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13 September 2002

The Secretary
EFTPOS Industry Working Group
C/- Payments Policy: EFTPOS Reform
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Dear Sir / Madam

OPTIONS FOR EFTPOS INTERCHANGE FEE REFORM

Commonwealth Bank of Australia (the Bank) refers to the EFTPOS Industry Working Group Discussion Paper "Options for EFTPOS Interchange Fee Reform" published on 4 July 2002 which seeks comments from interested parties by 13 September 2002. The Bank, the largest provider of EFTPOS services to businesses and the institution with the largest number of customers with debit cards, welcomes the opportunity to present its views.

1. Background

The Bank has made numerous public comments about payment systems reform. In its "Comments" on the Reserve Bank of Australia (RBA) / Australian Competition and Consumer Commission (ACCC) Joint Study (Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access), the Bank (20 December 2000) commented:

> *"The Study acknowledged Australia's world class card and ATM systems. This is the result of the significant and collective investment by all participating financial institutions over many years yielding innovative developments to the benefit of our customers – both consumers and merchants. As a leading participant in these systems, we are justifiably proud of this achievement.*
>
> *However, technology does not, of course, stand still. Financial institutions are now planning for further substantial investment in emerging payment technologies; for example, secure Internet payments, smart cards, which will need to be designed to maintain the system stability and interoperability that we enjoy today from our more traditional payment instruments.*
>
> *Government and regulators need to ensure that the financial institutions continue to have the incentive to develop innovative payment instruments that meet the future needs of all Australians."*

The Bank noted, in its letter to the Governor of the RBA of 20 December 2000, that it:

> *" … is keen to ensure that Australia retains its world class electronic payments networks, providing long term benefits to all participants - consumers, merchants and financial institutions. To ensure on-going investment and development, financial institutions need to be able to generate appropriate long-term returns on investment after allowance for associated risks. Only through considerable long - term strategic investment, with ongoing enhancements, will Australia retain its enviable position in electronic payments and enable the deployment of infrastructure for new and emerging technologies.*
>
> *We are concerned, therefore, for the long-term implications for investment in electronic payments systems if reduced returns to financial institutions from electronic payments systems lessen the incentive for financial institutions to invest in the maintenance of existing facilities or the development of new technologies."*

The Bank re-affirms its commitment to these views.

The Bank's December 2000 comments on the RBA / ACCC Joint Study included comments on debit card, or EFTPOS, interchange fees. For ease of reference, these comments are set out in the Attachment to this letter. As can be noted, the Bank has supported the current structure of EFTPOS interchange fees as being defensible and in the interests of consumers, businesses and participants. Equally, the Bank has been working with industry participants to explore opportunities for change that will not unduly impact on the world class network that our cardholders and businesses enjoy today, nor the incentive to invest and innovate.

2. Regulatory Environment

In relation to Debit Card networks, the RBA / ACCC Joint Study concluded (inter alia) that:

> *"The study did not find a convincing case for an interchange fee in the debit card payment network in Australia, in either direction" (p iv)*

and

> *"The study has not found a convincing case for an interchange fee in the debit card network in Australia, in either direction" (p 68)*

and

> *"… the study believes that the debit card network in Australia does not need an interchange fee" (p 69)*

and

> *"The study does not see a continued need for an interchange fee in the debit card network" (p 71).*

The Payments System Board Annual Report 2001 (published March 2002) repeated this conclusion and noted overseas experience. The RBA's powers to regulate payment systems under the Payment Systems (Regulation) Act 1998 (PSRA), where the RBA is of the view that this is in the public interest (as exampled with open credit card schemes), are noted also.

3. Legal Framework for Reform

This letter provides the Bank's position as to whether, as a matter of policy outcome, there should be interchange fees for EFTPOS and in what circumstances.

The Bank is also mindful of the views expressed by the RBA / ACCC in the context of the administration of the PSRA and the Trade Practices Act 1974 (TPA) respectively.

The Bank considers that a fundamental element in change is likely to be the establishment of cooperative activity between industry participants. That is, it is unlikely that a desired outcome can be achieved in a reasonable time simply by uncoordinated amendment of bilateral arrangements and there would seem to be a need for a framework which coordinates and gives effect to the arrangements on pricing.

The Bank understands that the legal frameworks within which change would be implemented will need to be addressed, including whether authorisation under the TPA (or other structures) are necessary or appropriate in light of the policy outcome to be determined by the Working Group. Indeed, different structures may be appropriate for particular aspects of EFTPOS reform such as the funding of infrastructure improvements.

While the Bank has not formed detailed views on what legal frameworks would be necessary or appropriate to implement reform, the Bank believes that voluntary change is, as a matter of principle, preferable to regulatory intervention such as the exercise by the RBA of its powers under the PSRA.

4. Policy Position

Notwithstanding the merit and considerable benefits in an "acquirer cost" model (which the Options paper notes appears *"consistent with the current flow of EFTPOS interchange fees*"), the Bank is cognisant of published regulatory positions and is supportive of voluntary change versus regulatory intervention. Accordingly, the Bank is willing to support a movement to zero EFTPOS interchange fees, subject to:

- A framework being established for the levy of fees to fund one-off EFTPOS infrastructure developments, where there are misalignments between the bearer of the project cost and the benefactor of the developments. (An example of such a scenario could be the cost of investment in 3-DES technology and EMV terminal upgrades which will largely fall on acquirers, but issuers will be the chief beneficiaries of the EFTPOS network improvement.) Such a framework has been used overseas to fund such costs.

