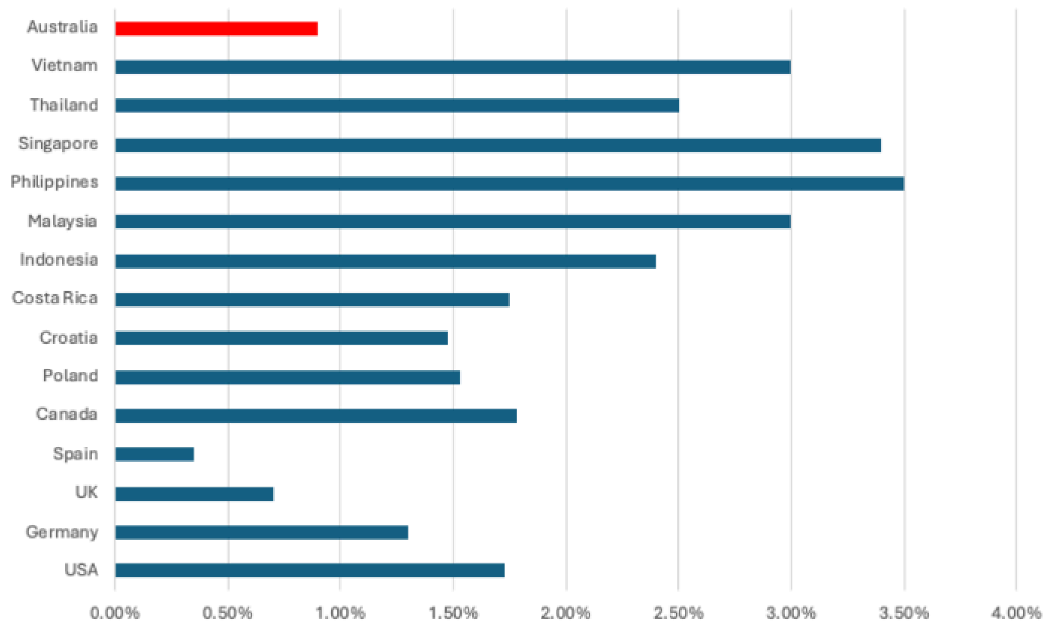
❖ ***Q1. Is there a case for lowering the level of interchange benchmarks or caps? Should the difference between the interchange fees paid by big and small businesses be limited in some way?***

Interchange rates in Australia are generally low compared to other markets

Merchant Service Fees (MSFs) in Australia are low by global standards. The Issues Paper notes that MSFs are comparatively low in Australia compared to the United States, but slightly higher than in a number of European countries.

An analysis of additional countries indicates that Australia's average credit MSFs are lower than those in Canada and Germany, as well as many countries in South East Asia and South America.[1] In order to interrogate the case for further lowering interchange rates in Australia, Block encourages the RBA to understand interchange levels for debit card payments when compared to the countries below.

Figure 1: Average credit card merchant service fee by country (The Initiatives Group, 2024)

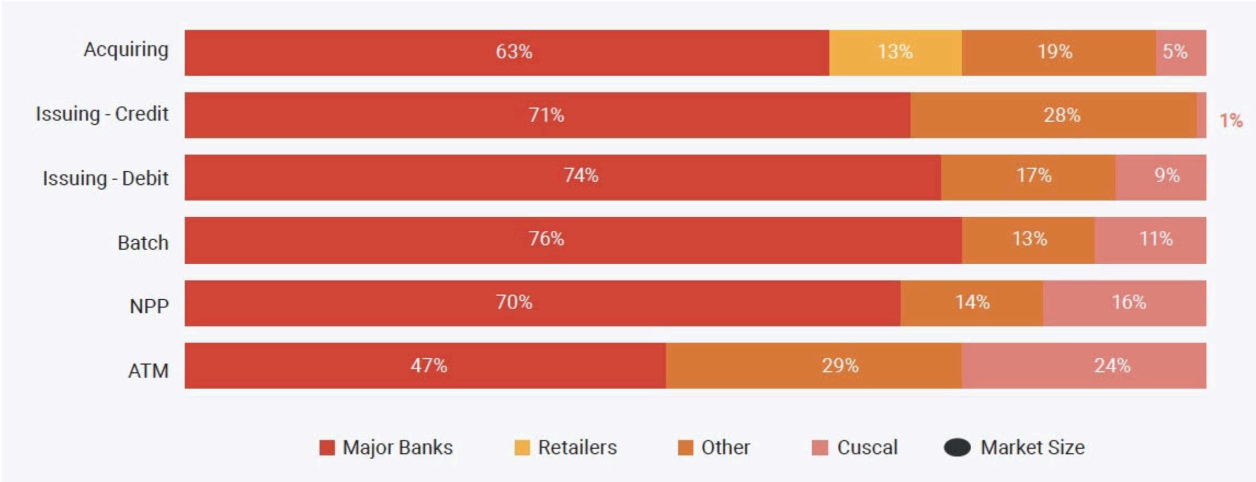


Differential interchange would increase the limited competition in Australia's card issuing market

Lowering interchange fees can result in a reduction in costs for merchants. However, unless changes are carefully targeted, this can reduce the already limited ability for small card issuers to compete sustainably in a market with comparatively low interchange rates. Should reforms not be appropriately calibrated, competition in card issuing would be reduced, leading to increased costs and reduced efficiency in payments. This should be of particular concern in Australia, where the card issuing market remains highly concentrated with limited new market entrants, as shown below.[2]

[1] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024
[2] Cuscal, ['Prospectus Initial Public Offering of Shares'](), 2024

Figure 2: Total Market Transaction Volume by Payment Type - FY24 (Cuscal, 2024)



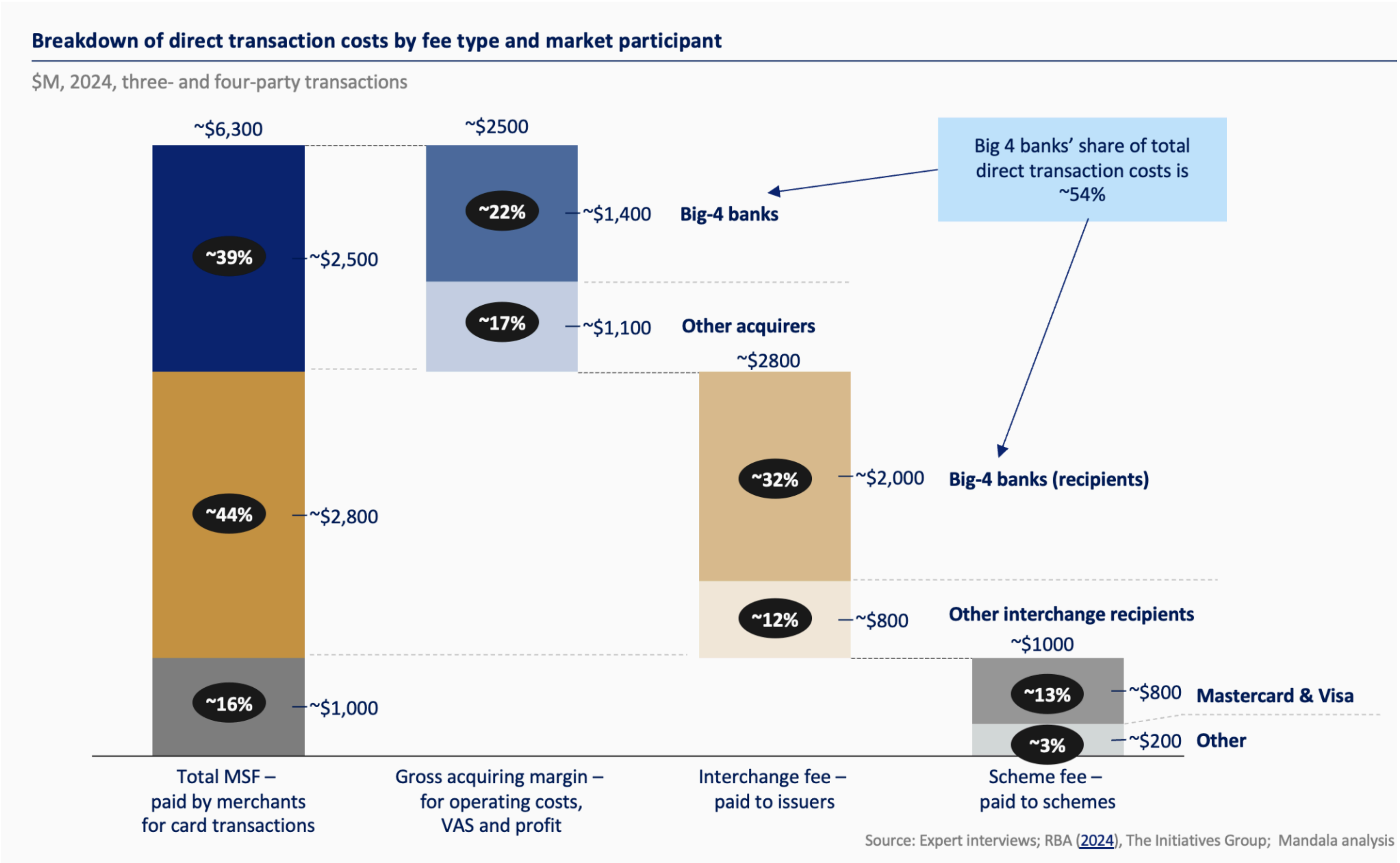
Smaller card issuers disproportionately rely on interchange to be commercially viable. Most smaller card issuers do not benefit from the major banks' economies of scale, with limited ability to cross-subsidise with other consumer offerings (such as deposit taking and lending products), or to avoid scheme fees by leveraging intra-bank transactions. This dynamic has created barriers to entry for new entrants, with the major banks estimated to hold around 73% of card payment interchange (see Figure 3 below)[3]. In this context, further reduction of interchange will hamper smaller card issuers' ability to compete.[4] The RBA should consider how policy settings can be tweaked to encourage smaller card issuers, potentially including targeted exemptions from proposed changes to interchange, forms of differential pricing or other incentives. Over time, increased competition among issuers directly benefits consumers, supports new entrants, and improves the overall efficiency of the payments system.

