

SUBMISSION TO THE ACCC

REFORM OF DEBIT CARD (EFTPOS) INTERCHANGE FEES

Background

The Payments System Board of the Reserve Bank has, since its establishment, given particular priority to issues of efficiency and competition in Australia's card payment networks – credit cards, debit (EFTPOS) cards and ATM networks. These issues were investigated in a detailed study of card networks undertaken by the Reserve Bank and the Australian Competition and Consumer Commission (ACCC) and published in October 2000 in *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (the “Joint Study”). The Joint Study concluded that in EFTPOS and other card payment networks, competition is not working as it should.

The EFTPOS payment network in Australia has a number of unique features. First, commercial and technical arrangements are conducted entirely on a bilateral basis; the industry has no decision-making body with authority on questions of network fees nor does it have a central switch. Secondly, interchange fees for EFTPOS transactions are negotiated bilaterally and are paid by the card issuer to the financial institution that provides services to the merchant (the acquirer). In other countries, the flow is almost always to the card issuer or there are no interchange fees at all.

The Joint Study identified a number of shortcomings with the bilateral structure of EFTPOS interchange fees in Australia:

- the fees have hardly changed since they were introduced in the early 1990s, and newer agreements appear to have been based on earlier agreements without regard for changes in costs;
- bilateral interchange agreements are not easy to re-negotiate and participants are under no strong competitive pressure to do so; and
- the need to negotiate bilateral agreements with established participants can put both new issuers and acquirers at a competitive disadvantage.

EFTPOS interchange fees – which are a major determinant of fees charged by issuers to their cardholders – and impediments to entry to the EFTPOS network have contributed to a distorted form of competition in Australia's card payment systems. Consumers using a debit card typically pay a fee to their financial institution (beyond a fee-free threshold) for accessing their own funds; credit cardholders who settle their account in full each month pay no transaction fee, and may be paid in the form of loyalty points, for using the funds of their financial institution. This is despite the fact that, for the community, debit cards are a much less expensive means of payment than credit cards in terms of the resource costs involved. As a consequence, the price signals facing consumers do not promote efficient resource use in Australia's retail payments system.

The Joint Study found that, on the basis of cost and revenue data provided by industry participants, there was no convincing case for an interchange fee in the EFTPOS payment network in Australia, in either direction. As with other means of accessing a transaction account, such as cheques, direct debits and direct credits, financial institutions offering EFTPOS payment services could seek to recover their costs directly from their own customers. Two countries with heavily used EFTPOS payment systems – Canada and the Netherlands – do not have interchange fees and the Joint Study found no reason why Australia’s EFTPOS payment network could not operate on the same basis.

Proposed reforms

In endorsing the conclusions of the Joint Study, the Payments System Board stated that the onus will be on the financial institutions involved in setting interchange fees and conditions of entry in card payment networks to move quickly to introduce more efficient arrangements. The Board confirmed its willingness to work with industry participants to bring about more efficient pricing arrangements for debit card payments.

Early in 2002, the Reserve Bank convened a series of meetings of industry participants to explore options for debit card reform, which culminated in the formation of the EFTPOS Industry Working Group. In July 2002, the Working Group published a discussion paper, prepared with Reserve Bank assistance, which set out alternative approaches. Following publication of this paper, the Reserve Bank, at the Working Group’s request, stepped back from its direct role in facilitating reform efforts to allow an industry-led consensus to develop. The Reserve Bank believes that the industry has, over the past year, made considerable progress in addressing the concerns raised in the Joint Study about efficiency and competition in the EFTPOS payment network.

Banks, building societies and credit unions have now applied to the ACCC for authorisation of a proposal to reduce EFTPOS interchange fees to zero (Applications for Authorisation Nos A30224 and A30225). The applicants have argued that this proposal “... will be likely to result in significant public benefits such as:

- reducing the overall cost of the Australian payments system, by decreasing the cost of EFTPOS for consumers and thereby encouraging the use of EFTPOS;
- introducing greater flexibility over time into the setting of EFTPOS interchange fees, reducing the inertia that has made them unresponsive to changes in market circumstances; and
- making entry as a new issuer or acquirer of EFTPOS transactions easier.” (Executive Summary of the Submission by the Applicants, page ii)

The Reserve Bank agrees that the proposal will have significant public benefits. In particular, a lowering of transaction fees for debit cardholders will produce a more efficient set of price signals for consumers choosing between EFTPOS and other means of payment. Public benefits will be maximised if the reduction in interchange fees, assuming it is authorised by the ACCC, is passed immediately and in full to debit cardholders. The Reserve Bank can see no reason why debit card issuers, in a competitive market environment, should not do so.

