



Review of Card Payments Regulation

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1. Introduction

Following the 1996–97 Wallis Inquiry, the Reserve Bank was given new powers with respect to the payments system and a new Board, the Payments System Board (the Board), to oversee the exercise of those powers. The Inquiry recommended that the Bank and the Australian Competition and Consumer Commission undertake a review of interchange fee arrangements for credit and debit cards and other aspects of Australia’s payments system. Over the early 2000s, the Bank undertook further work and extensive consultation, culminating in a series of reforms. These reforms included measures that changed the prices cardholders faced when using debit and credit cards, reducing the incentives to use higher-cost payment methods. The Bank’s reforms also required changes to certain rules in card systems, including enabling merchants to apply surcharges on card transactions so that cardholders were more likely to face prices that reflected the cost of the card they were using. It also took steps that reduced the barriers to entry for entities wishing to issue cards or provide card payment services to merchants.

In 2007–08, the Board conducted a review of the Bank’s reforms. The review concluded that the reforms had improved access, increased transparency and had led to more appropriate price signals to consumers. This review also explored a number of options for possible changes to the regulatory framework, including stepping back from formal regulation and relying on industry undertakings. However, the industry was unable to arrive at suitable undertakings so in August 2009 the Board decided against stepping back from interchange regulation and noted that the regulatory framework would remain under review.

A range of factors suggest that it may be timely for the Board to again review the regulatory arrangements applying to the payment card systems:

- Aspects of the interchange fee system and merchant surcharging practices have raised concerns, some of which were noted in the Board’s 2013 Annual Report and the Bank’s two submissions to the Financial System Inquiry (FSI).
- There have been some significant changes to the regulation of card payments in other jurisdictions.
- The completion in 2014 of the Bank’s third Consumer Use Survey and second Payment Costs Study have provided a useful evidence base for considering possible changes to policy.
- The continuing growth in the role of cards in the payments system since the initial reforms underscores the need for an appropriate regulatory framework for such payments.
- Interchange arrangements in the card systems will also affect the nature of new payment arrangements that are adopted by the payments industry. In particular, a more efficient and lower-cost new payment system might be hampered in its development to the extent that it had

to match existing interchange payments to card issuing institutions to ensure the participation of banks in the new system.

- Finally, the FSI has made recommendations directed at the Bank and its regulation of card payments, with particular focus on interchange fee regulation and surcharging.¹

In conducting a review, given the linkages between the different issues, it will be important to take a holistic view of the issues in the cards system and the broader payments system. Such a review will be an opportunity to think very carefully about the issues, to assess the experience since the Board's reforms were implemented in 2003, and to consider whether to make incremental or more significant changes to the existing framework.

This paper presents some background information on the Bank's reforms and the operation of the cards system in Australia. It also notes some developments that have raised concerns for various stakeholders and also for the Bank given its mandate to promote competition and efficiency in the payments system. It then outlines a range of policy options that might be considered to address these concerns. The Bank is seeking the views of stakeholders, including both participants in the payments system and end users, on the potential policy responses and will also consider any submissions on card payments regulation made in response to the current Government consultation on the FSI recommendations. The Bank would welcome written submissions and will then meet with interested parties to further discuss the options. Following this consultation process, the Board will consider whether to consult on some specific changes to the regulatory framework.

1 The FSI has also made recommendations in other areas relevant to the Payments System Board, in particular concerning digital currencies and the regulation of purchased payment facilities. The Board proposes to address these issues separately.

2. The Bank's Card System Reforms

The Bank's Early Reforms

The Reserve Bank's reforms in the card payments sphere have used regulatory powers given to the Bank following the 1996–97 Financial System Inquiry. The Wallis Report suggested that the Australian payments system could be characterised by relatively high overall costs and that there was scope for substantial efficiency gains, including greater use of electronic payments and reduced use of cash and cheques. It also noted, however, that card payment systems were characterised by opaque fee arrangements, distortionary incentives for certain cardholders and restrictive entry criteria and trade practices. In particular, the Report found that *ad valorem* interchange fees on credit cards meant that the cost to merchants of providing credit card acceptance to consumers could be very high and were ultimately borne by consumers in the form of higher prices.

The changes to Australia's financial regulatory structure introduced in response to the Wallis Report included a new structure for payments system regulation. Under the new structure, the Bank was given regulatory powers to promote efficiency, competition and stability in the payments system. The Payments System Board was established to focus on payments system issues and to determine the Bank's payments system policy. The *Reserve Bank Act 1959* (as amended) gives the Board a mandate to direct the Bank's payments system policy to the greatest advantage of the people of Australia. The Act specifies that the Board's powers under the *Payment Systems (Regulation) Act 1998* (PSRA) and the *Payment Systems and Netting Act 1998* are to be exercised in a way that will best contribute to:

- controlling risk in the financial system
- promoting the efficiency of the payments system
- promoting competition in the market for payment services, consistent with the overall stability of the financial system.²

The PSRA sets out the main powers of the Bank in respect of payments system policy and the factors that the Bank must take into account in determining the public interest. These include that payment systems should be financially safe, efficient and competitive, and that they should not contribute to increased risk to the financial system. Part 3 of the PSRA allows the Bank, among other things, to:

- 'designate' a particular payment system as being subject to regulation

2 While the Australian Competition and Consumer Commission (ACCC) has broad responsibility for competition and access issues in all industries under the *Competition and Consumer Act 2010*, the Bank and the ACCC have entered into a Memorandum of Understanding (MoU) to ensure appropriate coordination between the two agencies in the payments system. The legislation and MoU are designed to ensure that there is no regulatory overlap between the two agencies.

- impose an access regime for any designated system (i.e. a regulation that seeks to ensure that new participants are able to access a network on fair and reasonable terms)
- set standards with which participants of a designated system must comply.

Consistent with the model proposed by the Wallis Report, payment systems in Australia largely operate without regulatory intervention. The Board has not opted for regulation as a first resort but initially seeks to encourage industry initiatives to address areas of concern; only intervening on public interest grounds when industry is clearly unable to do so.

The Wallis Report recommended that the Bank and the Australian Competition and Consumer Commission (ACCC) should review interchange fee arrangements for credit and debit cards, and that access arrangements in the payments system be liberalised. Accordingly the Bank and the ACCC undertook a study of the pricing, rules and access arrangements of card payment systems in Australia. This detailed analysis culminated in the publication of the 'Joint Study' in October 2000 (RBA and ACCC 2000).³

The Joint Study found that the card systems, exercising market power, tended to have arrangements that detracted from the efficiency and competitiveness of Australia's payments system. The Study suggested that three aspects of credit card scheme rules seemed to be impeding the efficiency of the overall payments system: the collective setting of interchange fees; 'no surcharge' rules that prevented merchants from passing on the cost of accepting credit cards; and restrictions on membership that appeared to be stronger than needed to protect the integrity of the schemes. The Study concluded that the interests of end users of card payment services needed to be more directly engaged in the pricing process and conditions of entry to card payment networks needed to be more open.

The Board's reform process for credit cards formally began in April 2001, when, following a period of consultation, the Bank designated the Bankcard, MasterCard and Visa credit card schemes in Australia.⁴ The Bank then undertook a comprehensive evaluation of the credit card schemes' arrangements and examined whether there were any changes that could address the problems identified in the Joint Study and thus improve competition and efficiency and further the public interest. The Board announced a package of reforms in August 2002 after extensive consultation.

The first reform measure to take effect, the Standard on merchant pricing, came into force in January 2003. It removed the restrictions imposed by the international credit card schemes on the freedom of merchants in Australia to charge according to the method of payment. Although not formally captured by the Bank's regulatory measures, American Express and Diners Club gave voluntary undertakings to remove their restrictions on merchant pricing.

The second measure, the Standard on interchange fees, came into effect in July 2003. Interchange fees are wholesale fees paid between a merchant's financial institution and a cardholder's financial institution when a cardholder undertakes a transaction. Historically, interchange fees had been set collectively by the members of the scheme. Competition between the schemes had, if anything, created upward – not downward – pressure on these fees. The higher the interchange fee paid to

3 Concurrent with the Joint Study, but quite separately, the ACCC had asked Australian banks to consider having the setting of interchange fees on credit cards subjected to the test of authorisation under the *Trade Practices Act 1974*. In early 2001, however, the ACCC suggested that the Bank's powers could better address concerns with competition and interchange fees.

4 With the closure of the Bankcard scheme, the Bank revoked its designation and regulations in 2007.

card issuers, the greater their incentive to issue the cards of a scheme and the larger the subsidies that can be paid to cardholders to encourage use of those cards. At least up to some limit, merchants appear unable to resist the high merchant service fees that result, typically finding it difficult to decline acceptance of cards given the risk of losing sales (see 'Box A: Interchange Fees').

The Standard set an interchange fee benchmark for each scheme and increased transparency of these fees. The benchmark was based on the average costs of the issuers of each scheme. Since November 2006, there has been a common cost-based benchmark for average interchange fees of 50 basis points for both MasterCard and Visa.

The third plank of the Bank's reform of credit card schemes, the Access Regimes for the credit card systems, was intended to reduce barriers to entry, including for non-financial institutions wishing to participate in the designated card schemes. The regime was finalised in February 2004 and involved the creation of a special class of institutions, to be authorised by the Australian Prudential Regulation Authority, to conduct only credit card activities.⁵

In September 2002, the package of reforms was challenged in the Federal Court on procedural and jurisdictional grounds by MasterCard International and Visa International. The Court rejected the challenge in September 2003, finding that the Bank had validly and properly exercised its powers.⁶

Reform of the debit card systems began in 2004, with the Bank designating the Visa Debit system in February and the eftpos system in September.⁷ The Debit MasterCard system has not been formally designated but MasterCard provided a voluntary undertaking to comply with the standards applying to Visa Debit. In October 2004, a group of merchants mounted a challenge to the designation of the eftpos system, focused on the Bank's jurisdiction and regulatory processes. The challenge was dismissed on all counts.⁸

The structure of interchange fees at the time created a strong incentive for financial institutions to promote the international scheme credit and debit systems over the eftpos system, despite the eftpos system having lower resource costs. When a cardholder made a payment with an eftpos card, the institution that issued the card *paid* around 20 cents to the merchant's bank. In contrast, if the payment was made with an international scheme debit card, the institution that issued the card *received* around 44 cents on average. This difference in fees existed despite both forms of payment accessing a deposit account. In the Bank's view, if the arrangements remained unchanged, it was highly likely that the international scheme systems would grow at the expense of the eftpos system, simply because of the structure of interchange fees.

By significantly narrowing the difference in these fees, the Bank's debit card reforms sought to promote competition between the schemes based on the benefits that they offer to cardholders and merchants, rather than on fees that were not subject to normal competitive pressures. In April 2006, the Bank released a package of reforms to Australia's debit card systems, including Standards to apply

5 Subsequent changes in the ownership structure of the schemes and developments in card issuing and acquiring markets led the Bank to modify the Access Regimes in concert with changes to the *Banking Regulations 1966*, providing the schemes with greater flexibility to establish access eligibility and assessment criteria. These changes were implemented on 1 January 2015.

6 For the final judgment, see *Visa International Service Association v Reserve Bank of Australia* [2003] FCA 977.

7 References in this document to eftpos are to the domestic debit scheme, now operated by eftpos Payments Australia Limited (ePAL), rather than to the broader concept of electronic funds transfer at the point of sale.

8 For the final judgment handed down in the Federal Court, see *Australian Retailers Association v Reserve Bank of Australia* [2005] FCA 1707.

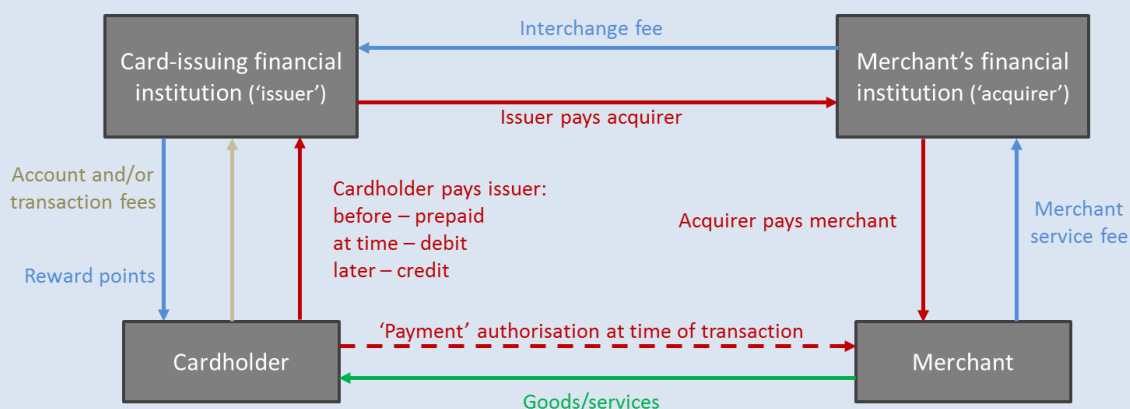
to Visa Debit interchange fees and Visa’s ‘honour-all-cards’ and ‘no-surcharge’ rules. These reforms took effect in July 2006. As a result of the reforms, the average interchange fee for a MasterCard or Visa debit transaction fell from around 44 cents to 12 cents. In addition, from January 2007, merchants were no longer obliged to accept a scheme’s debit cards as a condition of accepting its credit cards and vice versa. eftpos interchange fees were also reduced – to between 4 and 5 cents, paid to the merchant’s bank. Subsequently, with the creation of a scheme to govern the eftpos system, regulation of eftpos interchange fees has been aligned to that applying to the MasterCard and Visa debit systems, and eftpos interchange fees now typically flow to the issuer.