The RBA has acknowledged the need to support smaller issuers through Dual Network Debit Card (DNDC) rules. Under these rules, large issuers (representing over 85% of the market[5]) are required to issue DNDCs to support Least Cost Routing (LCR) enablement and drive competition among card schemes. However, smaller issuers are exempt, as Single Network Debit Cards (SNDC) are less resource-intensive, reduce operational costs, and provide a differentiated service which enhances competition with the major incumbents. This exemption creates greater competitive tension in card issuing, ultimately putting downward pressure on costs and improving customer outcomes. A similar approach could be applied to insulate small issuers from the impact of any reductions in interchange arising from the RBA's review. By leveraging the existing DNDC exemption threshold, small issuers could compete sustainably.

Recommendation 1: Exempt smaller issuers (i.e. those issuing SNDCs) from further interchange reductions, and explore other incentives for small issuers to increase competition.

[3] Mandala Partners, Report on Surcharging, Unit Economics and Competition, December 2024
[4] ibid.
[5] The Reserve Bank of Australia, 'The Australian Debit Card Market: Default Settings and Tokenisation Issues Paper', 2023.

Figure 3: Estimated breakdown of market share and revenue in issuing, acquiring and card schemes (Mandala, 2024)



Case study: United States debit interchange regulation and impact on small issuers (Durbin Amendment)

Since 2011, debit interchange has been regulated in the United States, under the 'Durbin Amendment' of the Dodd Frank Act,[6] aimed at driving competition, transparency and choice among issuers and networks. Notably, small issuers (those with assets under $10 billion) are 'exempt' from the interchange cap, as are three-party systems like Amex which directly link merchants and consumers (i.e. no explicit interchange fee paid to a customer's bank).

Evidence suggests that exempting small issuers has increased competition in the US card issuing market. From 2020 to 2021, growth in transaction volumes for exempt smaller issuers was 14.9% compared to 12.8% for larger issuers.[7] This has also spurred partnerships between fintechs and small issuers, fostering innovation and new services.

The ability to offer lower interchange specifically for smaller businesses should be considered

Implementing a differential interchange rate for smaller businesses could help reduce MSFs and go some way to leveling the playing field. As noted in the Issues Paper, smaller merchants often encounter higher interchange because they lack the bargaining power to negotiate such favourable rates. Solutions may include establishing lower interchange rates for small businesses, or introducing a cap on the difference in interchange charged between large and small businesses.

Recommendation 2: Explore differential interchange caps for small businesses or other means of reducing interchange spreads between small and large businesses.

- ***Q2. Should interchange regulation be extended to foreign card transactions in Australia?***

International Interchange fees are disproportionate and should be capped

International interchange rates are significantly higher (roughly 4.5x) than domestic rates, creating a significant disparity that can increase costs for businesses accepting international cards. While there are some additional costs with international transactions for schemes and issuers, this disparity warrants further scrutiny. Aligning international interchange rates more closely with domestic rates could help create a more level playing field, reduce costs for merchants, and encourage card acceptance, ultimately benefiting the economy and global customers. The European Union's regulation of international interchange presents a model for consideration.

Recommendation 3: Cap international interchange fees, looking to the European Union's approach for guidance.

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[6] Birnbaum, Robert, Hurh, Brian J., and Morgan, Robert, 'Federal Reserve Releases Final Rule to Implement the Durbin Amendment', 2011.

[7] Board of Governors of the Federal Reserve System, '2021 Interchange Fee Revenue, CoveredIssuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions', October 2023.

Card schemes and scheme fees

- ***Q6. What other regulatory action should the RBA consider to increase the competitive pressure on scheme fees?***

Simple and blended pricing models support competitive pressure between card schemes

PSPs offering simple pricing models like Square are incentivised to route transactions via the lowest cost network on behalf of every merchant and every transaction. PSPs can also have the ability to negotiate the establishment and delivery of programs with the schemes that deliver cost savings, which flow through to more competitive value propositions for merchants. This does not require any action on behalf of merchants, who benefit from reductions in PSP's wholesale costs in the form of lower MSFs and service improvements. (See our response to Question 8 for further details.)

Incentivising access to digital non-card payment methods is a key driver of reducing scheme fees

Card payments, particularly debit, comprise the vast majority of transactions in Australia. This trend has accelerated in recent years due to the decline in the use of cash.[8] In this context, the overall card scheme market will not face meaningful external competitive pressure in the foreseeable future. This inherently poses challenges to driving down scheme fees and overall scheme net compensation.

Increasing non-card digital transactions is an important and relatively untapped means of increasing external competitive pressure on card-based payments. While this may represent a small proportion of overall payments today, diversifying non-card digital payments has notable efficiency benefits for the payment system. The recent National Competition Policy Review indicated that greater uptake of account-to-account payments would reduce payment costs, resulting in an increase of up to 0.02% in real GDP (up to $445 million p.a.) and a reduction in consumer prices (CPI) of up to 0.06%.[9] It noted that expanding direct NPP access to non-Authorised Deposit-taking Institutions (non-ADIs) and implementing cost recovery pricing can further increase adoption, which should be considered alongside potential changes to surcharging rules (see our response to Questions 12/13 and 14/15).

Recommendation 4: Maintain access to simple and blended pricing models and incentivise uptake of non-card payment methods (including NPP direct access for non-ADI's and pricing, and potentially surcharging changes).

[8] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.
[9] The Productivity Commission, ['National Competition Policy: modelling proposed reforms'](), 2024.

Payment Service Providers and Least Cost Routing

- ***Q7. How do stakeholders assess the functioning and effectiveness to date of LCR for in-person transactions? Is further regulatory intervention needed? What might that look like?***

The current approach to Least Cost Routing is enhancing competition and efficiency of the card scheme market

Least Cost Routing (LCR) is in place for all Square merchants and increasingly for many PSPs.[10] This lowers cost inputs and increases competition between card schemes. As The Initiatives Group states:

“Large merchants (that can have staff devoted to payments) are actively choosing LCR, as they have a detailed understanding of the savings on offer that could be saved. Small merchants may be benefitting too, even though they may not explicitly choose LCR – as their PSP could be using LCR in the background, in order to reduce the overall fees that the merchant pays, particularly relevant where the merchant is paying a blended/bundled flat fee to accept cards.

PSPs offering a blended pricing model negotiate directly with the card schemes to route payments via the lowest cost rails. While this may not be evident to the merchant on a per transaction basis, In a competitive PSP market these savings can place downward pressure on Merchant Service Fees and support PSP service improvements This dynamic between PSP and schemes also supports the objectives of both LCR and surcharging policy by driving competitive tension in the card network market.”[11]

Every Square merchant is benefitting from LCR. Simple pricing is delivering on the objectives of LCR.

The Issues Paper asks whether the benefits of LCR are being passed on to merchants using simple pricing plans. As the RBA identifies, whether lower wholesale costs for PSPs from LCR are passed on to merchants on simple plans is dependent on the level of competition in the PSP market. As the PSP market is highly competitive and diversified, with fees reducing and services improving over time this is clearly the case (see Question 8 and 11). Evidence also indicates that PSPs with the highest LCR enablement are passing on these benefits to merchants through lower MSFs[12] demonstrating that LCR is functioning well and merchants are benefitting.

[10] The Reserve Bank of Australia, Update on availability and enablement of least-cost routing for merchants, June 2024
[11] The Initiatives Group, ‘The exchange of payment: the most critical part of a small merchant’s customer journey — a white paper on small and micro business payments acceptance’, 2024.
[12] Mandala Partners, Report on Surcharging, Unit Economics and Competition, December 2024

Figure 4: Least Cost Routing enablement by pricing plans (Mandala, 2024)

