

**DISCUSSION PAPER:**  
**OPTIONS FOR EFTPOS INTERCHANGE FEE REFORM**

**July 2002**

**EFTPOS Industry Working Group**



# OPTIONS FOR EFTPOS INTERCHANGE FEE REFORM

## 1. Introduction

This paper was prepared by an industry working group to facilitate discussions about options for revisions to EFTPOS interchange fee arrangements.<sup>1</sup> The paper provides background on the EFTPOS network and discusses the rationale for the current discussions. It lays out three general options for reform, and seeks comments from interested parties on these options and related issues. Comments are requested by 13 September 2002.

### *1.1 Background*

Electronic funds transfer at the point of sale, or EFTPOS, was introduced in Australia in 1984. The EFTPOS system allows any financial institution's debit cards to be used throughout Australia at the point of sale. One major bank first developed a nationwide EFTPOS system; other institutions quickly developed similar proprietary systems, which were then linked bilaterally. Gateway arrangements between small institutions and large institutions were also implemented to allow institutions such as credit unions and building societies to participate without direct interchange links to other institutions.

Usage of EFTPOS in Australia initially was moderate but was spurred by acceptance at petrol retailers. In 1991, several major retailers joined the network, after which fairly rapid transaction growth ensued. At least one major merchant installed its own EFTPOS terminals and switches its own transactions. In the later part of the 1990s, however, debit card transaction growth moderated while credit card transaction growth accelerated (Figure 1). Thus, despite very strong initial growth of EFTPOS in Australia, usage per capita is average when compared with other countries (see Table 1). In relation to other non-cash payment instruments, debit cards and credit cards have effectively replaced cheque transactions in Australia over the 1990s, with credit card usage recently overtaking debit cards as a share of total non-cash payments; debit cards and credit cards have, of course, also replaced cash to a significant degree, although data are not available on cash transactions.

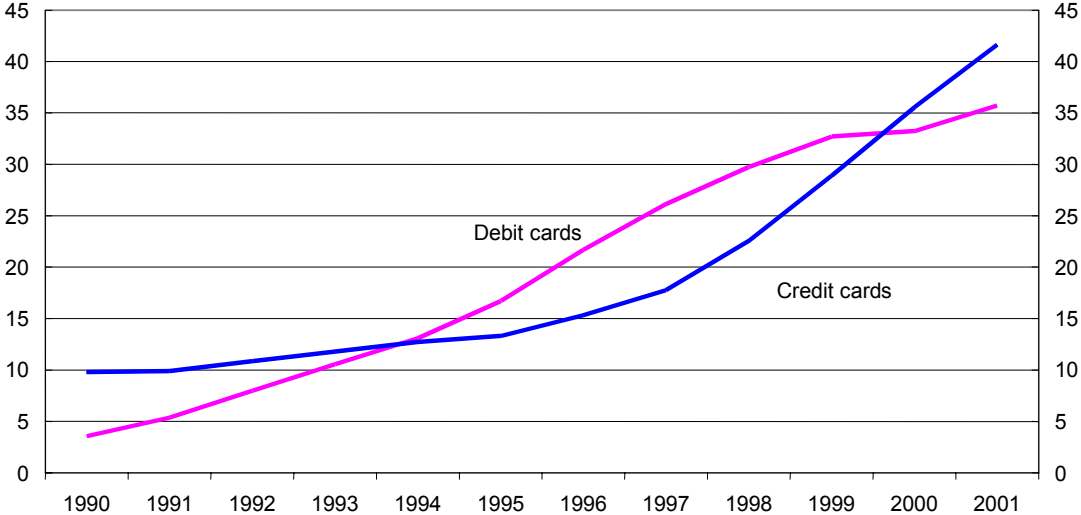
EFTPOS transactions are PIN-based and are authorised in real-time by the card issuer over a secure electronic network. The EFTPOS system also provides a cash-out feature, whereby some retailers provide cash to cardholders at the point of sale, both as

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<sup>1</sup> Organisations sponsoring this paper include Australia and New Zealand Banking Group, Australian Settlements Ltd., Bank of Queensland, Bank of Western Australia Ltd., Cashcard Australia Ltd., Coles Myer Ltd., Commonwealth Bank of Australia, Credit Union Services Corporation Ltd., National Australia Bank, St. George Bank Ltd., and Westpac Banking Corporation. The Reserve Bank of Australia provided administrative support.

a customer convenience and as a means of minimising cash-handling costs. The EFTPOS system has become an important cash distribution channel; Reserve Bank of Australia data indicate that approximately one quarter of EFTPOS transactions involve some cash-out at the point of sale.<sup>2</sup>

**Figure 1: Number of card payments per capita**



Source: Reserve Bank of Australia *Bulletin* and ABS Catalogue No. 3101.0

**Table 1: International EFTPOS usage comparison, payments per capita**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Canada	0.1	0.4	1.1	2.6	6.3	13.4	22.7	33.4	44.7	54.3
Belgium	7.9	9.9	12.0	15.6	18.0	20.9	23.9	27.5	32.7	38.6
UK	3.3	6.2	9.0	11.3	13.8	17.2	21.6	25.5	29.3	34.7
<b>Australia</b>	<b>3.6</b>	<b>5.4</b>	<b>8.0</b>	<b>10.6</b>	<b>13.1</b>	<b>16.7</b>	<b>21.7</b>	<b>26.1</b>	<b>29.8</b>	<b>32.8</b>
US	1.1	1.2	2.0	2.7	4.2	6.1	9.3	14.6	21.2	27.5
Sweden						8.0	10.8	13.6	14.9	19.1
Italy	0.1	0.1	0.2	1.0	1.6	2.1	2.9	4.4	6.0	8.1
Germany	0.0	0.3	0.3	1.3	0.8	1.8	2.6	2.8	4.4	5.2

Source: Bank for International Settlements.