Box A: Interchange Fees

An interchange fee is a fee charged by the financial institution on one side of a payment transaction to the financial institution on the other side of the transaction. They are most commonly seen in card transactions, although can arise in other payment methods.⁹

A typical card transaction (Figure 1) involves four parties – the cardholder, the cardholder’s financial institution (the issuer), the merchant and the merchant’s financial institution (the acquirer). For most card transactions, the interchange fee is paid by the acquirer to the issuer. Interchange fees can have important implications for the prevalence and acceptance of different cards as well as the relative costs faced by consumers and merchants. In contrast to normal markets for goods and services, competition in payment card networks can actually drive fees higher.

Figure 1: Stylised Flows in a Card Transaction



Financial institutions typically charge fees to their customers for payment services. Cardholders are charged by their financial institution in a variety of ways. In the case of payments from a deposit account such as debit cards, financial institutions typically charge a monthly account-keeping fee and, sometimes, a fee per transaction (or for transactions above a certain number). In the case of payments using a credit card, financial institutions usually charge an annual fee rather than a per transaction fee, and interest is charged on borrowings that are not repaid by a specified due date.

Merchants receiving payments are also typically charged by their financial institutions. The fees paid by merchants usually depend on the payment method. For credit and debit cards, merchants are usually charged a ‘merchant service fee’ for every card payment they accept. Some merchants are also charged a fee by their financial institution to rent a terminal to accept cards.

9 There is now a substantial theoretical literature on the role of interchange fees in card systems; see Verdier (2011) for a recent survey.

In contrast, interchange fees are paid between financial institutions and are present in many, but not all, card systems.¹⁰ Interchange fees are often not transparent; cardholders and merchants do not typically see them. But they have an impact on the fees that cardholders and merchants pay.

Prior to the Bank's reforms, interchange fees in the international credit and debit card schemes (MasterCard and Visa) worked differently to the domestic debit card system (eftpos).

In the MasterCard and Visa card schemes, interchange fees are paid by the merchant's financial institution to the cardholder's financial institution every time a payment is made using a MasterCard or Visa card. This has two effects. First, the merchant's financial institution will charge the merchant for the cost of providing it with the acceptance service plus the fee that it must pay to the card issuer (the interchange fee). The higher the interchange fee that the merchant's financial institution must pay, the more the merchant will have to pay to accept a card payment. Second, since the card issuer is receiving a fee from the merchant's financial institution every time its card is used, it does not need to charge its customer – the cardholder – as much. The higher the interchange fee, therefore, the less the cardholder has to pay. In effect, the merchant is meeting some of the card issuer's costs which can then be used to subsidise the cardholder. Indeed, with rewards programs, the cardholder may actually be paid to use his/her card for transactions.

Where the market structure is such that there are two payment networks whose cards are accepted very widely (i.e. merchants accept cards from both networks), and where consumers may hold one network's card but not necessarily both, competition tends to involve offering incentives for a consumer to hold and use a particular network's cards (loyalty or rewards programs, typically). A network that increases the interchange fee paid by the merchant's bank to the cardholder's bank enables the cardholder's bank to pay more generous incentives, and can increase use of its cards. However, the competitive response from the other network is to increase the interchange rates applicable to its cards.

That is, competition in well-established payment card networks can lead to the perverse result of *increasing* the price of payment services to merchants (and thereby leading to higher retail prices for consumers). This phenomenon has been most clearly observed in the US credit card market, which has not been subject to any regulation, with a 2009 report documenting a significant increase in interchange fees over the previous two decades (United States Government Accountability Office 2009). It has also occurred to an extent in the Australian credit card market over the past decade, with average interchange rates in the MasterCard and Visa systems tending to rise in between the three-year compliance resets under the current interchange Standard. As discussed further in Chapter 4, this has in part reflected the introduction of new, significantly higher interchange categories by the schemes.

In contrast to the fees charged in the international card schemes, in the eftpos system the cardholder's financial institution until recently paid the merchant's financial institution a fee for each eftpos transaction. This also had two effects. First, it increased the cost to the cardholder's bank and, potentially, the fee paid by the cardholder to use eftpos. Second, since the merchant's financial institution received a fee from the card issuer, it did not need to charge the merchant as much – if the fee was high enough, the merchant could even receive a fee from its financial institution. In this case, the cardholder was in effect meeting some of the costs of the merchant's financial institution.

When one compares the incentives for cardholders and merchants and for their financial institutions

10 For example, the European Commission (2013a) notes (p 53) that 'in Norway, the absence of IFs [interchange fees] for debit cards is accompanied by very high level of card acceptance by merchants and usage. Denmark also has one of the highest card usage rates in the EU at 216 transactions per capita with a zero-MIF [multilateral interchange fee] debit scheme. This is also true of international schemes: in Switzerland Maestro has no MIF and is the main debit card system. It is also worth noting that all European card schemes were originally created without MIFs. MIFs have been introduced by banks and card schemes only later.'

the implications of the different interchange flows described above are clear. Other things equal – in particular assuming no regulatory intervention and no surcharging by merchants to offset the differences in their costs – cardholders will have a preference to use a card from a network where interchange payments flow to the card-issuing financial institution, while merchants will prefer to receive cards from a network where interchange fees flow in the opposite direction. In circumstances where multiple card networks are widely accepted by merchants (as in Australia and many other developed countries), the consumer typically decides which means of payment is tendered and used in a transaction. Given this, financial institutions will have an incentive to issue cards from networks where interchange fees flow from the merchant’s financial institution to the cardholder’s institution, and competition may lead networks to increase the size of such fees. The generosity of cardholder rewards programs will rise, as will the cost of payments to merchants.

Interchange fees may be appropriate in some circumstances, particularly in the establishment of new systems where they may be necessary to rebalance costs between the sides of the market and ensure that both sides of a market have an incentive to participate. However, the major card schemes are mature systems, and regulators in many countries have reached the judgement that their cards are ‘must take’ methods of payments – that is, that merchants have little choice but to accept their cards. In practice, with interchange fees being used to incentivise issuers to issue cards from a particular scheme and cardholders to use that card, the tendency has been for competition between mature card schemes to drive up interchange fees and costs to merchants, with adverse effects on the efficiency of the payments system.

The 2007–08 Review

When the Bank announced its regulation of the credit card schemes in August 2002, it indicated it would conduct a review of its reforms after five years. In 2007 the Bank initiated a formal review of all of its payments system reforms, as well as the arrangements in some other payment systems that had not been subject to regulation, such as BPAY and ATMs. While this was the first formal review of the Bank’s payments system reforms to that point, the reforms had been subject to considerable external scrutiny via two unsuccessful legal challenges (noted above), as well as in a 1½ day special hearing by the House of Representatives Standing Committee on Economics, Finance and Public Administration. The Committee’s report, while recognising that there were a wide range of views about the reforms, concluded that ‘the benefits of the reform, at this point, outweigh any alleged disadvantages’.¹¹

The 2007–08 Review provided the opportunity to consider the reforms – which had been progressively implemented – as a package, with particular focus on the way the configuration of interchange fees across the various payment systems had influenced relative prices for payment services. In addition to extensive bilateral consultation, the Review encompassed an industry conference hosted by the Bank and the Melbourne Business School, which provided an open forum for discussion of the reforms. Around 90 people participated, including all members of the Board, representatives from financial institutions, merchants, schemes and academics.¹²

To inform its analysis, the Bank also undertook two studies: a cost study updating and extending the data on costs collected as part of the Joint Study in 2000, and an extensive study of how individuals make their payments. The Bank’s findings from these studies were presented at the conference. The new cost study confirmed the earlier findings on payment instrument costs. In particular, it confirmed that the resource costs involved in credit card transactions were significantly higher than for eftpos

11 House of Representatives Standing Committee on Economics, Finance and Public Administration (2006), p iv.

12 See Reserve Bank of Australia and Melbourne Business School (2008) for more detail.

transactions, even after excluding those costs associated with the credit function. Cash was found to be the lowest cost payment method for the low-value transactions for which it is generally used.

The Preliminary Conclusions of the Review were released in April 2008 (RBA 2008a). In September 2008, following further consultation, the Conclusions were released (RBA 2008b). In the Conclusions, the Board reaffirmed its view that the reforms had met their main objectives of: improving price signals in the payments system; increasing transparency; improving access; and creating a more soundly based competitive environment. The Review concluded that close oversight of retail payment systems would continue to be necessary.

The Review found no case for allowing the schemes to reimpose their 'no-surcharge' rules or to reimpose their earlier 'honour-all-cards' rules. It suggested that the various Access Regimes should remain in place and that there was a strong case for further improving the transparency of the payments system, in particular, by the publication of average interchange fees and scheme fees.

However, the Review identified an opportunity to step back from direct regulation of interchange fees, predicated on there being a sufficiently strong competitive environment to prevent interchange fees rising over time from their regulated levels. Two approaches to addressing this risk were identified:

- Industry could strengthen competition through measures which included: enhancement of the eftpos system to allow it to compete more effectively with the international card schemes and the development of an alternative system for online payments; further modifications to the honour-all-cards rules to allow merchants to make separate acceptance decisions for any card for which there was a separate interchange fee; and more transparent scheme fees.
- Four-party schemes could directly address the Board's concerns that interchange fees might rise by providing voluntary undertakings that the weighted average of credit card interchange fees would not rise above 0.5 per cent.

The Board indicated that, if industry was not able to make sufficient progress on these, interchange regulation would be retained and the benchmark for credit card interchange fees could be reduced to 0.3 per cent.

Following the release of the Conclusions, the Bank closely monitored industry progress. While progress was made, in August 2009 the Board concluded that it had not been sufficient to warrant a decision to step back from interchange regulation (RBA 2009). While the Board welcomed the establishment of eftpos Payments Australia Limited (ePAL) to operate the eftpos system as a scheme and the industry's commitment to develop an online payment system via its MAMBO (Me at My Bank Online) project, it did not believe that these initiatives had reached the point where they could exert significant competitive pressure on interchange fees. The Board also concluded that, despite the willingness of both MasterCard and Visa to work with the Bank to implement voluntary undertakings, the set of undertakings developed did not meet the Board's requirements.

Although the Board did not believe it was in the public interest to remove interchange regulation at the time, it decided to defer consideration of further reductions in interchange fees in light of the progress that had been made. It indicated that it would keep matters under review and would be prepared to reopen consideration of the regulations in light of industry developments.

Developments since the 2007–08 Review

Reforms to card payments regulation in Australia have been more incremental over the past five years. However, it is noteworthy that the initial reforms put in place by the Bank have been followed by similar reforms in a large number of other jurisdictions (see ‘Box B: Retail Payments Reforms in Other Jurisdictions’).

Box B: Retail Payments Reforms in Other Jurisdictions

At the time the Wallis Committee made its recommendations on the card systems, it was unusual for central banks or other authorities to take action focused on retail payments efficiency; restrictions on interchange fees and actions against scheme arrangements such as ‘no-surcharge’ rules were uncommon. However, subsequent to the reforms in Australia, an increasing number of countries have undertaken or proposed similar reforms.

In the case of interchange fees and merchant service fees, tables compiled by the Federal Reserve Bank of Kansas City list 38 jurisdictions as having undertaken action or initiated investigations (Hayashi and Maniff 2014). This includes recent actions in Europe and the United States.

By the end of 2015 the European Parliament and the Council of the European Union (EU) are anticipated to have approved an amended version of the package of reforms to retail payment regulations in the European Economic Area (EEA) proposed by the European Commission (EC) in 2013. The package takes a similar regulatory approach to that of the Board over the past decade, and the explanatory memoranda to the proposal made a number of references to Australian payments system reforms to support the EC’s proposed actions.

The proposed reforms include a cap on interchange fees on cards that are widely used by consumers and therefore difficult for retailers to refuse. Under the current amendments, interchange fees on all such transactions would eventually be capped at 30 basis points for credit cards and 20 basis points for debit cards, although member states also have the option of applying a fixed-value cap in combination with the basis point cap, or expressing the cap as the sum of a fixed value and percentage rate for domestic debit card transactions. While caps of 30 and 20 basis points have previously been agreed to by MasterCard and Visa for cross-border transactions in the EEA, implementation has been mixed, so the EC has decided that there is a need for an EC-wide regulatory cap applying to all transactions involving international and domestic four-party schemes. The EC argued that a failure to regulate would risk the disappearance of (typically cheaper) domestic card schemes and stymie the entry of new payments technologies and players.

The documentation to the reforms notes that caps of 30 and 20 basis points are consistent with the ‘merchant indifference test’.¹³ They also appear to be ‘reasonable benchmarks that have already been implemented without calling into question the operation of international card schemes’ (European Commission 2013b, p 13). The EC considered a zero interchange fee for debit cards and noted that eight EU member states currently have very low or zero debit interchange fees and these tend to be markets with high card issuance and use.