Debit card acquirers can be expected to seek to recoup the loss of interchange fee revenue directly from merchants through increases in merchant service fees on EFTPOS transactions. Based on current transaction volumes, the loss of EFTPOS interchange fee revenue received by acquirers will be around \$150 million per year. The extent to which this amount is recouped from merchants needs to be set against the reduction in merchant service fees from the Reserve Bank's concomitant reforms to credit card schemes, which are expected to reduce credit card interchange fee amounts paid by acquirers by around \$350 million per year. Merchants will therefore be significant direct beneficiaries of debit and credit card reform, taken together, in terms of the net costs they incur in accepting debit and credit cards; the impact will of course differ across merchants, depending on the mix of payment cards that they accept. Merchants will also see their costs reduced over time as a result of changes to price signals that provide consumers with greater incentives to use lower-cost payment methods. Competition will ensure that the lower costs incurred by merchants will pass through to consumers in the general level of prices.

The Reserve Bank recognises that some large merchants have made significant investments in their own EFTPOS terminals and related infrastructure, and have negotiated arrangements to share interchange fee revenue with their acquirer as a means of recovering costs. However, no evidence was presented to the Joint Study, or subsequently, that EFTPOS interchange fee revenue at rates largely set in the early 1990s continues to be required by merchants to recoup the costs of their initial investments, or any subsequent upgrades. If EFTPOS interchange fee revenues are eliminated, investment decisions by merchants would be determined by normal market mechanisms. Merchants would continue to invest in EFTPOS facilities if they perceive direct benefits in doing so, such as savings in merchant service fees by undertaking some acquiring services themselves, or greater customer satisfaction through improved transaction processing speeds.

Normal market mechanisms could also determine the pricing of banking-type services provided by merchants to their customers, particularly cash-back at point-of-sale. For many of the merchants that provide cash-back facilities, such a service reduces their total cash-handling costs and they would want to promote it; where this is not the case, merchants are free to charge customers directly for the service. Direct charging in these circumstances would provide a more efficient and transparent set of price signals than current interchange fee arrangements; it would also be consistent with industry proposals to introduce direct charging for "foreign" ATM transactions, which have recently been released for public discussion.

The applicants' proposal is to reduce all EFTPOS interchange fees to zero, rather than to eliminate interchange fees altogether. The economic consequences of these two alternatives would be identical. However, the application leaves it open to the industry to introduce a non-zero EFTPOS interchange fee, upon industry review after three years or earlier in the case of a material change in circumstances. The proposal does not provide any methodology for determining a non-zero interchange fee rate. In the Reserve Bank's view, *any* future changes to the multilateral interchange fee rate need to be explicitly approved by the ACCC on the basis of a transparent and objective methodology for collective fee setting that is in the public interest.

Access

The Payments System Board believes that reform also needs to address the issue of access to the EFTPOS network. In its view, current bilateral arrangements are not beneficial to the Australian payments system and can be a significant barrier to new entrants.

The applicants have argued that the proposal to eliminate bilateral interchange fees should facilitate access of new entrants to the EFTPOS network, since they will no longer need to negotiate interchange fees as a condition of entry. The Reserve Bank agrees with this argument. At the same time, without interchange fee revenues, some incumbents may have less financial incentive to establish interchange links with potential new entrants. In addition, the Reserve Bank continues to hear complaints from potential new issuers and acquirers about the difficulty in establishing both business and technical arrangements needed to join the EFTPOS network, and about the costs of existing gateway arrangements.

The applicants have suggested that access issues are more appropriately dealt with in the context of reauthorisation of the APCA Consumer Electronic Clearing System (CECS) rules, rather than in the current application relating to interchange fees. The Reserve Bank supports this approach but will want to be assured that APCA will address impediments to access to the EFTPOS network in a timely manner. Since the CECS rules set the operating procedures for the EFTPOS network, there is no clear need for the continued use of bilateral agreements, which appear to be a barrier to new entrants and which do not exist in other payment systems. A new entrant that is approved as a member of CECS and meets APCA's technical requirements should be entitled to exchange EFTPOS transactions with any other CECS member in a timely manner and at reasonable cost.

In the Reserve Bank's view, APCA and the industry need to review elements of current bilateral agreements with a view toward incorporating them into the CECS rules, and to consider mechanisms that would ensure that incumbents connect new entrants within a specified time period and at reasonable cost. There may also be some technical procedures relating to testing that could be streamlined to facilitate quicker and more open access, but such procedures alone are unlikely to significantly address access issues. APCA will also need to ensure that its membership criteria for CECS are as broad as possible (encompassing, for example, processors and switches which are integral to the EFTPOS network). Over the longer term, the industry might want to consider the case for developing an industry-owned switch to facilitate access and encourage competition and efficiency in the operation of the EFTPOS network.

Reserve Bank of Australia
SYDNEY

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