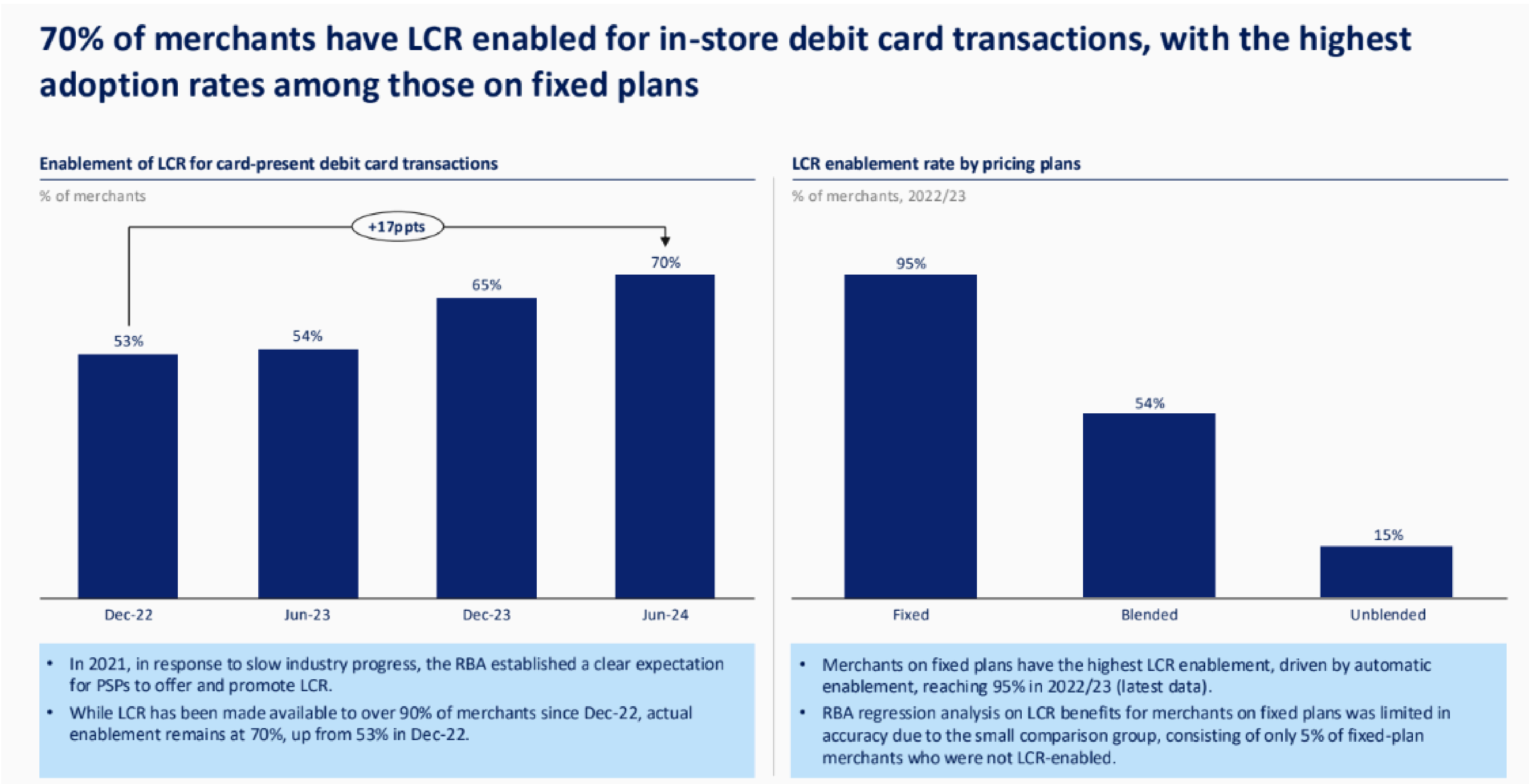
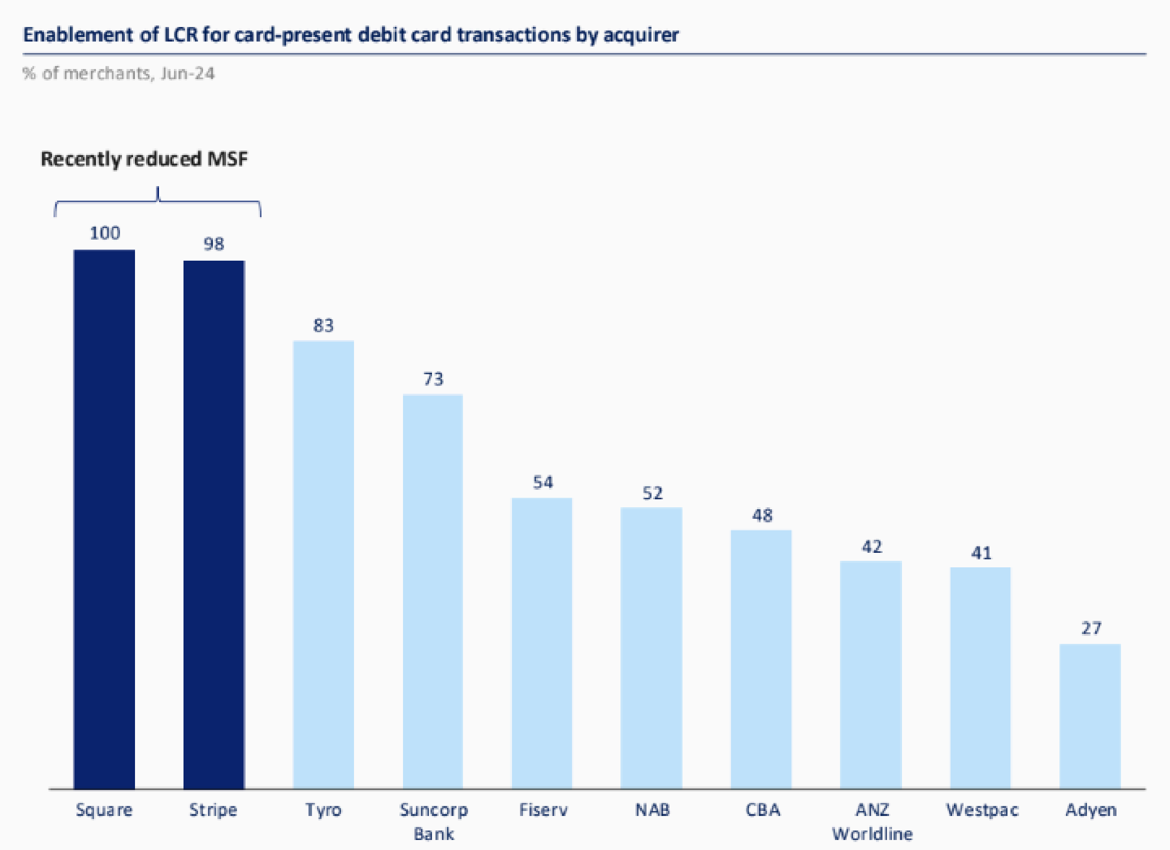


Figure 5: Least Cost Routing enablement by Payment Service Provider / merchant acquirer (Mandala, 2024)



Mandating Least Cost Routing availability is likely necessary to avoid further delays and should be prioritised ahead of interventions in competitive payments markets

Despite strong encouragement since 2017, the full roll out of LCR continues to be delayed. This is due in part to technical challenges and the adoption of new payment types (e.g. digital wallets), as well as many major traditional issuer-acquirers having little incentive to increase enablement. Until LCR is enabled for all card transactions (including online and in digital wallet transactions), introducing an LCR enablement mandate now appears to be appropriate. This should be prioritised before interventions are considered in the more competitive PSP market.

Recommendation 5: Mandate LCR for all PSPs before intervening in more competitive payments markets.

Recommendation 6: Maintain existing guidance that simple pricing plans are delivering on the objectives of LCR.

❖ ***Q8. Is there a case for greater transparency of fees, wholesale costs and market shares for some payment services? If so, what form should this take? What benefits or drawbacks might arise from implementing any of these measures?***

The PSP market is the most competitive and diverse in the retail payments landscape

Since Square's market entry in 2016, as well as entries by many other new providers, competition in Australia's PSP market has increased significantly. In the small business segment, this competition has been underpinned by simple and blended pricing plans that deliver maximum transparency and certainty to small businesses, allowing them to make informed decisions about which provider to choose.

Competition has only accelerated in recent years, with more providers driving improved services and reducing PSP margins.[13] The proportion of debit transactions where the card was issued and acquired by the same institution fell from 18% in 2016 to 6.4% today.[14] Between 2018 and 2024, the market share of the four major banks in the PSP market declined from 77% to 64%, making Australia's PSP market significantly less concentrated than those of the US, UK and Canada (see Figure 7).

Greater competition in the PSP market in the past 8 years has reduced MSFs and driven payments efficiency, even as scheme net compensation has remained stable or increased (Figure 6). At the same time, the level of "On Us" transactions (which do not incur scheme fees as the issuing and acquiring banks are the same) has declined (Figure 6). These changes indicate that PSP margins have compressed more than overall MSF reductions. Notably, the CEO of Australia's largest bank recently acknowledged that merchant acquiring is no longer a profitable business and is run at cost, implying cross-subsidisation from business banking products.[15]

Competition has driven significant service improvements, including improved fraud monitoring and management, "self-serve" payments dashboards with real time data, omni-channel payment capabilities, and advanced Point of Sale software. Innovations for small business include:

- Payment terminals supporting business management apps
- Smartphone-based contactless payments
- Industry-specific business software integrating payments with small business operations.[16]

[13] ibid.
[14] The Reserve Bank of Australia, Payments Data and Statistics, 2024
[15] Parliament of Australia Hansard, Matt Comyn's evidence to the House Economics Committee's Review into the Big 4 Banks, August 2024
[16] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.