In the United States, interchange fees have also been subject to recent regulatory action. Debit card interchange fees (on cards issued by institutions with more than \$10 billion in assets) have been subject to a cap since October 2011 (Federal Reserve System 2011). This follows the passage of the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*, which required the Federal Reserve Board to develop rules for debit card interchange fees and network routing restrictions. Credit card

13 The merchant indifference test is the proposition that interchange fees be set at a level that results in a cost of card acceptance that makes the typical merchant indifferent between accepting a card payment and other widely used forms of payment. For further details, see Rochet and Tirole (2011) and European Commission (2013b).

interchange fees in the United States are not subject to interchange regulation but are currently the subject of a number of legal challenges by merchants.

In the period since the implementation of the Wallis reforms, provisions such as 'no-surcharge' and 'honour-all-cards' rules have also come under increasing scrutiny by central banks and other authorities. As at August 2014, the Federal Reserve Bank of Kansas City listed 36 jurisdictions as having taken action in relation to surcharges and discounts (a majority of these allow or enable surcharging, but in some cases surcharging has been prohibited but discounts allowed).

In Europe, the amended reform package includes the regulation of scheme rules covering a wide variety of topics. 'Honour-all-cards' and 'no steering' rules must be removed, so that merchants have greater choice in accepting or rejecting individual card products, including categories within a product range (e.g. accepting standard but not premium products). Any rules preventing merchants from disclosing to customers the interchange or merchant service fees that they are charged for payment services will be prohibited.

However, surcharging would be prohibited for payment methods which have regulated interchange fees: the EC argues that the new, low interchange fee cap and changes to scheme rules (which will increase transparency on costs and allow merchants to limit the cards they accept) sufficiently reduce the costs faced by merchants for these transactions. For other transactions (including corporate cards and three-party scheme cards, but also credit transfers, direct debits and cheques), surcharges must not exceed the costs borne by the merchant for the use of the payment instrument, in line with the recently enacted Consumer Rights Directive.

Reforms in a range of other countries have also established the right of merchants to surcharge for more expensive means of payments. For example, in December 2013 the New Zealand Commerce Commission noted that the ability of retailers to surcharge has provided benefits to the consumer because it is now 'a user pays system'. That is, customers using more costly payment methods are not being effectively subsidised at the expense of customers who use cheaper payment methods.

Having determined in August 2009 that it would maintain the regulatory regime for card payments for the time being, the Bank then initiated consultation on a change to the regulation of eftpos interchange fees to ensure a more level playing field between the eftpos and international scheme debit systems. A revised Standard came into effect from January 2010, capping the weighted average of any multilateral interchange fees in the eftpos system (determined by ePAL) at the same level as for scheme debit – 12 cents paid to the issuer. Further changes became effective in July 2013, with the regulation of any bilaterally negotiated interchange fees shifting to a basis consistent with other eftpos interchange fees and those of the international debit schemes. The changes were intended to place eftpos and the international debit schemes on a more consistent regulatory footing. eftpos has now moved from bilateral to multilateral interchange fees, with the highest fees set at 5 cents per transaction – flowing to the issuer, the opposite direction to pre-reform fees – which is well below the cap of 12 cents per transaction.

The Bank has also made a number of changes to access arrangements for the card systems. In November 2012, the Board made an in-principle decision (which is likely to take effect in mid 2015) that it would revoke the existing Access Regime for the eftpos system once it was satisfied that ePAL, the company managing the system, had put in place suitable access arrangements for new entrants. And in March 2014, the Board made an in-principle decision to modify its Access Regimes for the MasterCard and Visa systems. This reflected its conclusion that, while the original Access Regimes were appropriate when introduced, changes in industry structure and in the ownership of the card systems had meant that the regimes were now unduly restricting access. The amended framework

became effective in January 2015 and will provide the card systems with the flexibility to expand membership beyond existing participants. The card systems are required to have in place transparent eligibility and assessment criteria and to report information about membership and applications to the Bank.

The Bank has also been involved in negotiations with the three debit networks (eftpos, MasterCard and Visa) regarding issues concerning dual-network debit cards – that is cards issued by banks and other financial institutions with point-of-sale debit functionality from two payment networks. While these cards are convenient for cardholders and allow stronger competition between networks at the point of sale, the Bank was concerned that actions by particular networks could inhibit competition, limit consumer choice and increase costs. Following discussions between the networks and the Bank, the networks agreed to address the Board’s concerns voluntarily, safeguarding the rights of Australian card-issuing banks and institutions to maintain existing dual-network arrangements as card transactions increasingly shifted to the contactless environment. In particular, where an issuer wishes to include applications from two networks on the same card and chip, the networks agreed to work constructively with the issuer to allow this. The networks also agreed not to prevent merchants exercising choice in the networks they accept, in both the contact and contactless environments. In addition, the networks have agreed not to prevent merchants from exercising their own transaction routing priorities when there are two contactless debit applications on one card.

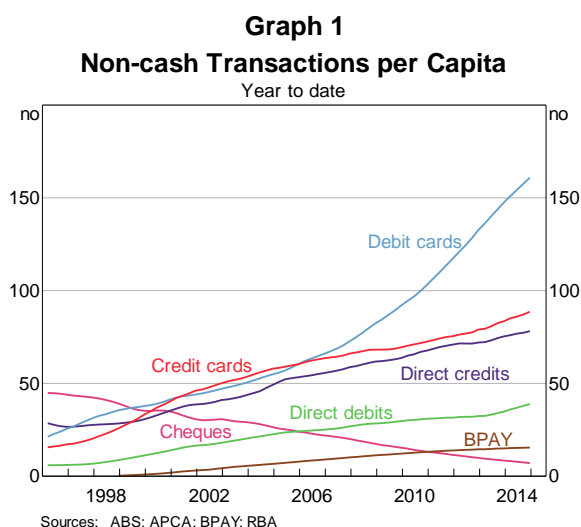
Finally, the Bank has modified its Standard with respect to surcharging. The initial reforms, effective January 2003, required the removal of the card schemes’ no-surcharge rules and allowed merchants to pass on the cost of credit card and scheme debit card transactions, resulting in improvement in price signals to cardholders. Reflecting concerns about excessive surcharging by some merchants and a tendency towards the ‘blending’ of surcharges for higher- and lower-cost schemes, in May 2012 the Board decided to vary the surcharging Standards to allow card scheme rules to limit surcharges to the reasonable cost of card acceptance. The Bank subsequently published a Guidance Note on the varied surcharging Standards, to provide clarification about the costs that might be included in ‘the reasonable cost of acceptance’. The Bank has continued to monitor developments with respect to card surcharging and signalled in its March 2014 submission to the Financial System Inquiry that it might consider additional changes to the regulatory framework in this regard.

3. Developments in the Card Payments Market

This chapter sets out the main developments in card payments and the broader Australian payments system over the past two decades or so, including the role of the Bank’s reforms in influencing outcomes.

Changes in the Use of Payment Methods

Over the last two decades there has been a marked increase in the absolute and relative use of debit and credit/charge cards in Australia (Graph 1). Card payments account for over 60 per cent of the number of non-cash payments in the economy, and card networks play an important role in determining the overall efficiency of the payments system.

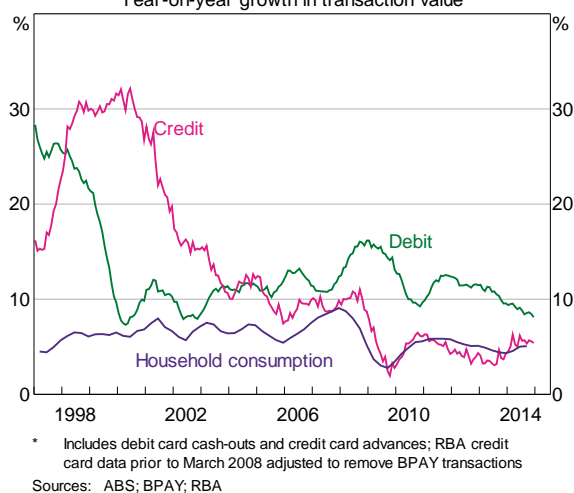


Overall, the value of card transactions in Australia has grown at an annual rate of 8.8 per cent since 2002, well above the average growth of 6 per cent in household consumption, indicating that the ‘death spiral’ that some observers predicted would result from the Bank’s reforms did not eventuate. The cards market continued to innovate, including the implementation of EMV chip cards and the introduction of ‘contactless’ (tap/wave) authentication for lower-value transactions. In particular, the adoption of contactless technology in Australia has been among the highest in the world.

Growth in credit card use was very strong prior to the reforms, reflecting among other things the increasingly generous rewards that were on offer at the time, but has moderated over the past decade (Graph 2). Growth in debit card transactions has tended to be much stronger since the reforms. This partly reflects the expansion of MasterCard and Visa in the debit market, enabling cardholders to use debit cards in a card-not-present environment (e.g. online). It is likely to also reflect the broader macroeconomic environment, with consumers reducing their use of credit following the cooling of the 1996–2003 housing boom and the subsequent global financial crisis.

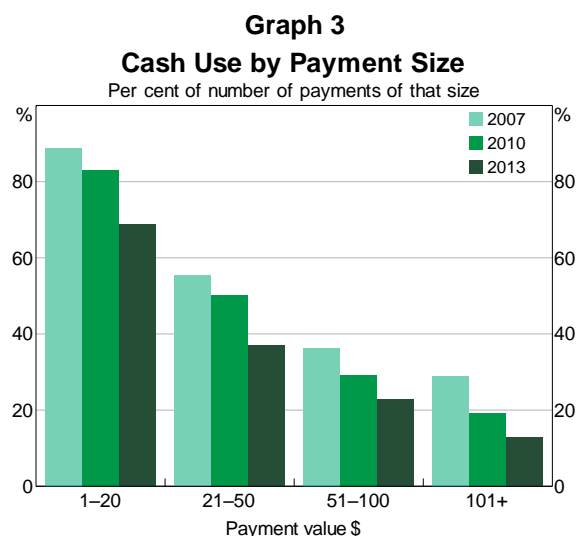
Finally, changes in price signals as a consequence of the Bank’s reforms – a reduction in the attractiveness of credit card rewards programs, greater use of credit card surcharges and a reduction in the likelihood that consumers face a charge for eftpos payments – are also likely to have had an effect.

Graph 2
Payment Card Transactions*
 Year-on-year growth in transaction value



The use of cards and other electronic payment methods (such as direct debits and credits and BPAY) is gradually replacing ‘paper-based’ methods such as cheques and cash. Cheque use in Australia has fallen from 31 per person in 2002 to 7 per person in 2014. Changes in the use of cash are more difficult to obtain since most transactions are not intermediated by a financial institution. The most comprehensive data on the use of cash – and other payment methods – by Australian consumers are found in the Bank’s Consumer Use Surveys that rely on ‘payments diaries’ to gather information on household payment patterns.¹⁴ While its relative importance for transaction purposes has declined over the Bank’s three surveys, cash was still the most frequently used payment method in 2013, accounting for 47 per cent of all payments by households and 69 per cent of transactions for \$20 or less (Graph 3).

14 See Emery, West and Massey (2008), Bagnall, Chong and Smith (2011) and Ossolinski, Lam and Emery (2014).



Sources: Colmar Brunton; Roy Morgan

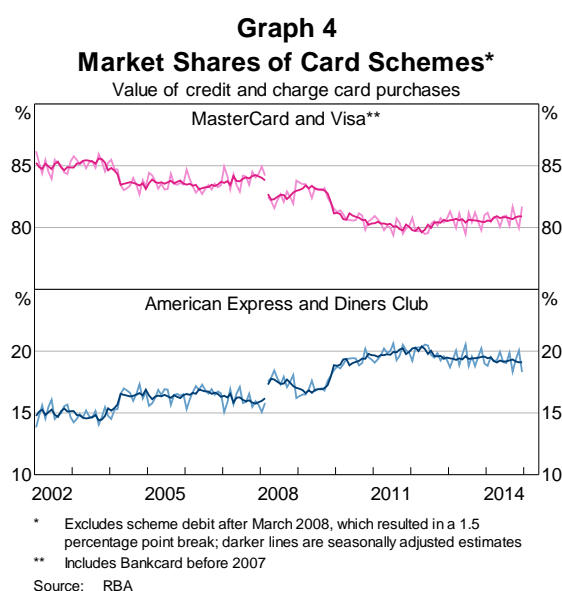
In recent years these changes in payment patterns have coincided with the emergence of new payment methods and form factors. These trends are likely to continue, or indeed accelerate, in the period ahead. One such development has been the introduction of digital wallets – systems that allow multiple payment methods to be presented simply and securely through a single interface, most often for online payments. PayPal was an early system to utilise this model and, according to the Bank’s Consumer Use Survey, was used for around 3 per cent of consumer purchases in 2013. The international card schemes are now beginning to offer similar services – MasterPass and Visa Checkout (formerly V.me) – while other wallet products are also likely to be offered in the future. Initially, many newer payment forms have been focused on online payments, which have in turn increasingly shifted to initiation via mobile phones. The use of mobile phones for point-of-sale mobile payments has been slower to emerge. However, the increasing presence of near-field communication (NFC) chips in smartphones and new approaches to utilising those chips is likely to see digital wallets increasingly enabled for point-of-sale mobile phone use, in a manner similar to contactless card payment.