- A mechanism for acquirers to recoup the cost of EFTPOS transaction processing from issuers on issuer-initiated rejected or declined transactions. (In this situation, acquirers incur the costs of a declined transaction but receive no revenue from businesses since the transaction is not successful; issuers should cover the cost of the transaction in such instances.)

- Acknowledgment that there will be implications for pricing of EFTPOS services to consumers and businesses.

- The ability of the Bank to renegotiate its merchant agreements with major businesses.

- Compliance with all legislative requirements – including the TPA.

- No exercise by the RBA of its powers under the PSRA.

- An industry review three years after implementation.

The industry review after three years provides the opportunity to assess the effects of a move to zero interchange fees and determine whether this is the desirable and appropriate long term level for EFTPOS interchange fees. The review's assessment of the consequences of introducing zero interchange fees, would need to consider, inter alia –

- Market impact – such as usage patterns (cardholders and businesses);
- Impact on investment in EFTPOS networks; and
- Impact on technological developments (such as funding for, and impact on deployment of, "chip" technology).

No doubt there will also be other elements to consider in the review which should be conducted by industry participants.

The Bank supports changes to EFTPOS interchange fees occurring concurrently with implementation of the RBA's Standard on credit card interchange fees in October 2003 so that any impacts on end-market pricing (businesses and / or consumers) can be managed consistently and with reduced likelihood of customer uncertainty.

The Bank's views on Visa debit interchange fees have been published previously (refer Attachment). The Bank reaffirms its views and looks forward to changes to Visa debit interchange fees taking place at the same time as changes to EFTPOS interchange fees and credit card interchange fees. The Bank understands that issuers of the Visa debit product and Visa International are currently considering this change initiative. The Bank is not privy to these considerations.

5. Conclusion

In conclusion, the Bank appreciates the opportunity to openly and transparently provide its views on change to EFTPOS interchange fee arrangements.

The Bank remains committed to ensuring that Australia retains its world class electronic payments networks to the benefit of all participants – consumers, businesses and financial institutions.

Yours sincerely

(Signed)

N. L. A. Kennett

ATTACHMENT

Extract from Commonwealth Bank of Australia "Comments" on RBA / ACCC Joint Study – 20 December 2000

4.0 Debit Cards

4.1 Rationale for Debit Card Interchange Flow

As noted by the Study, open debit card schemes have interchange fees which flow in the opposite direction to the credit card interchange fee; ie. debit interchange is paid by the card issuer to the merchant acquirer. The interchange fee runs in the opposite direction because merchants provide a service to bank customers to access their funds at the merchant (analogous to ATM services and interchange fee flows). As noted in the Study, larger merchants frequently enjoy a "sharing" arrangement under which the acquiring institution pays the merchant for transactions captured. This is analogous to payments to third party ATM providers.

The current structure of debit card interchange payments clearly values the benefit received by different participants and has contributed to the investment necessary to foster the world class system that we enjoy today.

Other than the minor benefits to merchants of reduced cash handling and storage costs, debit cards are not designed to enhance the welfare of merchants. Issuers offer debit cards to their customers as a convenient and inexpensive substitute for cash or cheques. The availability of a debit card is unlikely to induce a customer to make a purchase that he or she would not have otherwise made with cash. The business generation potential of credit cards is clearly superior to that of debit cards.

4.2 Debit Card Value Proposition

The debit card is a substitute payment mechanism to cash, and should be seen as a different proposition to, and with a different supporting infrastructure from, credit cards, rather than an alternative payment instrument. Debit cards provide more convenient and secure access to cash in a bank account. The value of debit cards include:

- *Access to funds secured by the use of PIN and password;*
- *Access to funds directly from the cardholder's bank account;*
- *Debit cards are only used in a "card present" mode, which increases security;*
- *Debit cards can be used on a global basis via the Bank's membership of the Cirrus / Maestro and Visa / Plus [1] networks; and*
- *Debit cards do not rely on the use of signatures.*

4.3 Visa Debit Cards

The Study expressed concerns over the interchange fees applying to Visa debit card transactions. The Bank agrees that Visa debit transactions (where the consumer selects the credit option rather than the debit option) should be subject to debit card rather than credit card interchange arrangements and is reviewing the Visa debit card product that was acquired from Colonial Ltd [1].

4.4 Implications of Debit Card Interchange on Merchants

The direction and size of the debit card interchange rates will have significant implications on our merchant and consumer relationships. For example, in negotiating merchant service fees, a pricing structure is agreed with each merchant, which covers the total cost of servicing that merchant, given the volume and mix of debit card and credit card transactions the merchant is likely to experience.

4.5 Way Forward

In light of the bilateral nature of debit card interchange and associated merchant agreements, any change to the debit card interchange model will require considerable investigation and analysis. Issues to be addressed include the review (and possible renegotiation) of bilateral and merchant contracts, methodologies for ensuring an industry wide approach to implementing potential change and associated legal and systems issues.

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[1] As noted in the Bank's submission to the RBA dated 3 July 2001, the Bank discontinued the Visa debit product and replaced all debit cards issued by Colonial Limited with standard Bank debit cards as part of the Bank's conversion of Colonial's products in June 2001.