Figure 6 (left): Proportion of debit card transactions with the same Issuer and Acquirer (Mandala, 2024)
Figure 7 (right): Issuer and Acquirer market share and Merchant Service Fee comparison (Mandala, 2024)

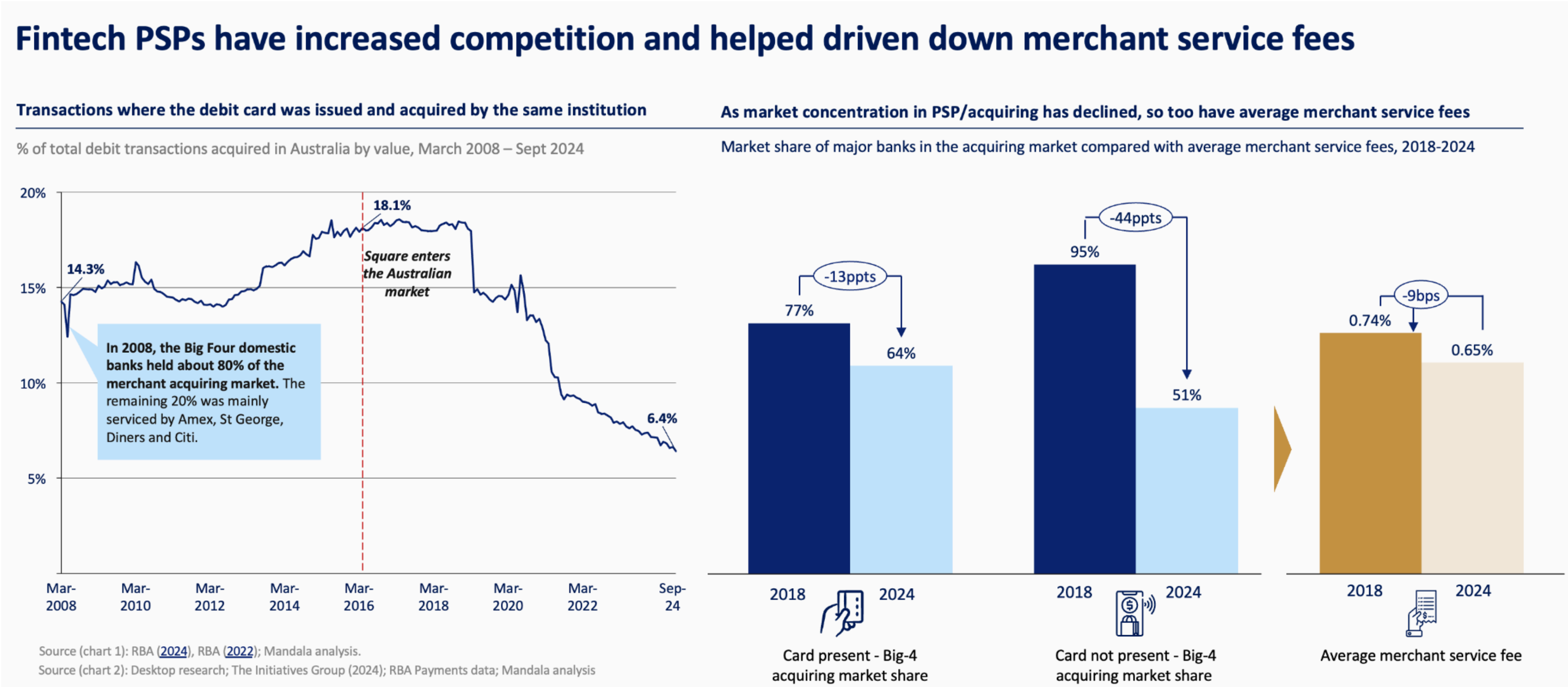
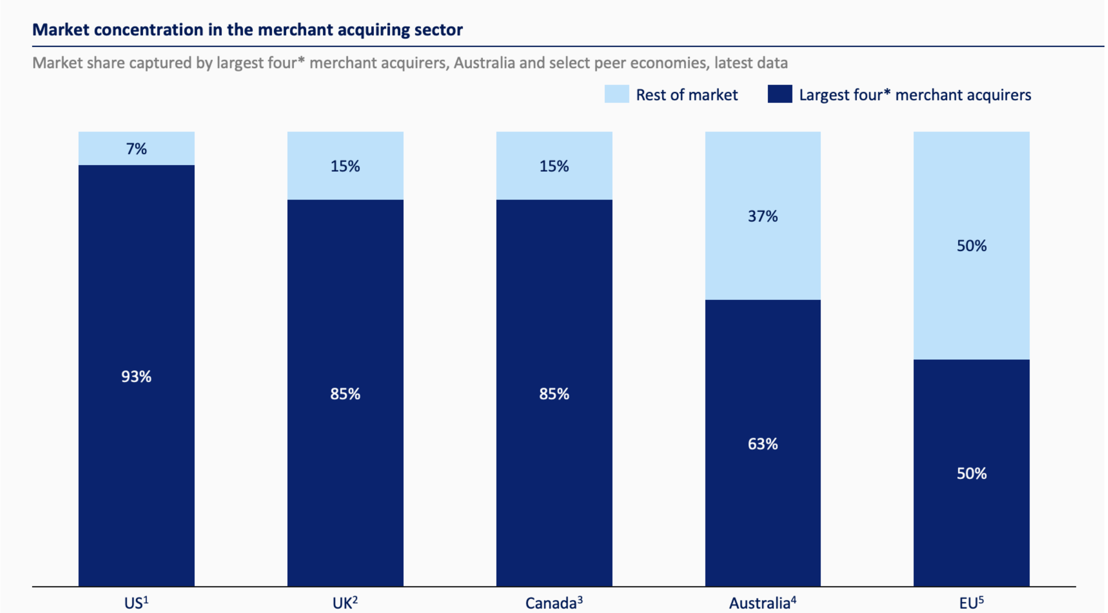


Figure 8: Global comparison of PSP / merchant acquiring market share (Mandala, 2024)



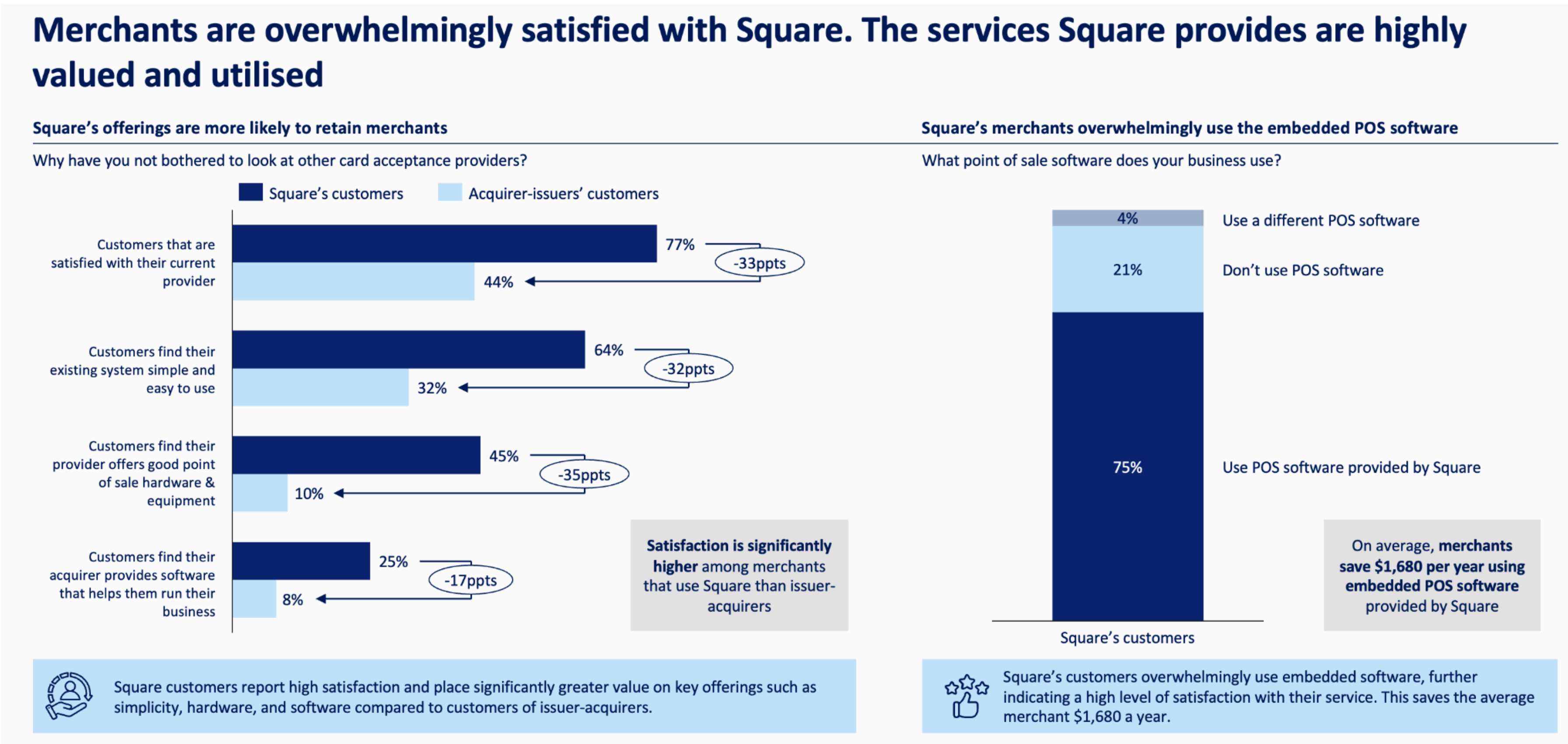
Notes and sources: * Data for Canada represents only largest two merchant acquirers. 1) Market share of four largest merchant acquirers by transaction value, 2023; 2) Market share of two largest merchant acquirers by transaction volume, 2024; 3) Market share of four largest merchant acquirers by transaction volume, 2020; 4) Market share of four largest merchant acquirers by transaction volume, 2024; 5) Market share of four largest merchant acquirers by transaction value, 2022; Mandala analysis.

Three quarters of merchants using Square use embedded software, saving up to an average of $1,680 p.a.

Small business merchants look to embedded software and simple products when judging the value of a PSP's offering. In a survey of Square merchants, over 75% chose to use the point-of-sale software provided, with 'easy set up and use' identified as the most valued aspect of the service.[17] Having access to these services saves the average small business from $400 to $1,680 a year on average compared to sourcing software from another provider.[18] This contributes to 77% of merchants reporting satisfaction with their PSP, compared to only 44% among those with traditional acquirer-issuers — historically the major banks which offered limited functionalities or productivity dividends (see Figure 9).