In general, the above developments represent new channels for existing payment methods, rather than new payment methods per se. They may nonetheless provide opportunities for new authentication methods (such as biometric identifiers or single-use tokens) and, for merchants, the opportunity for an enhanced interaction with the customer. However they may equally present new types of challenges for transparency and competition.

A more fundamental change, however, is the emergence of digital currencies, including Bitcoin. Some utilise a completely new payments model which no longer relies on a central register of value. Instead they use a ‘distributed’ ledger, where transactions are verified by the other users of the system. To date, the use of these systems in Australia has been extremely limited, but the underlying techniques may find greater use in the years to come.

Developments in market shares in the cards market

Within credit and charge cards, there has been some shift in market share away from MasterCard and Visa since the early 2000s. While there are certain issues with the data,¹⁵ the share of the value of credit and charge card transactions held by these two schemes is estimated to have fallen by several percentage points since 2002, to around 81 per cent recently (Graph 4). This change in market share of the two major international schemes largely occurred in two steps that coincided with the launch of bank-issued American Express cards in 2004 (by NAB and Westpac) and 2009 (by ANZ and CBA).¹⁶



While bank-issued American Express cards were initially offered as stand-alone products, they are now issued as part of ‘companion’ card arrangements. Under this model, cardholders are provided an American Express card as part of a package with a MasterCard or Visa credit card, with both cards accessing the same line of credit. Cardholders are offered more reward points for spending on the American Express card, creating an incentive for the cardholder to use this card more heavily. For example, the spending required to earn a reward of a \$100 voucher is typically one-half to two-thirds lower with an American Express companion card than with the MasterCard or Visa card linked to the same account. As with its traditional own-issued ‘proprietary’ cards, American Express is the sole acquirer of companion card transactions – that is, it is responsible for relationships with merchants.

In the debit card market, there has been a steady fall in the market share of the domestic eftpos system and a rise in the share of the MasterCard and Visa schemes. While eftpos has long been priced more favourably for merchants, interchange fee differentials have made issuance of international scheme cards more attractive for banks and other financial institutions. In addition, the greater functionality of the international scheme cards (eftpos is still working to develop online and contactless functionality) has also contributed to the shift in market shares.

15 For example, debit card transactions are included in the MasterCard and Visa data prior to March 2008, resulting in a series break.

16 An ANZ-issued Diners Club card was launched in 2004 and may have contributed to the shift in market share at this time. Presently, Citibank issues a Diners Club card where the cardholder has the option of a companion MasterCard card.

Prepaid cards still represent a small proportion of the payment cards market compared with credit and debit cards, but there has been significant growth in the use of such cards in recent years. All three debit card networks have prepaid card products. A range of financial institution issuers and sponsored third-party issuers have marketed prepaid cards, both broadly, and also to specifically targeted sectors (e.g. associated with frequent flyer programs or useable at certain shopping centres or within particular retail groups). Most recently, 'premium' prepaid cards connected to airline frequent flyer programs have been introduced that not only allow for domestic use but also enable cardholders to load foreign currency balances for use overseas. These feature reward programs, and are also associated with higher *ad valorem* interchange fees rather than the per transaction rates that apply to most other prepaid cards.

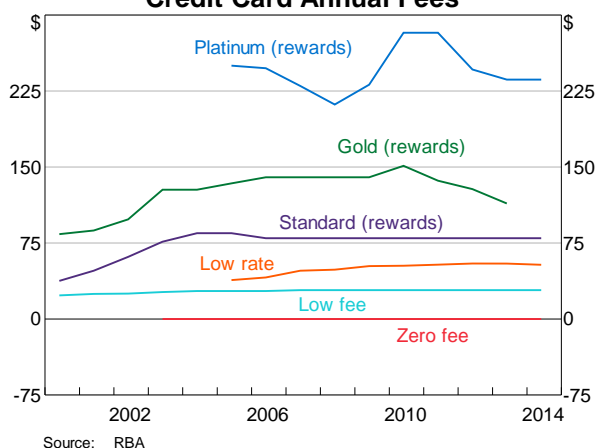
Pricing, fees and rewards in the cards market

Over the past decade, a broader range of card products has become available. The credit card market in particular has been subject to strong competition, with much greater product differentiation in terms of features attached to a credit card account.

At the broadest level, cardholders can choose between holding credit cards that offer no rewards (now including 'low-rate' and 'low-fee' cards) and cards with rewards programs of varying levels of generosity (cards offering more substantial rewards generally command higher annual fees). Consumers who use their credit card relatively frequently may be attracted to cards offering rewards points and other benefits such as travel insurance and enhanced warranties for goods purchased on the card. Low-fee cards may be more attractive to cardholders who use their credit card relatively infrequently and typically pay their credit card balance in full each month or within the interest-free time frame. For cardholders who carry outstanding balances outside of the interest-free period, low-rate cards tend to be more attractive as the average interest rate on these cards is around 6½ percentage points lower than the interest rate on rewards cards.

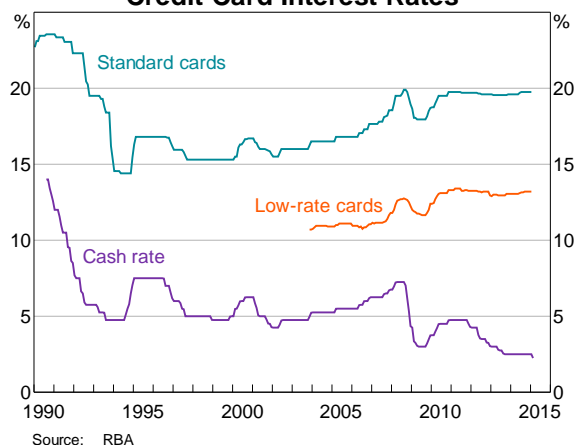
The Bank undertakes an annual survey of bank fees, which includes annual fees for a selection of credit cards (Graph 5). Annual fees appear to have risen somewhat around the time of the reforms, but have since been reasonably stable and have tended to decline in real terms. However, care should be taken with any data on annual fees since the population of card types has changed substantially over time. For example, 'gold' cards were originally offered as premium cards, with higher fees and higher rewards, but are now viewed as similar to 'standard' rewards cards, having been supplanted in the hierarchy by 'platinum' and 'super-premium' cards.

Graph 5
Credit Card Annual Fees



As in many other countries, credit card interest rates in Australia do not always track movements in other rates particularly closely (Graph 6). Based on a sample of cards tracked by the Bank, since around 2010 the average interest rate for standard cards has been fairly steady at just under 20 per cent, while for low-rate cards the average interest rate has been about 13 per cent. However, it is important to note that these data are advertised ‘ongoing’ interest rates rather than the average interest rate actually paid. They do not take into account special balance transfer offers that cardholders may receive for switching their debt to another issuer, with most banks currently offering such programs, often with zero rates for 12 months or more. Furthermore, interest on credit card debt is only paid by some cardholders (‘revolvers’), who account for less than 30 per cent of credit card holders according to the Bank’s 2013 Consumer Use Survey.¹⁷

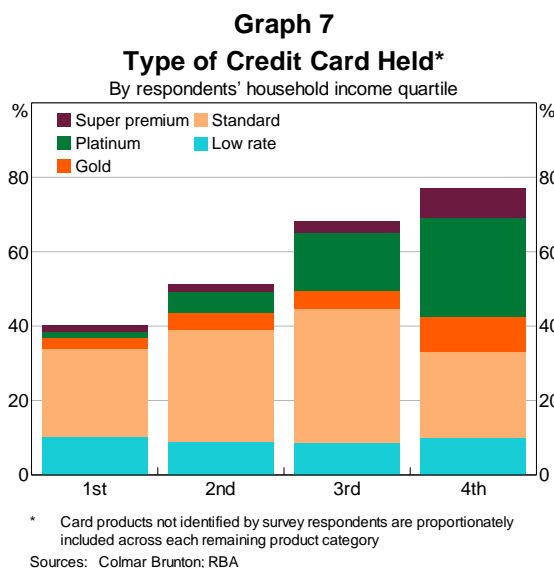
Graph 6
Credit Card Interest Rates



The Bank’s 2013 Consumer Use Survey also shows that credit cards are more widely held by higher income individuals, with those in the highest income quartile far more likely to hold a premium-status

¹⁷ Cardholders who pay their credit card balance in full before the interest-free period expires are typically called ‘transactors’; those who regularly carry outstanding balances and thus pay interest on their credit cards are ‘revolvers’.

card than those in the lowest quartile (Graph 7).¹⁸ Since the Bank's reforms, rewards available on credit cards have tended to fall, although the changing range of credit card products and the introduction of 'platinum' and 'super-premium' cards mean that comparisons over time need to be interpreted carefully. A fall in the generosity of rewards programs was to be expected following the reduction in interchange fees payable to card issuers.



Debit card services are generally bundled with a range of transaction and account services. The pricing arrangements for transaction accounts have been largely unchanged over the past few years, generally featuring a monthly account-keeping fee which entitles the user to make an unlimited number of card, internet/telephone banking, cheque and branch transactions, along with withdrawals at ATMs operated by the cardholder's own institution or an affiliated network.¹⁹ Some financial institutions offer these accounts for a zero monthly fee, while others offer low-fee accounts that provide free electronic, but not branch or cheque, transactions. In practice, many account holders are not required to pay the posted monthly fee, with institutions commonly waiving this if the cardholder deposits sufficient funds into the account each month or if the account is part of a broader package of banking services (e.g. if the cardholder has a home loan with the institution). Premium debit cards are much less common than premium credit cards, though 'premium' MasterCard and Visa debit cards have recently emerged, in response to interchange categories encouraging such issuance. These feature some of the benefits traditionally associated with premium credit card programs.

Developments in Surcharging

The take-up of surcharging by merchants following the removal of no-surcharge rules in 2003 was gradual. While only a relatively small share of merchants initially exercised the right to surcharge, the proportion of merchants applying a charge for one or more card schemes has increased over time. Survey evidence suggests that surcharging behaviour is linked to the cost of card payments, with merchants more likely to surcharge American Express and Diners Club (typically the more expensive

18 If 'gold' cards are treated as having premium status, the fourth quartile (that is, the highest-income quartile) is six times more likely to hold a 'premium' card than the first quartile; including only 'platinum' and 'super-premium' products, holdings of the fourth quartile are 10 times larger.

19 Previously, some institutions charged for eftpos (but not international scheme debit) transactions, reflecting the cost to issuers arising from the eftpos interchange fee which at the time flowed from issuer to acquirer.

schemes) than MasterCard and Visa. Furthermore, the Bank's 2013 Consumer Use Survey indicated that the median surcharge on transactions involving American Express cards was 2.0 per cent, compared with 1.5 per cent for surcharged MasterCard and Visa transactions. Debit cards are less likely to be surcharged than credit cards, consistent with the difference in cost to most merchants.

The ability of merchants to surcharge has made the cost of particular payment methods more apparent to consumers and enabled merchants to encourage the use of lower-cost payment methods. The Bank's 2010 Consumer Use Survey found that around half of consumers who hold a credit card would seek to avoid paying a surcharge by paying with a debit card or cash, payment methods that typically do not incur a surcharge. Both the 2010 and 2013 surveys indicated that a surcharge was actually paid on only around 4 per cent of transactions. The more recent survey showed that surcharges were more commonly paid in the 'card-not-present' environment (13 per cent of such transactions) than in the 'card present' environment (2 per cent). This may reflect a number of factors including fewer alternative payment options in remote or card-not-present environments, fewer concerns about adverse effects on the customer experience in online situations, greater pressure to reduce headline prices due to online price comparison activity, and higher card acceptance costs in the card-not-present environment (due to higher interchange rates and higher risk of fraud).

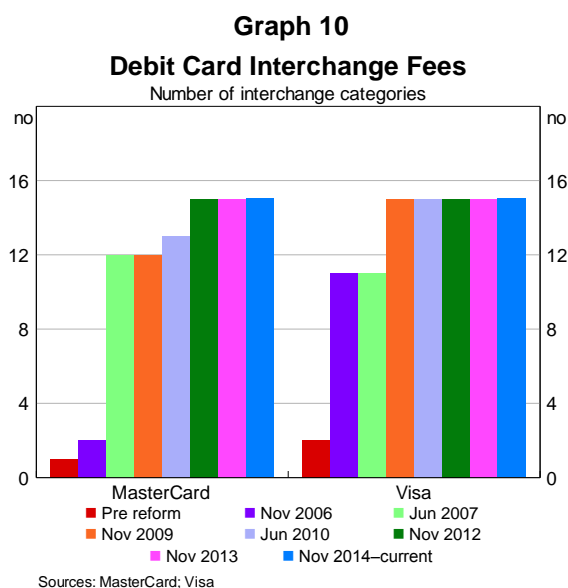
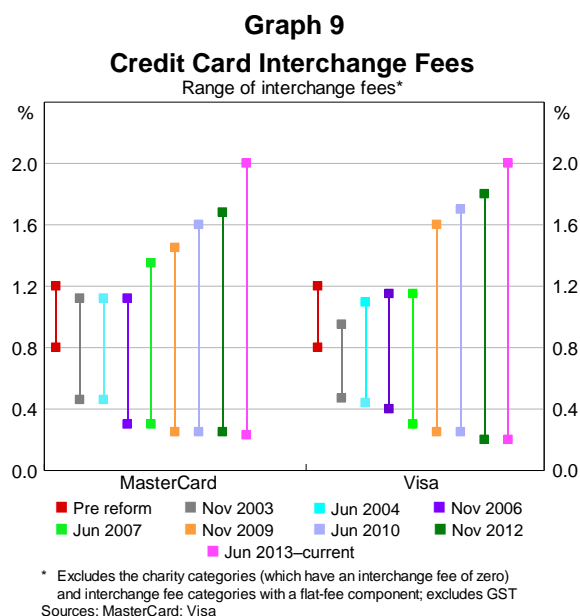
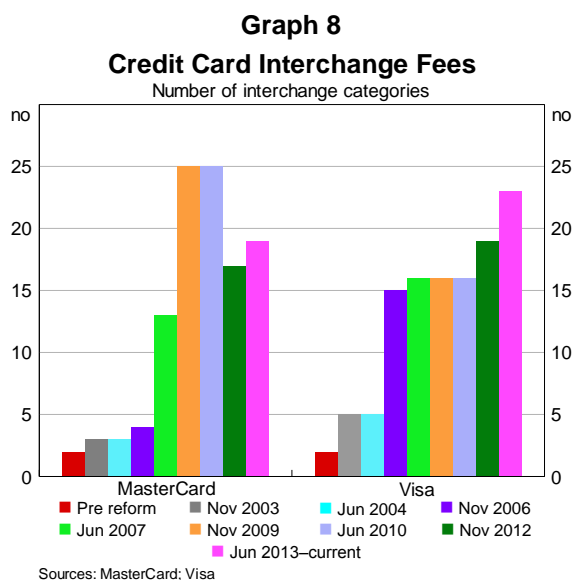
Despite the modification of surcharging Standards in March 2013 to address concerns about 'excessive' and blended surcharging, excessive surcharging remains a concern for many stakeholders, with the recent Financial System Inquiry (FSI) receiving over 5 000 submissions on the topic as part of a public campaign. Such concerns have been focused on the taxi industry (where a 10 per cent card surcharge has long been imposed, though some state governments have now imposed caps of 5 per cent) and the airline industry (where fixed-dollar, rather than percentage-based, surcharges are typical). The FSI's Final Report recommended that the Board consider a three-tiered approach to addressing excessive surcharging (see Chapter 5).

Interchange Fees

The Standards on interchange fees for the MasterCard and Visa systems set benchmarks for the average interchange fee that can be paid in those systems. The Standards require that every three years, or at the time of any other reset of interchange fees, the weighted average of the new schedule of interchange rates does not exceed the benchmark, with weights based on the transactions of the most recent financial year. In practice, compliance resets have occurred every three years on 1 November, with MasterCard and Visa voluntarily resetting their interchange schedules on 30 June of the following year and on a few other occasions. Reflecting the backward-looking compliance calculation, the incentives created by the international schemes' interchange fee schedules and the issuance strategies of financial institutions, the weighted-average interchange fees for the two schemes have followed a 'sawtooth' pattern and the weighted-average interchange rates have tended to be above the benchmarks, albeit well below the average levels of before the reforms.

For credit cards, the number of categories of interchange fees has risen from 3 to 19 for the MasterCard system and from 5 to 23 for the Visa system since November 2003 (Graph 8). Furthermore, there has been a significant widening in the range of interchange rates. For the MasterCard system this range has widened from 66 basis points in 2003 to 177 basis points currently,

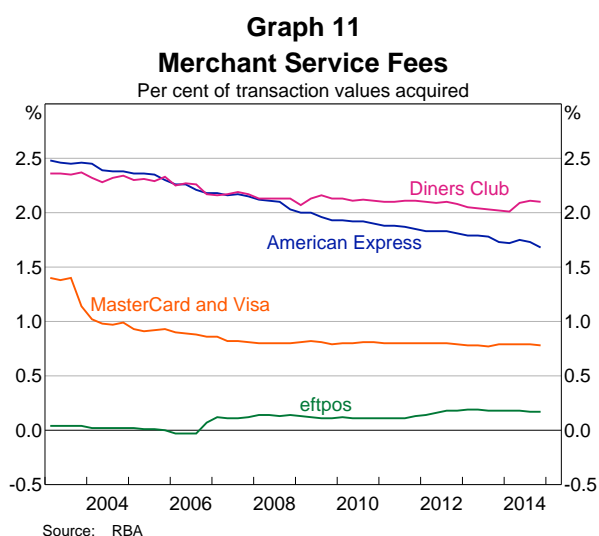
while the range for Visa has widened from 48 basis points to 180 basis points (Graph 9).²⁰ In the case of debit cards, the number of categories has increased to 15 for both MasterCard and Visa from 1 and 2 categories, respectively, pre-reform (Graph 10). The range of debit interchange rates has also widened. However, because some rates in the debit card systems are now *ad valorem*, the extent of this widening varies with transaction size. For a \$50 transaction, the difference between the highest interchange rate and the lowest (excluding charities and micropayments) is 43 cents or 87 basis points.



²⁰ This range excludes the rate for charities, which is zero. All interchange rates quoted in the paper are excluding GST.

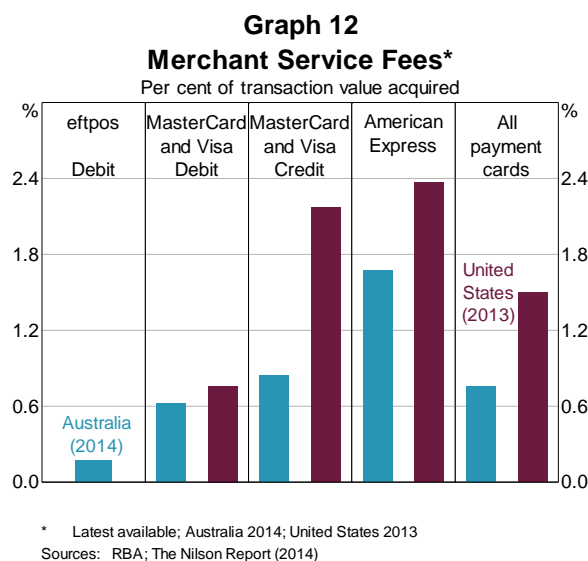
Merchant Service Fees

Average merchant service fees for MasterCard and Visa transactions have fallen by 63 basis points relative to their levels prior to the reforms (Graph 11). This is a larger fall than the reduction in interchange fees for the MasterCard and Visa credit card systems. Despite there being no direct regulation of the ‘three-party’ schemes, merchant service fees in these systems have also fallen, with the decline in American Express’ fees slightly larger than that of MasterCard and Visa. Average merchant service fees for eftpos transactions have risen by around 12 cents (or by 0.20 per cent of transaction value) from their levels prior to the start of the eftpos interchange fee reforms in 2006, although eftpos remains the lowest cost scheme for merchants in terms of average merchant service fees.²¹



Combining transactions across all card systems, average merchant service fees in Australia have fallen by around 38 basis points from their level prior to the Bank’s reforms. Furthermore, the latest available annual data show that average merchant service fees are around 74 basis points lower than in the United States, where reforms to card systems have been much more limited (Graph 12).

21 The increase in the cost of eftpos reflects the regulated reduction of eftpos interchange fees in 2006 and the subsequent reversal of their direction after the eftpos interchange cap was aligned with that of the Visa Debit system in 2010. While fees to merchants have risen, the change in interchange arrangements means – as would be suggested by ‘Box A: Interchange Fees’ – that fees to account holders for eftpos transactions have tended to fall. Previously, many account holders had monthly limits on the number of fee-free eftpos transactions they could make in a month: such transactions are now typically unlimited.



Overall, the effect of the reforms has clearly been a reduction in merchant costs: one simple estimate of these savings is a total of around \$13 billion relative to the amount merchants would have paid since November 2003 if merchant service fees had remained at the rates existing prior to the reforms.²² To the extent that interchange fees might have risen significantly in the absence of the Bank’s reforms, any estimate of the savings to merchants would be far larger. For example, if average merchant service fees on card payments in Australia had instead risen to the levels seen in the absence of interchange regulation in the United States, *annual* costs to Australian merchants would now be around \$4–4½ billion higher than current levels.²³

It is impossible – given the imprecision in any econometric model of consumer price inflation – to measure exactly how these reductions in merchant service fees have flowed through into prices for consumers. However, just as with reductions in any other business costs – such as wages, taxes, the cost of energy, etc – that influence the prices charged by business in any industry, it seems reasonable to assume that they have mostly flowed through to lower retail prices for consumers, just as it is reasonable to assume that increases in merchant costs are similarly passed on to consumers over time. While the presumption that interchange rates influence the retail prices for goods and services faced by consumers has been questioned by the international schemes and in studies funded by them, it has been widely accepted by others (see for example, FSI (1997), p 396; Vickers (2005), p 233; FSI (2014b), p 173; European Commission (2014), p 14).

22 Similar estimates can be obtained from comparing total merchant service fees paid between November 2003 and December 2014 for observed transaction volumes to two counterfactuals which both assume that average merchant service fees had remained at their starting level: the first scenario is based on the actual progression of each scheme’s share of the total value of card transactions; while the second scenario assumes that schemes’ market shares remained at their starting levels.

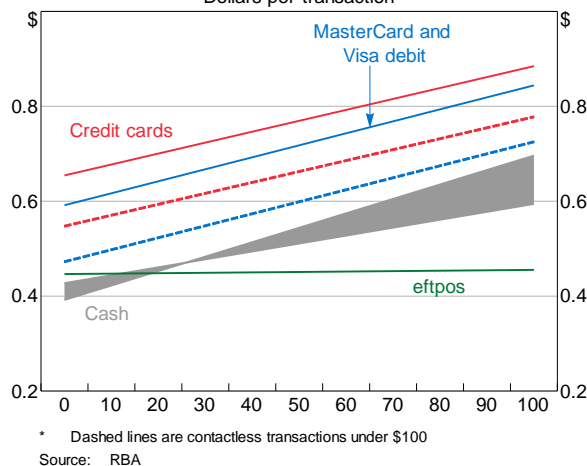
23 The calculation takes the number and value of card transactions acquired in Australia and applies US merchant service fees. The US merchant service fee data are from The Nilson Report (2014) for the latest available year (2013) except in the case of debit cards, where pre-Durbin Amendment merchant service fees (2010) are assumed (The Nilson Report 2011). The implied average of merchant service fees for the United States is 1.70 per cent, compared with the actual average for Australia of 0.73 per cent.

Payment Costs

The Bank has conducted two comprehensive studies of the aggregate resource costs (the economic resources that are expended to ‘produce’ a payment) incurred by financial institutions and merchants in accepting payments from consumers.²⁴ The results suggest that the costs involved in providing payment services to households have fallen from 0.80 per cent of GDP in 2006 to 0.54 per cent of GDP in 2013. Based on the most recent estimate, it appears that Australia now has a relatively low cost payments system by international standards. The fall between the two surveys reflects per transaction costs having fallen across most instruments. Marginally offsetting this effect, there was a shift towards greater use of more expensive instruments between the studies.

Direct debit was the lowest cost of all methods considered in the 2013 study, while cheques were the most expensive. Among the methods typically used at the point of sale, cash and eftpos were the least costly in 2013, with cash having become slightly more expensive as its use has declined and eftpos having become less expensive. Cash, eftpos and contactless MasterCard and Visa debit were estimated to have broadly similar resource costs for transactions of under about \$20 (Graph 13). Above \$20, eftpos was the lowest cost point-of-sale payment method. MasterCard and Visa debit card payments were more resource intensive than eftpos, while credit card transactions were the most resource intensive card payment method even when excluding the costs of credit and rewards.

Graph 13
Resource Costs by Transaction Value*
 Dollars per transaction



Given that decision-making by consumers and merchants is not driven by resource costs, but rather the private costs and benefits that these groups face, the 2013 study also considered the effect of fees and other transfers between consumers, merchants and financial institutions. This issue is most relevant in the case of credit cards, where consumers pay fees for cards but also receive significant incentives to use them to make purchases, due to rewards points and the interest-free period. The results indicate that on average the private cost to consumers of using a credit card is similar to that for a debit card despite the significantly higher resource costs incurred for credit card transactions.

24 See Schwartz *et al* (2008) and Stewart *et al* (2014)

4. Issues for the Review

With the benefit of further evidence since the time of the 2007–08 Review, the Bank’s view remains that its reforms have been in the public interest and helped contribute to a more efficient and competitive payments system. Contrary to the ‘death spiral’ predicted by some who opposed the reforms of the early 2000s, the Australian cards market has continued to grow and innovate, with the value of card transactions growing from \$187 billion in 2002 to \$510 billion in 2014. Furthermore, as outlined in ‘Box B: Retail Payments Reforms in Other Jurisdictions’, the Bank’s reforms have been followed by similar reforms in many other jurisdictions.

However, the previous chapter has touched on some developments that raise concerns from the perspective of competition and efficiency in the payments system. Accordingly, the Bank considers that there would be benefits to a review of the current regulatory framework for the cards system.