[17] The Initiatives Group/eDentify, Market Research with Small Merchants in Australia on Payments Acceptance', 2024.
[18] Mandala Partners, Report on Surcharging, Unit Economics and Competition, December 2024

Figure 9: Comparison of traditional acquirer and modern PSP value proposition to merchants (Mandala, 2024)



There is little evidence that greater PSP disclosures will further increase competition

Evidence from behavioural economics suggests that increased PSP disclosures are unlikely to encourage competition, given the limited resources of small businesses. As noted above, Square's simple and blended pricing model provides small businesses with maximum transparency and certainty. Market share data, merchant switching behaviour and surveys all indicate that merchants are highly informed and feel empowered to choose effectively between PSPs. Requiring PSPs to continuously disclose commercially sensitive information on wholesale costs, margins and transaction volumes could dissuade new entrants and reduce current high levels of competition.

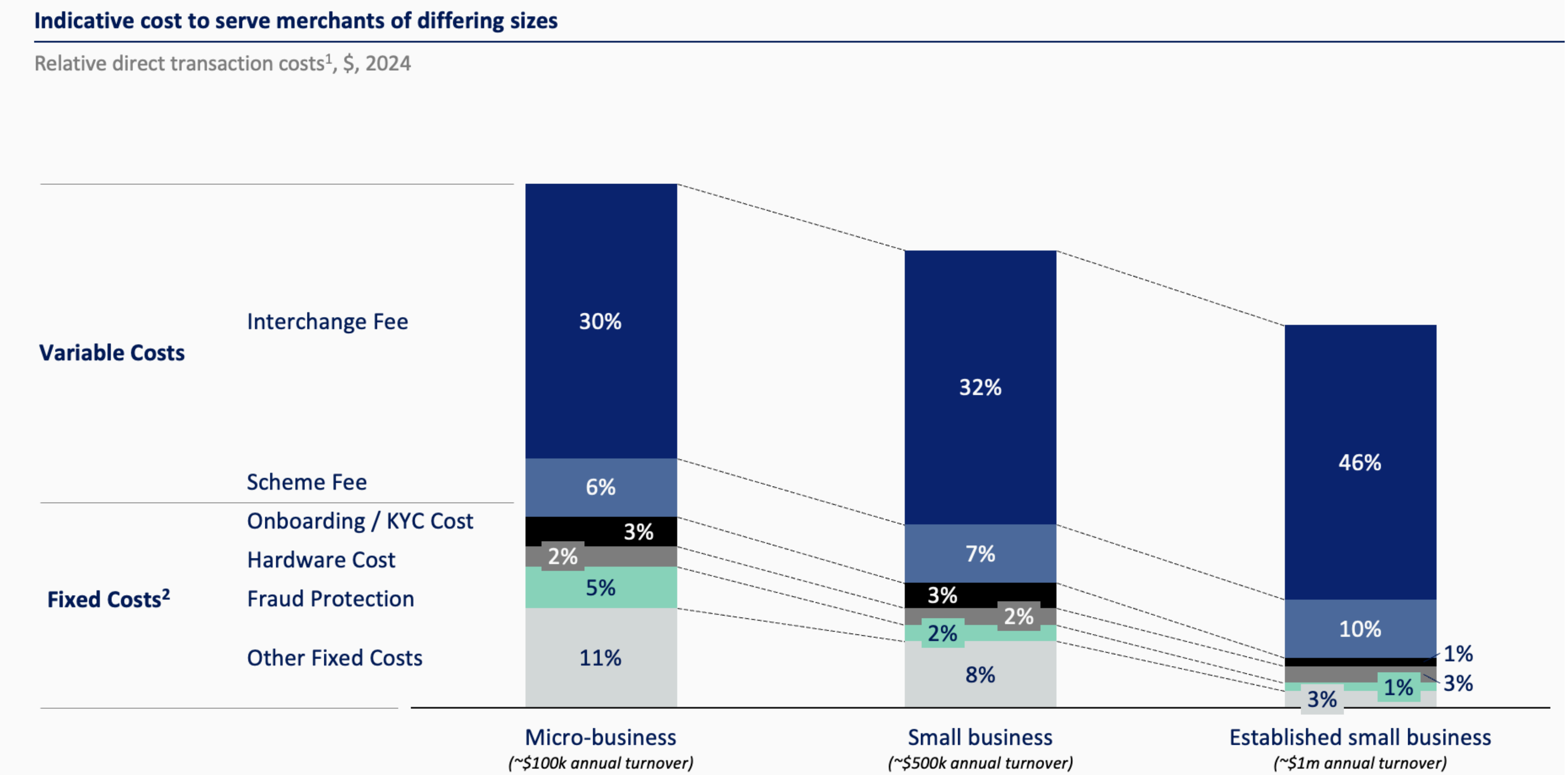
Providing PSP services consists of fixed and variable costs, meaning costs are higher for serving smaller merchants.

Providing PSP services involves both fixed and variable costs, which are often recouped through percentage-based MSFs. Variable costs include customer service, dispute resolution, fraud prevention, chargebacks, and interchange and scheme fees. Fixed costs, which are not necessarily tied to a merchant's size or turnover, include sales, onboarding, hardware, compliance (eg, KYC, AML/CTF, PCI), and broader regulatory and service improvement investments and commitments to industry transformation initiatives.

For smaller merchants, the high proportion of fixed costs relative to overall costs makes percentage-based fees an insufficient metric to fully understand margins or unit economics. This imbalance is felt most acutely for PSPs like Square, which predominantly serves small and micro businesses. As the Initiative Group states:

"Although it is the RBA's chosen approach, we would note that expressing merchant service fees as a percentage figure for small merchants can be misleading, and ignores the fixed costs involved in servicing these accounts (particularly meeting the AML/CTF regulations during the onboarding process, which can exceed $500 per merchant - or more if Family Trusts are involved, a favoured structure of small business). Why is using a percentage misleading? Because 1.5% of $100,000 (the turnover of a small/micro merchant) is a relatively modest $1,500 revenue for the PSP, from which $600 may go in interchange and scheme fees - leaving $900 for the costs of PSP operations, as noted above. Many PSPs servicing this sector do not have "lock in" contracts, so, if the merchant leaves within a short time after onboarding, a loss can occur - making it important to provide good service and a compelling value proposition."

Figure 10: PSP cost breakdown by merchant size (FinTech Australia and Mandala, 2024)



Notes: 1) Assumes $100 transaction, does not factor additional fees a PSP would incur including switching fees and operational costs associated with provision of broader services 2) Other Fixed Costs include other direct transaction costs including marketing, customer support related costs.
Sources: Expert interviews, RBA

Publishing broader market share information can better inform payments policy

Market interventions should be based on robust evidence. At present, the RBA includes detailed information regarding interchange fees and scheme market share among other policy levers. There is an opportunity to expand on this by including updated market share statistics for card issuing and PSPs (in addition to digital wallets and NPP transactions which are now included). This would provide a broader overview of the competitive dynamics in the payment ecosystem. Displaying market share information, as the RBA does for card schemes, can help inform the rationale for policy interventions to increase competition in these markets. The RBA collects this information already from industry participants (including Square) and it could assist in evaluating whether policy interventions are successful.

Recommendation 7: Maintain existing reporting requirements for PSPs, as the market is highly competitive and diverse.

Recommendation 8: Obtain and publish market share information in card issuing and PSPs to better assess competition impacts of reforms.

- ❖ ***Q9. Should PSPs be required to provide individual merchants more detailed information on their regular statements (or through other channels)? How could this information be presented without creating additional complexity for merchants?*** *(response combined with Question 10)*
- ❖ ***Q10. Should PSPs be required to publish standardised information on their pricing and services for merchants (in line with reforms introduced in the United Kingdom)?***

Square's pricing model is designed for simplicity and transparency, reducing complexity for merchants. Through an online dashboard, businesses can access transaction-level data and cost reporting at any time, offering greater value compared to static periodic statements alone. While standardised pricing information can aid in comparing like-for-like services, PSPs' diverse value propositions and pricing models make such comparisons challenging. Any standardised pricing table should factor in this diversity to avoid inaccurate or misleading comparisons.

It is too early to determine the relevance for Australia of the UK Payment System Regulator's (PSR) initiative to publish standardised pricing information. The PSR is gathering feedback from small businesses on the effectiveness of Card Acquiring Market Review remedies, with a progress report expected in 2025.

Recommendation 9: Evaluate forthcoming evidence from the PSR's reform to determine relevance for Australia.

❖ ***Q11. What other regulatory measures should the RBA consider to improve competition between PSPs?***

Hundreds of thousands of small businesses have actively chosen simple pricing PSPs because it better suits their needs. Small businesses and competition would be harmed if they could no longer do so.