Issues that might be addressed in such a review include:

- The decline in transparency for some end users of the card systems, in part due to the increased complexity and the wider range of interchange fee categories.
- Whether there is scope for interchange fees to fall further, consistent with falls in overall resource costs and as was contemplated in the conclusions to the 2007–08 Review.
- Widespread perceptions that card surcharges remain excessive in some industries.
- Perceptions that the growth of companion card arrangements may indicate that the current regulatory system is not fully competitively neutral.
- Some uncertainty in the regulatory treatment of prepaid cards.
- Clarifying arrangements for cards offering access to more than one payment network (whether presented physically or virtually via a wallet application) and more broadly for competing payment options in a single device or application.

Issues in the Transparency of Card Payments

This section describes some areas where there has been a decline in the transparency available to many merchants about the cost of cards. These merchants are hindered in their ability to control their payment costs, given that they are typically unable to see the cost of different cards, are restricted by card scheme rules from choosing to accept only some types of debit or credit cards, and in practice are unable to differentially surcharge to reflect the difference in payment costs. As a result, cardholders may not face the correct price signals associated with their choices, which is likely to result in cross-subsidisation and less pressure to reduce the cost of payments.

One example of the lack of transparency in the card systems concerns the inability of merchants to distinguish between debit and credit cards in some contexts. In the card-present/point-of-sale

environment, a merchant should have full visibility over whether a physical card is a debit card or a credit card, given that the relevant Standard requires that all debit cards must be *visually* identifiable as such. In principle, cards should also be *electronically* identifiable as debit rather than credit in the card-not-present environment, given that the Standard requires that debit cards are issued on identifiable Bank Identifier Numbers (BINs) and that acquirers are required to provide these to merchants on request. In practice, however, some merchants in the card-not-present environment report that they are unable to distinguish between debit and credit. One reason that has been reported is that acquirers are unable to obtain reliable and timely lists of debit and credit BINs from the international schemes.

Based on follow-up on some of the consumer complaints about surcharging that the Bank receives, the inability of merchants to distinguish between debit and credit cards appears to be a fairly common phenomenon. It may not, however, be that surprising, given that until now many merchants have been presented with a single merchant service fee applying to both credit and debit transactions, and may not have perceived an incentive to distinguish debit from credit cards.

A second example of the lack of transparency stems from the increase in the number of interchange categories in the MasterCard and Visa credit and debit systems and the widening in the range of different interchange rates, both described in Chapter 3.²⁵ Schedules of interchange rates are set by the two international schemes and specify the interchange rate to be paid based on the category of merchant ('strategic', service station, etc), the type of card (various types of premium cards, corporate, etc) and the nature of the authentication (contactless, SecureCode, etc) or value of the transaction (Table 1). There is a hierarchy of categories, which determines how the merchant, card and transaction categories interact. Typically, the relatively low 'strategic' interchange rates for large merchants have precedence over the interchange category for the type of card, so that the same relatively low rate for strategic merchants applies for all their transactions, including for those using premium cards with high interchange rates. However, merchants that do not have access to strategic or merchant-specific rates will face different rates based on the type of card presented.

There have been significant changes in the average credit card interchange rates that apply to particular types of merchants since the introduction of merchant-based interchange categories in 2006 (by Visa) and 2007 (by MasterCard). Interchange rates for 'strategic' and some other specific types of merchants have been lowered over this period, while the interchange fee rates that apply to the various types of premium cards have risen. Visa and MasterCard initially each had a single tier of premium interchange rates in 2006, but Visa now has six different premium fee categories for consumer cards and five commercial fee categories, while MasterCard has three consumer premium categories and three commercial categories. Based on the hierarchy of interchange rates, the cost of the high interchange rates for consumer premium and commercial cards falls entirely on small merchants and other merchants that do not benefit from special rates.

25 The tendency towards a larger number of interchange categories is not, however, a purely Australian phenomenon nor a product of our regulatory system. In the United States, where there is no regulation of credit card interchange, the average number of credit card interchange fee categories for MasterCard and Visa increased from 4 in 1991 to 151 in 2009 (United States Government Accountability Office 2009). Currently MasterCard's US credit card interchange rates are generally lowest for strategic merchants such as Tier 1 supermarkets (1.15–1.25 per cent) and for utilities payments (65–75 cents) but can be as high as 3.25 per cent (plus 10 cents) in the case of premium cards for merchants that do not benefit from strategic rates.

Table 1: Interchange Fees^(a)
Excluding GST; as at February 2015

	Credit card Per cent		Debit card ^(b) Cents unless otherwise specified	
	MasterCard	Visa	MasterCard	Visa
Consumer electronic	0.30	0.30	9.1	8.0
Consumer standard	0.30	0.30	0.21 %	0.30 %
Consumer premium/platinum	0.95	0.93	0.91 %	0.91 %
Super premium	1.59	–	–	–
Visa Rewards	–	1.50 or 1.70 ^(c)	–	–
Visa Signature	–	1.80	–	–
Consumer elite/high net worth	2.00	1.80 or 2.00 ^(c)	–	–
Commercial	1.00	0.97 or 1.20 ^(d)	0.91 %	0.91 %
Commercial premium	1.30 or 1.35 ^(e)	1.30 or 1.80 ^(f)	–	–
Strategic merchant	0.23 or 0.29	0.20 to 0.40	2.8 or 3.6	2.0 to 60.0
Government/utility	0.29	0.30	7.0	6.0
Charity	0.00	0.00	0.0	0.0
Petrol/service station	0.29	0.30	7.0	6.0
Education	0.29	0.30	–	6.0
Supermarket	–	0.30	–	6.0
Insurance	–	0.30	–	6.0
Transit	–	0.30	–	6.0
Recurring payment	0.29	0.30	10.0	6.0
Contactless ^(g)	0.29	–	5.0	–
Quick Payment Service	0.40	–	6.0	–
Micropayment ^(h)	–	–	0.4	–
SecureCode merchant	0.30	–	8.0	–
SecureCode full	0.30	–	10.0	–
Benchmark	0.50	0.50	12.0	12.0

(a) Fees are paid by the acquirer to the issuer, except for transactions involving a cash-out component

(b) For comparison, the multilateral interchange fees in the eftpos system are: 0 cents per transaction (charity and low-value transactions); 0 to 4.5 cents per transaction (strategic merchants); 4.5 cents per transaction (electronic POS)

(c) The higher rate applies if an account is deemed qualified (if spending on that account exceeds a card-specific threshold)

(d) Visa has three types of non-premium commercial rates; the 'business' category attracts a fee of 0.97% while the 'corporate' and 'purchasing' categories attract a fee of 1.20%

(e) 1.30% for the 'commercial corporate executive' category and 1.35% for the 'commercial business executive' category

(f) 1.30% for the 'commercial premium' category and 1.80% for the 'business signature' category

(g) MasterCard *PayPass* transactions equal to or less than \$60, excluding commercial credit cards

(h) Transactions with a value equal to or less than \$15

Sources: ePAL; MasterCard; RBA; Visa

Broadly similar developments have also occurred with respect to the debit interchange rates of MasterCard and Visa. The schemes have introduced low strategic or special rates for particular types of merchants as well as high rates for commercial cards. They have also introduced high rates for premium cards, though there has been relatively little issuance of such cards, with rewards programs hitherto being much less prevalent and less generous than for credit cards. For both schemes, the precedence hierarchy is such that merchants receiving strategic and other special rates receive low rates on all their transactions, so that only non-qualifying merchants are subject to the high commercial and premium rates.

There are two significant consequences of these developments in interchange schedules. First, there are now large differences in the average interchange rates paid on the transactions of strategic or qualifying merchants compared with other merchants. The Bank estimates that the average credit card interchange rate for non-preferred merchants (i.e. those not benefiting from strategic or other preferential rates) was more than 50 basis points higher than the interchange rate applying to preferred merchants in the December quarter of 2014. For MasterCard and Visa debit cards, the average interchange rate paid by the non-preferred group of merchants is estimated to have been around 12 cents per transaction higher than the rate applying to the preferred group.²⁶ These differences in interchange rates have a corresponding effect on the merchant service fees faced by the two groups which is in addition to the higher margin that acquiring banks would normally apply to small merchants relative to large merchants. For both debit and credit cards, the tendency has been for the differences in interchange fees applying to the two groups to have widened significantly since merchant specific rates were first introduced.

The second consequence of the complex interchange fee schedules is that the non-preferred merchants have little transparency over the cost of particular transactions. In the case of a MasterCard or Visa credit card transaction, the interchange rate will be 30 basis points on a standard card but will be 200 basis points if the transaction involves the highest level of premium card. In the case of an average-sized debit transaction, the interchange payment would be around 8 or 9 cents on a standard debit card transaction but around 50 cents on a premium or commercial card. Without any visibility over the cost of the particular card used in the transaction, a merchant that wishes to charge to reflect the much higher cost of some cards is unable to do so.

At present, there is no requirement that credit and debit cards should be identifiable to merchants in terms of their interchange cost, either visually or electronically, and the Bank is not aware of any acquirer in the Australian market that provides such information to its merchants at the time of the transaction. In any case, while BINs for each card type have traditionally been associated with a particular interchange category and rate, this is becoming less so with the recent introduction of 'account-level processing' for premium cards. This allows issuers to upgrade (or downgrade) the benefits and interchange rate associated with a card without changing its BIN and account number. More broadly, the issue of the lack of transparency of the cost of payments to merchants is likely to grow based on some ongoing changes in payments technology. In particular, as card-present transactions shift from involving physical cards to information stored on mobile phones, the ability of

26 For eftpos, the gap is estimated to be much smaller. The interchange schedule for ePAL is much simpler, with all merchants eligible for an interchange rate of zero on transactions of less than \$15, and then subject to a rate of between zero and five cents on larger transactions, depending on whether they qualify for a strategic rate. ePAL does not have 'premium' category cards and therefore does not have any such interchange rates.

merchants to observe the nature of the ‘card’ declines. Similarly, if the share of card-not-present transactions continues to rise, problems with the lack of transparency may increase.

Interchange Fees and Payments System Efficiency

While the regulatory changes implemented by the Bank starting in 2003 reduced the potential for interchange fees to drive inefficient payment choices, it is nonetheless possible that at current levels interchange fees continue to distort decisions to some degree.

Potential distortions from interchange fees come about because many merchants may feel that they have no choice but to accept the cards of a large scheme – that is, the cards are regarded as a ‘must-take’ form of payment – and have no capacity to influence a significant component of the cost in the form of the interchange fee. With little downward competitive pressure on interchange fees and little capacity for many merchants to refuse acceptance, interchange fees can be focused largely on providing incentives to issuers to issue the cards of a particular scheme and to cardholders to use those cards. These incentives are independent of the resource costs of a particular card scheme and may distort payment decisions, leading to overuse of some higher-cost payment methods and inefficiency in the payments system more generally. For instance, the Bank’s 2013 Payments Cost Study shows that – for the average-size transaction for each payment method – the effective price paid by a cardholder to use a credit card is lower than that for a debit card, even though the resource costs are substantially higher. While these tensions are most evident in competition between card schemes, the same principle is valid more broadly; it is entirely possible that interchange fee flows are leading to card payments being overused relative to non-card systems, for instance the Direct Entry system which was estimated to have the lowest cost of any system in the Payments Cost Study. Similarly, a new, low-cost payment system might have difficulty establishing itself in the face of existing interchange fees in mature card systems.

The Bank’s reforms starting in 2003 have served to bring the average interchange fees of the different card systems closer together (and closer to zero), meaning that decisions about the choice of payment method are more likely to be based on the relative attributes of the different systems themselves, rather than being driven by price signals underpinned by centrally set interchange fees. The Bank’s assessment is that the caps on card interchange fees have limited the potential for those fees to disrupt efficient payment choices, and have contributed in a significant way to the fall in the overall resource cost of payments that is apparent in the Bank’s recent Payments Cost Study.

However, as suggested in the recent Financial System Inquiry (FSI 2014b, p 173), it is possible that existing caps are still inefficiently high. It is apparent from the data shown in Chapter 3 that the reduction in interchange fees for the international systems has not prevented continued strong growth in the card systems in Australia. Indeed, given that one of the justifications often cited for interchange fees is that they may be helpful in stimulating growth in a payment system in its early phase, it is noteworthy that the significant increase in card payment volumes and the accompanying fall in average resource costs have not been associated with a fall in interchange fees in Australia. In addition, there are instances internationally of card systems that function effectively without interchange fees and also recent cases where regulators and card schemes have set lower

interchange caps than exist in Australia, including by seeking to align interchange fees with the transactional benefits that merchants derive from card payments (the Merchant Indifference Test).²⁷

Furthermore, there continue to be indications that the differential in interchange fees between the eftpos system and the international scheme debit products is influencing behaviour. While cardholder rewards have not generally been used to drive adoption of debit cards, issuers appear to have responded to interchange fee differentials and other incentives from payment schemes. For instance stand-alone 'proprietary' ATM/eftpos cards, which once were a standard offering for financial institutions, have in most cases been replaced with MasterCard or Visa branded dual-network cards over recent years (often with a sticker urging the cardholder to use the MasterCard or Visa network rather than eftpos). It is also notable that, once placed on the same interchange cap as MasterCard and Visa debit products, ePAL has moved eftpos interchange rates closer to those of the international schemes, suggesting that it considers the interchange differential to be detrimental to its capacity to compete and confirming that there are few forces constraining interchange fees beyond regulation.

In addition, the current mechanism used for capping interchange fees raises some issues in regard to the level of interchange fees over time. Interchange regulation for both credit and debit cards involves the Bank setting a benchmark for the weighted-average interchange rate. Credit card schemes' benchmarks were initially scheme specific, but since November 2006 have been set at 50 basis points for both MasterCard and Visa. The Standard requires that at the time of any reset, the weighted average of each scheme's interchange fees – based on applying the new interchange rates to the transactions of the most recent financial year for which data are available – does not exceed the benchmark. The combination of the infrequent and backward-looking nature of benchmark compliance and the schemes' management of their interchange fee schedules has meant that in practice the weighted-average interchange fees for the schemes (using the current mix of transactions) have almost always been above the benchmark.

By setting different interchange fees for different card types, card schemes encourage card issuers to issue and promote those cards with the highest interchange rates. This leads to a tendency for average interchange fees to increase between benchmark compliance points. However, a more active strategy employed by the schemes has been to introduce completely new, higher interchange rate categories. These initially have a zero transaction weight for benchmark purposes and thus provide the opportunity for issuers to increase interchange revenue received from acquirers by modifying the mix of their card products following the reset – replacing standard cards with 'premium' cards, premium cards with 'super-premium' cards, and so on. Of course, after three years of upwards interchange drift, the schemes must then reduce some rates to ensure compliance with the benchmark, and they have tended to again set their schedules in ways that will cause interchange rates to rise again during the next three-year period. The resulting expansion in the number of categories and the range of fees is illustrated in Chapter 3 (Graph 8 and Graph 9). As noted in footnote 25, the broader tendency to an expansion in the number of fee categories is not purely a reflection of the Australian regulatory framework – the unregulated US credit card market provides a much stronger example of this tendency.

The behaviour resulting from the current benchmark approach means that average interchange fees (at least in the case of credit cards) have been consistently over the benchmark. This implies that

27 See footnote 10 which identifies that there are a number of European countries with high use of card payments but where debit systems have no or very low interchange rates.

credit card interchange fees should be thought of as loosely anchored around an average of something over 0.5 per cent over a three-year compliance cycle, rather than capped at 0.5 per cent. Of more concern is the fact that there has been a tendency for the upward drift relative to the benchmark to increase over time, so that the average interchange rate for each compliance cycle is increasing.

A separate issue is whether the specification of interchange fee caps remains appropriate. In particular, the current debit benchmark is specified in cents per transaction. The evolution of the payments system over recent years has seen increasing use of card payments for low-value transactions. This has, for instance, resulted in the average value of a MasterCard or Visa debit card transactions falling by around 40 per cent since 2008. This in turn has meant that average interchange fees have increased as a percentage of the average debit transaction and, while the schemes have some pricing arrangements that accommodate it, interchange fees can in some cases be very high relative to the value of a small payment.

Excessive Surcharging

The right to surcharge is an important mechanism for improving payments system efficiency. It allows merchants to signal the cost of different payment methods to users, influencing payment choices, and allowing merchants to pass costs directly on to those using more expensive payment methods so that the general level of merchants' prices can be kept lower. Surcharging is also one means by which merchants can exercise some pressure on merchant service fees and interchange fees; for example, the removal of the no-surcharge rule in the American Express system is likely to have contributed to the decline of merchant service fees for that system.

While ensuring that merchants have the ability to pass on the cost of expensive payment methods has been beneficial for the payments system, the Bank has been concerned that in a small number of cases, merchants have been able to apply surcharges that are well in excess of acceptance costs, leading to poor price signals. While this should not be sustainable in a competitive environment, circumstances appear to exist in a small number of industries that allow it to occur.

The Bank responded to these concerns with changes to its Standards that became effective in 2013; these changes allow the card schemes to use their rules to limit surcharges to the reasonable cost of acceptance. There has, however, been limited effective enforcement of these rules. There have been suggestions that the schemes and acquirers (who have the direct relationship with the merchant) have insufficient visibility of merchants' acceptance costs and, in the case of acquirers, little incentive to create a conflict with a customer. This was a focus of the FSI, which noted that current rules may be difficult for schemes to enforce, potentially complex for merchants to comply with and can cause frustration for consumers. There has also been public concern about surcharging in particular sectors, including the 10 per cent surcharges that have typically applied in the taxi industry (though this has recently been addressed by state legislation in some cases). In the airline industry, fixed-dollar surcharges can amount to a very high proportion of the purchase price for lower-cost airfares. For example, payment surcharges for return domestic fares range from \$2.50 to \$17 for debit cards and \$7 to \$17 for credit cards, implying surcharges of up to 8½ per cent on a \$200 return fare (Table 2).

Table 2: Online Domestic Airline Surcharges

Airline	Name of surcharge	Standard surcharge per return ticket, per person		Non-surcharged payment methods ^(a)
		Debit card	Credit card	
Jetstar	Booking and service fee	\$17 (2 x \$8.50)	\$17 (2 x \$8.50)	<ul style="list-style-type: none"> • Jetstar MasterCard • POLi • Direct deposit (>14 days before flight) • Voucher
Qantas	Card payment fee	\$2.50	\$7	<ul style="list-style-type: none"> • BPAY (>7 days before flight) • Debit card/'Qantas Cash' (<7 days) • Credit voucher • Qantas UATP card
Tiger	Booking and service fee	\$17 (2 x \$8.50)	\$17 (2 x \$8.50)	<ul style="list-style-type: none"> • Debit MasterCard
Virgin	Booking and service fee	\$7.70	\$7.70	<ul style="list-style-type: none"> • POLi • Voucher

(a) Some payment options may not be available to customers of all financial institutions.

Source: Airlines' websites, information sourced on 2 March, 2015.

More generally, there are concerns that some sectors may be more susceptible to excessive surcharging. This may be where a high proportion of payments are made using credit cards, for instance where they offer a significant advantage in speed and convenience over other payment methods or where cards are used to provide security deposits. It might also be the case where online price comparisons are common and merchants have an incentive to hold down the headline price. These factors mean that online commerce is likely to be more susceptible to excessive surcharging than 'bricks and mortar' retailers. A contributing factor is the lack of ubiquitous and convenient online payment alternatives that are low cost to the merchant.

Competitive Neutrality and Companion Cards

In a typical 'three-party' scheme such as American Express or Diners Club, the scheme is both issuer and acquirer, with no role for interchange fees. Accordingly, while American Express and Diners Club are subject (by voluntary undertaking) to the Bank's standard on merchant pricing which prevents them from having no-surcharge rules, these schemes have not been subject to the Bank's interchange standards. However, companion card arrangements, where the scheme continues to acquire transactions but partners with financial institutions to issue cards, do have interchange-like fees that are paid from the scheme to the issuer, and – as with traditional four-party arrangements (such as MasterCard and Visa) – may involve other incentive or marketing payments to issuers.

The emergence of American Express companion card arrangements is likely to have led to an increase in the overall issuance of American Express cards and increased the average number of credit cards consumers hold. This may have adversely affected the competitive position of other card schemes. As

noted, in Chapter 3, there has been an increase in the share of American Express and Diners in the credit and charge card market over the past decade. However, American Express cards are not as widely accepted as MasterCard and Visa cards, and are more often surcharged, or are surcharged at a higher rate. Merchants appear to be more comfortable declining acceptance or surcharging because they can be reasonably confident that an American Express cardholder is also holding a MasterCard or Visa credit card; the Bank's 2013 Consumer Use Survey indicated that this was true in around 95 per cent of cases. These factors mean that the market power of American Express is less than that of the other two large international schemes, although there are industries where this may not be the case (e.g. some businesses oriented to overseas visitors, like hotels in major tourist destinations).

The Bank foreshadowed in its initial submission to the FSI (RBA 2014) that it would review whether any changes to the regulatory treatment of American Express companion card arrangements (or of any other scheme that is not currently designated) might be warranted. In addition, several submissions to the FSI have argued that the lack of formal regulation of companion card arrangements results in a lack of 'competitive neutrality' in the Bank's regulation.

Prepaid Cards

In many respects, prepaid cards are similar to debit cards. In 2006, the Board determined that it was not necessary to regulate prepaid cards at the time, but noted its expectations regarding their treatment, including that interchange fees for transactions on these cards would be published and set broadly in conformity with the Standard on interchange fees in the Visa Debit system, and that merchants would not be prevented from surcharging transactions on these cards if they chose. The Board also noted that, consistent with the intent of the Standard on 'honour-all-cards' rules, were a prepaid card introduced with features substantially different from a scheme debit card, merchants should not be required to accept that card.

More recently, the Bank has received queries from a number of payments system participants about the meaning of 'broadly in conformity with', with some parties suggesting that the ambiguity in the wording might contribute to an uneven playing field. In addition, the factors that are present in the 'drift' of average credit and debit interchange rates apply equally to prepaid cards. Accordingly, in the Bank's view, a review that dealt with credit and debit card regulation should consider bringing prepaid cards into formal regulatory arrangements.

Arrangements for Competing Payment Options within a Single Device or Application

Issues concerning competing payment options on a single device have recently arisen in the case of dual-network debit cards. These are cards issued by banks and other financial institutions with point-of-sale debit functionality from two payment networks. The Board has indicated that it supports the longstanding practice of issuing dual-network debit cards in Australia, because they are convenient for cardholders and allow stronger competition between networks at the point of sale.

One concern that may arise with dual-network cards is that networks may seek to implement scheme rules that prevent a card-issuing institution from including payment functionality from another network on the issuer's card. Another question concerns the rights of merchants, cardholders, card issuers and networks in deciding which network will be used for a transaction. Until recently, debit card holders have typically chosen the network used, by pressing one of three buttons when they have inserted their cards into point-of-sale terminals, though, in principle, merchants also have had

the ability to exercise choice in the routing of transactions.²⁸ However, questions about choice of network may be raised more frequently as contactless authentication becomes more widely used, because contactless technology creates an element of automaticity in the routing of transactions. In particular, it removes the need (and the option) for holders of dual-network cards to choose the payment type and network at the point-of-sale terminal.

As discussed earlier, following concerns expressed by the Board, in August 2013 the three debit card networks (eftpos, MasterCard and Visa) reached voluntary agreements on principles relating to dual-network debit cards. The agreement aimed to maintain existing dual-network arrangements in the contactless environment and to safeguard the right of merchants to exercise their own transaction routing priorities.²⁹ The agreements are consistent with some principles set out by the Board and to date the Bank's understanding is that the networks have worked constructively in relation to dual-network issues.

A related set of issues are posed by the emergence of wallet applications, which store payment card details and may be used to make payments online or with a mobile device capable of making contactless transactions via Near Field Communication (NFC) or a QR code. Wallets potentially raise new questions about access and within-application competition between payment options as well as cardholder and merchant control over transaction routing.

Accordingly, in light of the likely continued growth of arrangements where multiple competing payment options may be present in a single device or application, it may be useful to consider whether there are issues that arise that touch on the Board's mandate for competition and efficiency and where more formal 'rules of the game' might be appropriate.

28 Woolworths, a retailer with its own payments processing capacity, between April 2010 and September 2012 chose to route all debit transactions on dual-network cards through the domestic eftpos network rather than the networks of MasterCard and Visa, citing the higher cost of the latter networks (Woolworths Limited 2010). A number of other retailers have asked their financial institutions to route transactions via a preferred network but have been unable to obtain this capacity.

29 To date, cards with two contactless debit card applications (e.g. MasterCard and eftpos or Visa and eftpos) are not generally available, although eftpos is expected to commence a widespread rollout of its own contactless debit card this year.

5. Issues for Consultation

The Payments System Board would be interested in hearing the views of stakeholders about the issues raised in the previous chapter and possible changes to the regulatory framework that might address those issues.

Some of the possible changes to the regulatory framework are along the lines of those suggested in the Final Report of the Financial System Inquiry (FSI). The Final Report endorsed the broad nature of the Bank's reforms over the past decade or more. In particular, the Report stated that 'the Inquiry believes interchange fee caps improve the efficiency of the payments system. Without interchange fee caps, price signals for customers are less clear and outcomes are less efficient because customers can be encouraged to use higher-cost payment methods' (FSI 2014b, p 171). In addition, the Final Report stated that 'the Inquiry agrees with the RBA that surcharging can improve the efficiency of the payments system by providing accurate price signals to customers' (FSI 2014b, p 175).

However, the Final Report noted a few areas where the Inquiry believed the existing regulatory framework could be improved. These included lowering the existing interchange fee caps and broadening their application, and improving the accuracy of price signals in surcharging and the enforceability of mechanisms against excessive surcharging. The FSI Final Report took a holistic view of the card systems, just as the Bank's earlier reforms have recognised the interlinkages between different aspects of the operations of the card systems. One example is that the Report's recommendations on surcharging were linked to its recommendations on interchange fees. In particular, the surcharging recommendations reflect the idea that if it was possible to promote the availability of low-cost methods of payment for consumers and merchants, the case for merchants retaining the right to surcharge for those low-cost methods of payment would be reduced.