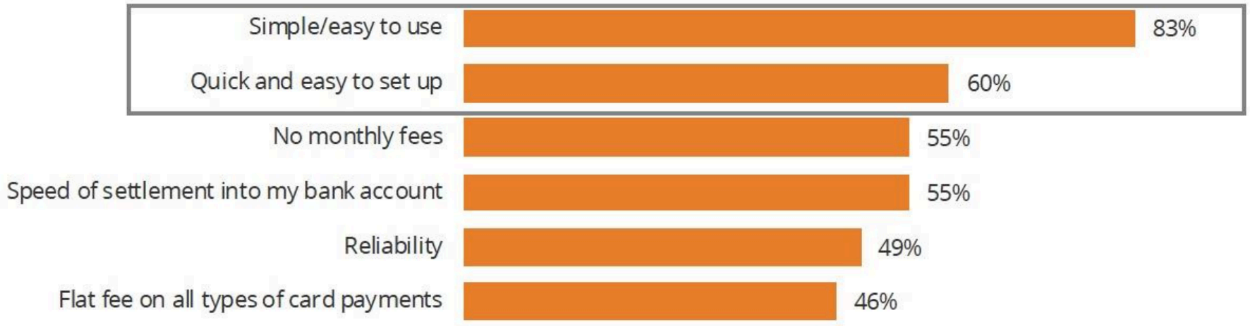
Square merchants benefit from a flat rate, with no extra fees for account activation, early termination, interchange, chargebacks, cash payments, inactivity, or PCI compliance. In addition, Square provides software services to support card acceptance (such as point-of-sale software), which save small businesses between $400 and $1,680 annually.[19]

Square's simple pricing model aligns with small business preferences. A survey revealed 84% of Square users prefer flat-rate fees for their transparency and predictability, compared to 60% of non-Square merchants. A trend also recognised by traditional major acquirers *"In CBA's experience, customer research has consistently demonstrated that small merchants prefer the convenience of bundled plans or rates that remove ambiguity and simplify the process"*[20]. This reflects a competitive market where small merchants are rightly choosing the pricing model that best suits their needs, as highlighted by The Initiatives Group below:

"The landscape looks somewhat different for small/micro merchants, who often prefer a commercial arrangement offering bundled services and a blended rate. It can be more important for them to know how much they will pay for each transaction: for example, 1.6% of the value for every transaction that includes point of sale software, no locked-in terminal contracts or monthly fees. Or, they may want to pay a lower flat rate and pay separate monthly fees for the payment terminal and the POS software of their choice (although our research suggests otherwise)."[21]

This insight is reflected in the reasons why merchants choose to use Square. A recent survey showed highly valued attributes include Square being simple to set up, easy of use, fast settlement, and no ongoing fees (see Figure 11 below). Small businesses' desire for simplicity in payment services and costs is further revealed in their reasons for switching PSP providers, with top reasons for changing providers being price (44%), not wanting to pay a terminal fee (37%), not wanting a lock in contract (25%), and avoiding complicated pricing (21%).[22]

Figure 11: Merchants' primary reasons for using Square - survey results (Initiatives Group, 2024)



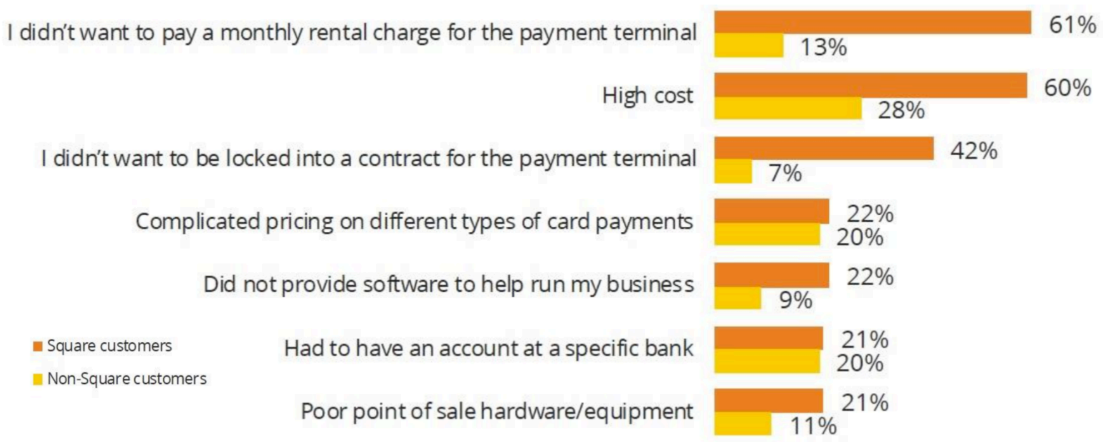
[19] ibid.
[20] CBA, [Response to the Review of Retail Payments Regulation - Issues Paper](), 2020
[21] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.
[22] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.

Mandatory differential or unblended pricing will stifle PSP competition, increase costs and reduce payment system efficiency for no clear policy benefit

The Issues Paper has raised the prospect of unblended or differentiated pricing being mandated for transactions processed across different card networks. This would prevent or significantly impair the ability for PSPs to offer simple and bundled pricing plans for merchants. Competition and choice in the PSP market would decline as a result. The Issues Paper also proposes a ban on the surcharging of debit card transactions, which would further inhibit the ability for simple pricing plans to be offered. (The impacts of this proposal are addressed in Questions 12 and 13).

Hundreds of thousands of small businesses in Australia have made an active, informed decision to use simple pricing products (as shown in Question 8 and 11). They have done so because they offer lower overall costs, improved services and time savings. A survey of merchants who moved to Square found 60%+ moved to avoid terminal fees and to gain a lower MSFs, while 42% wanted to avoid a lock-in contract and 22% wanted to avoid complicated pricing on different types of card payments (see Figure 12).

Figure 12: Reasons a merchant switched to Square from another PSP (Initiatives Group, 2024)



Constraining or preventing the ability of PSPs to offer simple and blended pricing would amount to a heavy-handed form of regulation in the payments system, and a high bar of evidence is required to support such a move, particularly given the highly competitive PSP market. A significant proportion of merchants value these pricing models and make active and informed decisions to use them in their businesses. If a merchant believed they would be better off using unblended pricing instead of simple or blended pricing models, they would do so. With Square, nothing is stopping them from making this move, and there is no policy rationale for limiting merchant choice in this competitive market environment.

Mandatory differential or unblended pricing would significantly undermine competition in the PSP market. Many PSPs would be forced into a narrow set of pricing models, with limited differentiation and merchants no longer being able to avoid the complexity of interpreting the multiplicity of processing costs. This would reduce the ability for smaller PSPs, and PSPs that focus on small merchants, to compete and deliver products that are tailored to the needs and preferences of small businesses. Importantly, many of these providers do not have the ability to cross-subside PSP activity with business banking, as is the case with traditional acquirers.[23] This would likely see

[23] Parliament of Australia Hansard, Matt Comyn's evidence to the House Economics Committee's Review into the Big 4 Banks, August 2024

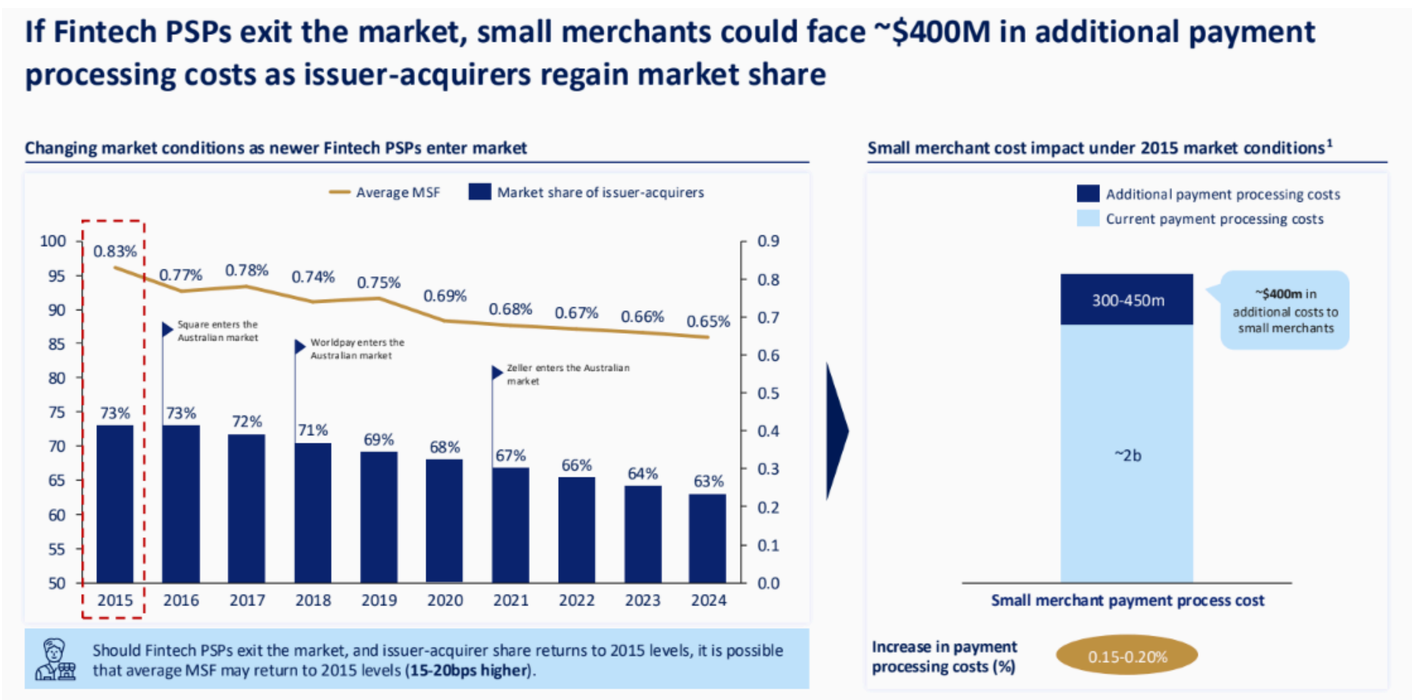
PSP market share revert closer to historic levels, where merchant service fees were higher and PSP service levels were lower. If average MSFs returned to previous levels where competition was limited, small merchants would incur an additional $400 million in payment-related costs annually (see Figure 13).