Specific Issues for Consultation

The Board is interested in the views of stakeholders on the following issues.

With respect to the regulation of interchange fees, the Board is interested in views on the following options:

- **Publishing thresholds for which payment system providers will be subject to interchange or related regulation, possibly based on transaction values and/or market shares.** The FSI Final Report suggests that that this would give new entrants and existing providers greater certainty about how regulation will be applied and would enhance competitive neutrality between providers. Such thresholds could potentially apply to providers such as American Express, as well as other international schemes such as UnionPay, if they entered the domestic market. Thresholds might also be applied for surcharging regulation and could potentially apply to providers such as PayPal.

- **Broadening interchange fee caps to include other payments between schemes and issuers.** There are a range of payments (such as marketing fees, sign-on fees, incentive fees and rebates) from schemes to issuers that are used in both three- and four-party schemes. These other payments can potentially be used to circumvent interchange caps: for example, a four-party scheme can increase fees charged to acquirers and use these funds to pay rebates to issuers, mimicking an interchange payment. Similarly, rebates or incentives paid by a network to an issuer in a companion card arrangement can achieve similar outcomes to an interchange fee. The FSI Final Report suggests that broadening the current interchange fee caps to apply on a broader functional basis would help prevent circumvention of interchange caps and enhance competitive neutrality in the case of companion card arrangements. Regulation of other incentive payments has already been implemented for debit cards in the United States, and is proposed for both debit and credit card schemes in the new EU payments regulation.
- **Making changes to the interchange benchmark system to reduce the upward ‘drift’ in average interchange rates inherent in the current three-year reset cycle.** One option would be to shift to more frequent benchmark observance, such as annually or even quarterly. This would ensure that average interchange rates were much closer to the benchmark, though this might not have much effect on the tendency for the gap between the highest and lowest interchange rates to widen.
- **Lowering interchange caps.** The FSI Final Report suggests that payments system efficiency could be enhanced by lowering interchange fee caps, with the benefits including lower product prices for all consumers as a result of lower merchant service fees, and less cross-subsidisation in the payments system.
- **Replacing weighted-average interchange caps with hard caps.** The FSI Final Report notes that weighted-average caps allow schemes to set interchange schedules which imply relatively high payments costs for smaller merchants without market power and low costs for larger merchants. In addition, the widening in the range of interchange fees raises questions about the transparency of costs for many merchants. Furthermore, as noted in Chapters 3 and 4, the current system of observance of the caps has meant that weighted-average interchange fees in the MasterCard and Visa systems have typically been above the caps. In the new European Union (EU) payments regulation previous settlements reached with MasterCard and Visa, constraining interchange fees for cross-border consumer credit card transactions to 30 basis points per transaction or a maximum weighted-average cap of 30 basis points respectively, will be replaced by a hard cap of 30 basis points on all credit card transactions.
- **Applying caps as the lesser of a fixed amount and a fixed percentage of transaction values.** The FSI Final Report suggests that applying a fixed percentage cap for debit cards, in addition to a fixed-value cap, would ensure low interchange payments on low-value transactions which would promote merchant acceptance. The use of a dual percentage/value cap has also been proposed in the new EU payments regulation, where debit card interchange could be capped at the lower of 20 basis points or a fixed-value cap which member states may set at their own discretion. In the case of credit cards, the FSI Report notes that the introduction of a fixed-value cap would be a significant change and that a transition period might be warranted if it were adopted.
- **Including prepaid cards within the caps for debit cards.** As noted above, there is a degree of ambiguity in how prepaid cards are dealt with under the interchange benchmarks. Accordingly, it would be helpful to clarify this in a review.

- **Allowing for ‘buying groups’ for smaller merchants to group together (subject to any competition law restrictions) to negotiate to receive the lower interchange rates that are accessible to larger merchants.** This option might be considered in the event a future interchange system continued to generate large differences in the interchange rates faced by different types of merchants. A similar measure was part of a settlement between US merchants and MasterCard and Visa in 2012, although that agreement only requires that card companies meet with merchant buying groups, and not that card schemes must offer similar rates to merchant groups that bring similar transaction volumes.

With respect to surcharging, the Board is interested in views on the following options:

- **A tiered surcharging system, perhaps along the lines of the FSI recommendations.** The FSI Final Report suggests that a three-tier approach would be likely to reduce cases of excessive surcharging by providing merchants with clearer surcharging limits that will reduce problems with enforcement in the current system. Alternatively, other variants of a tiered system might be appropriate. The FSI Final Report proposal would include:
 - **Allowing low-cost system providers to prevent merchants from surcharging, to encourage consumers to use low-cost payment methods.** The Final Report suggests that systems would qualify as low-cost if their interchange fees were below the caps for debit systems (or if three-party systems were equivalently low-cost in terms of merchant service fees). Given the widespread holding of debit cards, this would imply that essentially all consumers would be able to make card payments (presumably including in the online environment) without being surcharged.
 - **Allowing medium-cost providers to limit surcharges to limits set by the Board.** The Final Report suggests that schemes would qualify as medium-cost if their interchange fees were below credit card interchange fee caps (and three-party systems could qualify if their merchant service fees were equivalent to those of other medium-cost providers). The limit set by the Board might be based on average card acceptance costs. Such limits would be published, which would ensure that it was immediately observable to card schemes, consumers and others if a merchant was surcharging excessively – this would enhance the enforceability of such limits.
 - **Allowing high-cost providers to limit surcharges to the reasonable cost of acceptance.** Such providers would also be required to disclose that they were high-cost providers so that their customers would understand why they were likely to be surcharged. The reasonable cost of card acceptance would be based on the costs of the particular merchant, meaning that there would remain scope for dispute over whether a merchant was surcharging excessively.
- **Targeted changes to reduce particular cases of excessive surcharging.** The two industries where concerns about surcharging are most vocal are the taxi and airline industries. Surcharging in the taxi industry is becoming the focus of most state taxi regulators. In the case of the airlines, the current fixed-dollar surcharges would appear to be well above the reasonable cost of card acceptance for low-value fares, given that the costs associated with credit cards are typically mostly ad valorem or percentage-based. Accordingly, a simple measure might be to modify the Bank’s surcharging Standard or Guidance Note to allow schemes to cap any surcharges that are not percentage-based at some low fixed-dollar amount. This could result in a significant reduction in surcharges payable on lower-value fares. It is possible that a change such as this,

which would be largely independent of potential other changes to the regulatory framework, could be made relatively quickly.

- **Any other changes to enforcement procedures and disclosure practices.** Where merchants wish to surcharge for particular high-cost payment instruments it is important that any charge should be properly disclosed up front and that there is at least one non-surcharged method of payment that is generally available to consumers. The Board is interested in stakeholder views regarding the extent to which these requirements are met by merchants and also in more general views as to mechanisms by which excessive surcharging or incomplete disclosure of surcharges might be addressed.

The Board is also interested in views on some other possible regulatory changes that could improve the way that market forces operate in the cards system:

- **Strengthened transparency over the cost of payments to merchants and cardholders.** To the extent that there continued to be large differences in interchange rates on cards from a particular system, it would seem important for merchants to know the cost of accepting a card at the time of the transaction, so they can make informed decisions regarding acceptance or surcharging. Greater transparency would also be important for consumers to enhance their understanding of whether they are using a low-cost card or a high-cost card that may be surcharged. Measures to improve transparency could include:
 - Ensuring that debit and credit cards are more readily identifiable by merchants electronically.
 - Requiring, as in the new EU payments regulation, that categories of cards with different interchange fees should be identifiable both visually and electronically, so that consumers and merchants are aware when a high-cost card is being used.
 - Requiring, as in the EU payments regulation, that acquirers must offer merchants pricing and billing that separately shows the interchange fee and merchant service charges that apply to each brand and category of cards. While many Australian merchants are now subject to ‘interchange-plus’ pricing for each scheme, others are still subject to blended rates, including between debit and credit, and some merchant statements do not promote a good understanding of card costs borne by merchants.
- **Further easing of ‘honour-all-cards’ rules to allow merchants to decline to accept cards with high interchange fees.** The current restrictions on honour-all-cards rules allow merchants to make separate acceptance decisions on debit versus credit, but could be extended to allow merchants the freedom to decline high-cost cards within a particular scheme.
- **Facilitation of differential surcharging by merchants.** To the extent that the acquiring market was not providing the ability for merchants to surcharge differentially based on the nature of the card, it might be desirable to explore measures that would require card schemes and acquirers to provide merchants with such ability to differentiate. This might be supplemented, as in the EU proposal, with controls on scheme rules or contractual terms that prevent merchants from informing consumers about the cost of interchange fees or merchant service charges: this would mean that Australian merchants could not be prevented from informing customers of their cost of card acceptance if they wished to justify their surcharging policies.
- **Ensuring that merchants have the ability to choose to route their transactions via lower-cost networks or processors.** This might involve requiring, as is the case for debit cards in the United

States, that acquirers must route transactions through the network which the merchant has nominated as their preferred option among those networks available on a card. This could provide some offset to the tendency for competition between schemes to drive interchange fees higher. A stronger option, as will be required in the EU payments regulation currently being considered, would be that the scheme activities and processing infrastructure of card networks are legally separated, so as to facilitate competition in the market for processing transactions.

- **Clarifying arrangements for competing payment options within a single device or application.** One option might be along the lines of the proposed EU payments regulation concerning ‘co-badging’ and choice of payment application. Regulatory measures might include restrictions on scheme rules that prevent the inclusion of other payment brands or payment applications on a device (e.g. mobile phone) or that may prevent different payment options being included within a payment application. The proposed EU payments regulation also requires that security standards or technical specifications, and arrangements for routing transactions, should be applied in a non-discriminatory manner when handling two or more different payment brands or applications on a single device. Similarly, providers of payment services might be required to allow merchants or cardholders the option of specifying their own preferences regarding the priority of different networks or payment methods, both on co-badged devices and in mobile wallet applications.

Finally, the Board is also interested in stakeholder views on the appropriate regulatory arrangements for prepaid cards.

General Issues for Consultation

The Board expects that stakeholders may wish to raise other issues concerning card payments and their role in the broader retail payments system. Accordingly, it encourages stakeholders to suggest any additional measures that the Bank should consider in a review of the regulatory framework. The Board will also take account of any relevant responses to the Government’s current consultation on the recommendations in the Final Report of the Financial System Inquiry.

The Board recognises that some of the possible regulatory changes discussed above (e.g. changes to the interchange fee caps) could imply significant changes to business models in the cards industry while other possible changes (e.g. to improve the transparency of costs to merchants) could imply significant systems changes by schemes and acquirers. It will be mindful of these issues as the Review proceeds. However, the Board notes its concerns about the existing cards model which results in most merchants facing significant variability in the cost of card transactions within the four-party schemes, while having no visibility over these costs at the time of the transaction. Similarly, merchants have limited or no ability to respond to these differences by charging differentially or declining to accept high-cost cards. Accordingly, the Board encourages stakeholders to suggest measures that could address its concerns in ways that would minimise adjustment costs for the payments industry.

During the 2007–08 Review, the Board and the Bank spent a considerable amount of time exploring a non-regulatory approach whereby voluntary undertakings from schemes in relation to interchange fees could serve in place of formal regulation. As noted above, ultimately industry participants were unable to arrive at arrangements that the Board considered were in the public interest. International experience also suggests that non-regulatory solutions have been difficult to achieve. Furthermore, the option of removing interchange fee caps was touched on in the Interim Report of the FSI (FSI 2014a, p 2-31) but not endorsed by the Final Report (FSI 2014b). The Board sees challenges in a non-

regulatory approach, but would nonetheless be interested in stakeholder views on approaches that could result in a sustainable framework that met the Board's concerns and were in the interests of competition and efficiency in the Australian payments system.

Finally, while it is important that any changes to the regulatory system should occur in a way that recognises all the interdependencies, the Board is interested in views about whether there are particular targeted changes, for example to the surcharging framework, that could usefully occur ahead of any more general package of reforms.

6. Next Steps

The Board is seeking views from interested parties on the issues raised in this Paper. Formal written submissions on the options discussed in Chapter 5, or on any other aspect of the Bank's card payments reforms, should be provided by no later than 24 April 2015, and should be sent to:

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

or

pysubmissions@rba.gov.au.

Submissions provided by email should be in a separate document, in Word or equivalent format. Submissions in PDF format must be accompanied by a version in an accessible format such as .rtf or .doc.

All submissions will be published on the Bank's website, unless it is specifically requested that the Bank treat the whole or any part of a submission as confidential. In the normal course of events, those making submissions will be provided with an opportunity to discuss their submission with the Bank. The Bank will also consider any submissions on card payments regulation made in response to the current Government consultation on the FSI recommendations.

Following this consultation process, the Board will consider whether to consult on some specific changes to the regulatory framework. In the event that the Board considers that legislative reform would be desirable it will refer the issue to the Government.

Reserve Bank of Australia
4 March 2015

Privacy

Unless requested otherwise, published submissions will include contact details and any other personal information contained in those documents. For information about the Bank's collection of personal information and approach to privacy, please refer to the Personal Information Collection Notice for Website Visitors and the Bank's Privacy Policy, which are both available at <http://www.rba.gov.au/privacy>.

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