Recommendation 10: Maintain access to simple and blended pricing models (as per Question 6 / Recommendation 4)

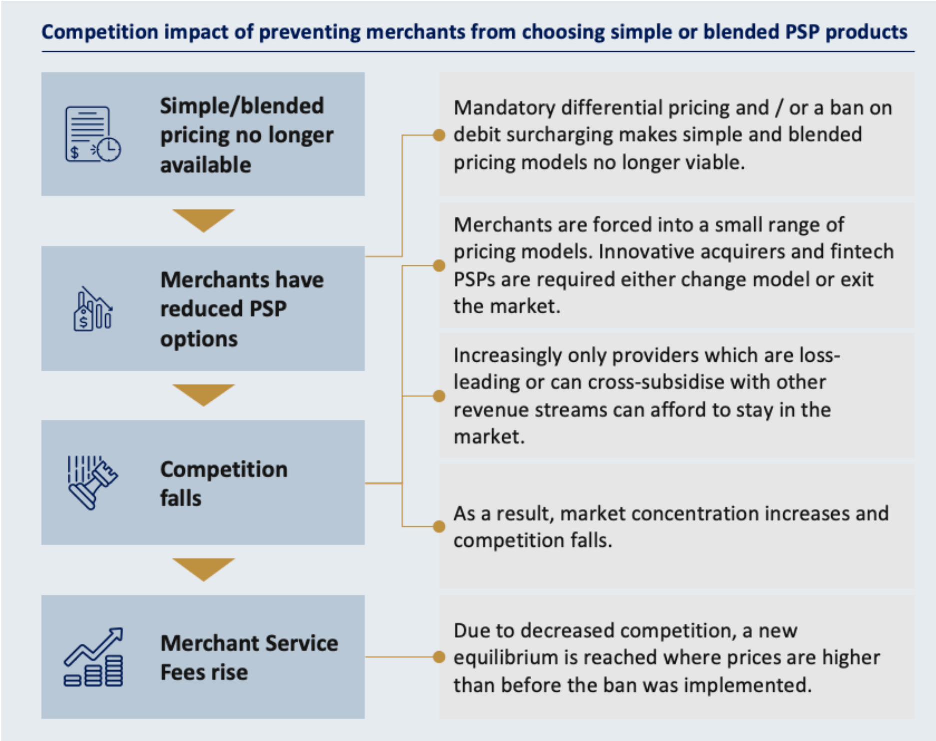
Making it easier for smaller merchants to use PSPs not linked to their bank could further increase competition between PSPs

Among non-Square merchants, the leading reason for using their PSP is that they are an existing banking customer (37%).[24] Just 17% of surveyed Square merchants said that Square allowing them to 'use any bank they wish' was the best thing about how they accept card payments today, suggesting that business banking relationships create barriers for merchants to switch PSPs. One example of how switching is discouraged is seen in banks not providing same day settlement unless the merchant also has an account with the same bank. Competition can be increased if such approaches are addressed.

Figure 13: Comparison of Merchant Service Fees and competition in the PSP market



[24] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.



Surcharging and miscellaneous

- ***Q12. Is there a case for revising the RBA's surcharging framework? If so, which options or combination of options would best address the current concerns around surcharging? What other options should the RBA consider?*** *(response combined with Question 13).*
- ***Q13. What are the implications for merchant payment costs from changes to the surcharging framework? Could the RBA address these with other regulatory actions?***

Surcharging prevalence is not correlated to the cost of payment acceptance

The Issues Paper suggests that merchants that face higher processing costs are more likely to surcharge. In practice, the inverse has been observed. In 2019, around 5% of transactions by volume were surcharged, which increased to 9.5% in 2024 (totalling an estimated $600 million in MSFs). Over that same period the RBA's data shows average MSFs reduced by 13.3%.[25] This point is further reflected in RBA's data indicating that merchants with unblended pricing are also imposing surcharges, with debit transactions now just as likely to be surcharged as credit.[26]

The uptake of surcharging has been particularly correlated with businesses facing major economic headwinds in recent years, suggesting card surcharging is more closely aligned with macro-economic conditions than with payments costs. The preparedness of some larger merchants to surcharge - regardless of their processing costs - also suggests that surcharging does not operate as a price signal to consumers, and may instead constitute a form of drip pricing in some circumstances.

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[25] Mandala Partners, Report on Surcharging, Unit Economics and Competition, December 2024 and FinTech Australia's, Submission to the RBA Merchant Card Payment Issues Paper, 2024
[26] Reserve Bank of Australia, The Evolution of Consumer Payments in Australia Consumer Payments Survey, 2023

Providers of simple pricing plans are incentivised to reduce processing costs (through enablement of LCR) to improve their competitive position in the PSP market

The Issues Paper raises that simple pricing may dampen the surcharge price signal to consumers to use lower cost payment methods. However, there is no evidence of this occurring in practice. Since simple pricing was introduced into Australia, RBA data shows debit market share has continued to increase over that of credit and remains high by global standards.[27] PSPs that experience a higher mix of debit transactions will see their overall costs fall, and in a competitive PSP market, will further reduce their MSFs. Average MSFs have declined by over 13% since Square's arrival in 2016.

Even if such a price signal was actually effective in changing consumer behaviour in reality, unwinding the price signal by forcibly requiring PSPs to unbundle their pricing cannot be justified. Such a policy change would amount to significant regulatory overreach and would target the business models of fintechs that have generated innovation and competition in the PSP/merchant acquiring market. It would also deliver the major banks the policy outcome than they already advocate for, and increase their competitive advantage. We have not seen any evidence such a change would drive positive outcomes.

Simple pricing PSPs have a direct incentive to use the lowest cost payment network to process transactions, which is why Square has enabled LCR for 100% of our merchants. In the highly competitive PSP market, lower costs are then passed on to merchants through lower fees and improved service offerings. This has seen MSFs continue to decline in Australia as simple pricing models have become more prevalent (see Figure 14).

A ban on debit surcharging would significantly reduce competition between PSPs and entrench major bank incumbents - leading to higher Merchant Service Fees

As outlined in Questions 1, 7 and 11 the PSP market is the most competitive part of the retail payments sector. Much of the increased competition has been driven by simple and blended pricing models that are highly valued by smaller businesses. This trend has been a leading driver of efficiency and choice in the payment system.

A debit surcharge ban makes the ability for PSPs to offer businesses simple pricing models more difficult, costly and unattractive for merchants.[28] For many PSPs, it also requires significant hardware and software upgrades to differentiate between debit and credit transactions (with some estimating this at over $100 million cost industry-wide). This makes the ability of smaller and pureplay PSPs to compete against major banks increasingly onerous (as they cannot cross subsidise with broader banking products or intra-bank transactions). This reduces merchant choice and access to PSP value added services while making the ability to serve micro merchants increasingly unviable.

It should be acknowledged that a debit surcharge ban may see a perceived reduction in costs for consumers in some circumstances (as debit transactions would no longer incur a surcharge). However, this would largely be a short-term 'sugar hit' as a ban would significantly reduce competition leading to increased total payment related costs, which many merchants have indicated would ultimately need to be absorbed into prices.[29] As a

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[27] ibid.

[28] Mandala Partners, Report on Surcharging, Unit Economics and Competition, December 2024 and The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.

[29] Australian Financial Review, Restaurants warn fee ban will lead to prices to rise, 4 Dec 2024

result, the only real beneficiaries of a debit surcharge ban would be the major bank acquirers (who have come out strongly in favour of such an approach) as they would face less competition.[30] The major banks' gain from a debit surcharge ban would be at the expense of small merchants losing the ability to surcharge debit transactions; but also consumers (who face higher total costs due to reduced payments system efficiency) and fintech PSP competitors (who have less ability to compete with incumbents).

A ban on debit surcharging is not technology neutral and hinders the ability of other payment methods to gain traction

Banning debit surcharging alone might incentivise customers to use debit over future payment types which could be cheaper, including those which do not use one of the card schemes. The most promising example of these is real-time account-to-account payments made via the New Payments Platform (NPP) often referred to as Pay by Bank or PayTo.

Real-time account to account transactions (A2A) can already be cheaper than debit for higher value online transactions. With NPP transactions currently increasing 20% year-on year — a rate nearly four times that of card based payments — these costs should continue to decline as transaction volumes increase and the operating costs of establishing the network are recovered across a larger base of activity[31].

The Federal Government's recent National Competition Policy identified greater adoption of NPP transactions as a key financial services reform due to its ability to reduce payment costs: *"Currently, fees on debit cards range between 0.27 to 0.52% and credit cards from 0.90 to 1.53%. Comparatively, payment systems similar to the NPP have achieved transaction fees between 0.2 and 0.3% of transaction cost."* The Productivity Commission estimates that widespread take up of A2A payments would increase competition and put downward pressure on interchange and scheme fees: *"This reform is expected to reduce average debit card merchant fees by 0.3 percentage points for the share of purchases currently done with Mastercard/Visa and 0.1 percentage points for the share of purchases currently done with Eftpos. For credit cards, we anticipate a flat 0.05 percentage point reduction in average credit card merchant fees."*[32]

A debit surcharge ban could mean surcharges create a perverse incentive where consumers face surcharges for the potentially cheaper A2A method but not for the debit payment (particularly as surcharging propensity is not necessarily correlated with processing costs, as noted above). This contradicts the RBA's stated rationale for surcharges, which is to *'encourage consumers to use less expensive payment methods.'*[33] As A2A transactions become more common and cost-effective, this perverse incentive would be increasingly common and increase MSFs.

A debit surcharge ban could stymie further development of A2A payments and the NPP. Customers would have little incentive to switch to using A2A payment methods as these could incur a surcharge in many situations while debit payments would not. The Productivity Commission warns that missing the opportunity to grow NPP and A2A payments would mean Australia is denied one of the few opportunities to drive meaningful payments competition and lower costs for consumers and merchants.

[30] Australian Financial Review, cut surcharges by divorcing debit and credit Westpac tells RBA, 2024
[31] The Reserve Bank of Australia, Retail Payments, October 2024.
[32] The Productivity Commission, National Competition Policy: modelling proposed reforms, 2024.
[33] The Reserve Bank of Australia, Payment Card Surcharging, March 2013

A debit surcharge ban would stifle PSP competition and increase overall payment-related costs. If a partial surcharge ban is introduced, it should be payment-method neutral.

As the Australian Securities and Investments Commission notes *"'Australia's financial services regulatory regime is broad and technology neutral."*[34] If a partial surcharge ban is considered, it is critical that this long-held principle is maintained. The RBA should not mandate what specific form of digital payment should be free from a surcharge. Instead, consumers should simply be guaranteed a digital, surcharge-free option at point of sale at every merchant. This could be debit, credit or potentially A2A payments. In the future, it may be something else entirely. Merchants are then able to make a decision about which form a surcharge free payment takes that best reflects their lowest cost of payment acceptance.

Many merchants are already identifying the benefits of offering A2A payments to lower their overall cost of acceptance. Chemist Warehouse, Baby Bunting and Harris Farm among others have recently introduced QR Code A2A payments via the NPP. The reason many are doing so is to reduce total payment processing costs, while also establishing competitive pressure to negotiate strategic interchange rates.[35] Similarly, many online retailers today are already using A2A payments as their surcharge-free method of payment as it can be is the lowest cost (and the option to pay by cash cannot be offered online).

A technology neutral surcharge-free option could help supercharge uptake of A2A non-card payments. Both consumers and merchants would be incentivised to offer and use A2A payments, which would drive behaviour in a two sided marketplace. Mandala estimates that this approach could deliver 5-10% of payment volume to NPP transactions; delivering savings, subject to NPP pricing, of around $500 million (Figure 14).

Smaller merchants should be exempt from any prospective surcharge bans.

Banning all surcharging, as some industry participants suggest, could address many of the negative impacts on PSP competition compared to only banning debit surcharges.[36] However, if the RBA pursues this approach, it is crucial to accommodate small and micro businesses to avoid unfairly impacting them.

Many smaller businesses have integrated existing surcharging rules into their pricing and payment processes over the years. Removing this ability could result in an immediate and significant revenue loss for many businesses, in the absence of them instituting immediate price increases. Mandala estimates that for businesses with annual revenues under $1 million, a complete surcharge ban would reduce sector-wide revenue by $465 million, or $275 million for a debit-only surcharge ban (if prices were not increased). This equates to an average revenue loss of around $2,000 per business (or $1,200 for a debit only ban). Concerningly, a survey of small merchants indicated that 13-14% of merchants would stop accepting debit cards altogether if they could no longer surcharge debit transactions.[37]

The RBA's Issues Paper proposes other measures to reduce MSFs alongside potential surcharge bans. However, these reforms are longer term initiatives, whereas the revenue impact of a surcharge ban would be immediate. It is unclear if the potential benefits for merchants outweigh the losses associated with removing surcharges, especially in Australia, where interchange rates are already low and the PSP market is highly competitive.

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[34] Australian Securities and Investment Commission, Media Release on Draft Digital Asset Guidelines, December 2024
[35] Australian Financial Review, Chemist Warehouse goes to war with card fees – using QR codes, 10 October 2024
[36] FinTech Australia's, Submission to the RBA Merchant Card Payment Issues Paper, 2024
[37] The Initiatives Group, 'The exchange of payment: the most critical part of a small merchant's customer journey — a white paper on small and micro business payments acceptance', 2024.

To mitigate the immediate revenue impact on small businesses, exempting them from any surcharge ban is a reasonable solution. Using a $1 million annual turnover threshold, as often applied by the RBA to segment small businesses, is a practical starting point. This exemption could remain in place until the cost-saving measures proposed by the RBA have proven to be effective, ensuring small businesses are not left worse off overall by payment reforms.

Reducing the definition of payment related costs will reduce competition between PSPs and introduce significant costs into the payment system.

As outlined in Questions 7 and 11, pricing simplicity, transparency and embedded software is highly valued by smaller merchants. In addition, the costs associated for PSPs are not linear based on each transaction (see Question 8). These factors mean the ability to further isolate payment processing costs from PSP offerings is unlikely to be achievable at scale. Any value in doing so is also unclear given the highly competitive nature of the PSP market and the popularity of bundled PSP services with small businesses. This would reduce competition between PSPs and merchant choice for no tangible benefit.

Recommendation 11: Do not introduce a debit surcharge ban as it would stifle PSP competition and increase overall payment-related costs. If a partial surcharge ban is introduced, it should be payment-method neutral.

Recommendation 12: Exempt smaller merchants from any prospective surcharge bans.

Recommendation 13: Maintain existing definition of payment-related costs to support high levels of competition and choice in the PSP market.

- ❖ ***Q14. Are there any other regulatory actions that the RBA should consider taking in response to the issues raised in this paper?*** *(response combined with Question 15).*
- ❖ ***Q15. Are there any issues in, or implications for, the broader payments ecosystem that the RBA should be aware of when designing a regulatory response to any of the issues discussed in this paper?***

Broader factors and data should be factored into payments policy decisions, including competition in consumer credit, as well as and competition in card issuing and PSPs.

Australia's fragmented payments regulatory landscape includes regulators with narrow remits.[38] The RBA's focus on reducing MSFs has sometimes sidelined other important considerations. For example, the RBA has stated that it does not factor competition in consumer credit into its payments policy decisions,[39] even though credit cards account for a significant share of overall transactions, with the big 4 banks currently holding 93% of credit card debt.[40]

While payments policy can require tradeoffs between consumers, merchants and industry participants, consumer benefits are a critical consideration. To improve policy decisions, consumer credit impacts should be estimated, published and included in the policy development process.

Broaden direct access for non-ADIs to the New Payments Platform and maintain cost recovery model.
The Productivity Commission's recent National Competition Policy Report highlighted that many of Australia's payment product markets have become relatively underdeveloped compared to other countries. Notably there are significant opportunities to lower fees, increase transparency and access for participants to drive growth in account-to-account payments made via the New Payments Platform (NPP).

Lack of direct access to the NPP for non-Authorised Deposit Taking Institutions (non-banks) remains a key inhibitor to greater take up of account-to-account payments. Despite the RBA, ACCC and Treasury' support for and efforts to expand NPP access[41], as the National Competition Policy notes access requirements are "not transparent or are perceived as being overly onerous relative to the risks posed by PSP".[42] The current Issues Paper process presents an important opportunity to renew efforts to expand NPP access, alongside continued investment in functionality under a cost recovery model.

Recommendation 14: Further incorporate consumer credit and competition in card issuing and acquiring into payments policy decisions.

Recommendation 15: Enable access for non-ADIs to the New Payments Platform and maintain cost recovery model for the NPP to encourage uptake for retail payments.

[38] The Treasury, A Strategic Plan for the Payments System, June 2023
[39] Australian Financial Review, 'Payments innovation under threat from RBA', 12 May 2024
[40] Cuscal, 'Prospectus Initial Public Offering of Shares', 2024
[41] The Reserve Bank of Australia, 'NPP Functionality and Access Consultation: Conclusions Paper', June 2019.
[42] The Productivity Commission, 'National Competition Policy: modelling proposed reforms', 2024.

Summary of recommendations

Interchange and card issuing (Questions 1 - 2)

1. Exempt smaller issuers (i.e. those who can currently issue SNDCs) from further interchange reductions, and explore other incentives for small issuers to increase competition.
2. Explore differential interchange caps for smaller businesses or other means of reducing interchange spreads between small and large businesses.
3. Cap international interchange fees, looking to the European Union's approach for guidance.

Card schemes and scheme fees (Question 6)

4. Maintain access to simple and blended pricing models and incentivise uptake of non-card payment methods (including NPP direct access for non-ADI's and pricing, and potentially surcharging changes).

Payment Service Providers and Least Cost Routing (Questions 7 - 11)

5. Mandate LCR for all PSPs and ensure before intervening in more competitive payments markets.
6. Maintain existing guidance that simple pricing plans are delivering on the objectives of LCR.
7. Maintain existing reporting requirements for PSPs, as the market is highly competitive and diverse.
8. Obtain and publish market share information in card issuing and PSPs to assess competition impacts of reforms.
9. Evaluate forthcoming evidence from the PSR's reform to determine relevance for Australia.
10. Maintain access to simple and blended pricing models (as per Question 6 / Recommendation 4)

Surcharging and miscellaneous (Questions 12 - 15)

11. Do not introduce a debit surcharge ban as it would stifle PSP competition and increase overall payment-related costs. If a partial surcharge ban is introduced, it should be payment-method neutral.
12. Exempt smaller merchants from any prospective surcharge bans.
13. Maintain existing definition of payment-related costs to support high levels of competition and choice in the PSP market.
14. Further incorporate consumer credit and competition in card issuing and acquiring into payments policy decisions.
15. Enable access for non-ADIs to the New Payments Platform and maintain cost recovery model for the NPP to encourage uptake for retail payments.