<sup>2</sup> This information is derived from the Reserve Bank’s new retail payments data collection and is preliminary and incomplete.

Today, the EFTPOS network is comprised of a series of proprietary bilateral communications links that transmit transaction data between merchants and their financial institutions (“acquirers”) and debit card issuers. These proprietary communications links allow real-time transaction authorisation by the card issuer for each EFTPOS transaction, significantly reducing fraud and credit risks to issuers and merchants. The bilateral links are supported by bilateral interbank agreements on the terms, conditions, and fees surrounding the bilateral exchange of EFTPOS transactions, and by bilateral settlement arrangements. Third-party providers also provide switching and processing services in some cases.

The Australian Payments Clearing Association Limited (APCA), through its Consumer Electronic Clearing Stream (CECS), is an industry body that sets technical and operational standards for participation by financial institutions and others in the EFTPOS network. The CECS regulations and procedures are authorised by the Australian Competition and Consumer Commission (ACCC).<sup>3</sup>

The fee structure surrounding the EFTPOS network is complex and varied. All fees are individually negotiated between contracting parties.

- **Interchange fees** are wholesale, per-transaction fees paid between card-issuing and transaction-acquiring institutions. Interchange fees are set bilaterally between each issuer and acquirer, and in some cases, merchant principals.<sup>4</sup> EFTPOS interchange fees in Australia are paid by the issuer to the acquirer. The Reserve Bank of Australia found that interchange fees generally range from 18 cents to 25 cents per transaction.<sup>5</sup> In some cases, these interchange fees are shared by acquirers with major merchants or offset merchant fees paid to acquirers, particularly where the merchant provides EFTPOS infrastructure.
- **Merchant fees** are per-transaction fees charged by acquirers to their merchant customers for transaction acquiring, processing, and related services. Merchant fees are individually negotiated and may vary significantly depending on transaction volume, whether the merchant switches its own transactions, and other factors.
- **Switching fees** may also be paid by either an issuer or an acquirer to an entity performing telecommunications routing services for transactions between

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<sup>3</sup> See ACCC Determination of 16 August 2000 regarding the Application for Authorisation (A30176, A30177, A90620) of the Australian Payments Clearing Association Limited in relation to its proposed Regulations and Procedures for the Consumer Electronic Clearing System (“ACCC Authorisation”). <http://www.accc.gov.au/adjudication/Docs/A90620.pdf>

<sup>4</sup> Merchant principals are merchants that are members of CECS.

<sup>5</sup> See Reserve Bank of Australia and Australian Competition and Consumer Commission, *Debit and Credit Card Schemes in Australia: A study of Interchange Fees and Access*, October 2000 (“Joint Study”). <http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/PaymentsInAustralia/index.html>

acquirers and issuers to facilitate real-time electronic transaction authorisation. There may be more than one switch involved in a transaction.

- **Gateway fees** are per-transaction fees that are generally paid by institutions that issue cards to another institution that provides access to the network of bilateral EFTPOS linkages.
- **Cardholder fees** are per-transaction fees assessed by card issuing institutions for EFTPOS transactions. The Reserve Bank's annual survey of bank fees indicates that cardholders are not charged for EFTPOS transactions below a threshold (on average, eight free EFTPOS, ATM, and other electronic transactions per month); EFTPOS and other electronic debit transactions above that amount are assessed an average of 50 cents per transaction.<sup>6</sup>

### ***1.2 Perceived problems with EFTPOS interchange arrangements***

Although some participants are satisfied with the current bilateral EFTPOS interchange arrangements, and some with at least the direction of interchange fees, other participants are convinced of the need for reform. Potential concerns that have been cited include:

- Fees set through bilateral contracts have been rigid and appear to lack flexibility to change;
- Direct network access is linked to successful negotiation of an interchange arrangement, which includes an interchange fee, with each counterparty issuer or acquirer;
- This structure leads to difficulties and inefficiencies in negotiating bilateral interchange arrangements due to market and network structure;
- There is the potential for shifting of issuer and consumer incentives away from promotion and use of EFTPOS, particularly relative to credit cards; and
- There is an apparent lack of consistency between EFTPOS payment interchange fees and those for other retail payment types.

### ***1.3 Relationship to other interchange reform initiatives***

As the current discussions and regulatory initiatives regarding credit card interchange fees continue, there is benefit in considering potential changes to EFTPOS interchange fees in conjunction with those reforms, in addition to industry deliberations surrounding ATM interchange fees and the global credit card schemes' debit cards (referred to as "scheme-based debit", comprising primarily signature-based VISA debit cards in Australia). Efforts at reform of interchange fees for credit cards, ATM

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<sup>6</sup> See "Bank Fees in Australia", *Reserve Bank of Australia Bulletin*, July 2001.

transactions and scheme-based debit cards have been initiated. The Reserve Bank of Australia has formally designated three credit card schemes through its powers under the *Payment System (Regulation) Act*, and in December 2001 issued draft standards addressing interchange fee setting and merchant pricing restrictions and a draft access regime for new specialist participants to enter the credit card systems.<sup>7</sup> The Reserve Bank has engaged in consultation with interested parties on the draft standards and is developing final measures. ATM and scheme-based debit card interchange fees are both in process of review by industry working groups. The working group on VISA debit cards is expected to draw on the results of both the credit card and EFTPOS interchange fee reform efforts.<sup>8</sup>

Moving forward, consistency of approaches with respect to other retail payment instruments may help ensure that relative costs and benefits to users and providers are transparent and consistent. Coordinated implementation of interchange fee reforms across payment instruments may minimise operational costs on payment service providers as well as reduce the overall impact of reforms on merchants, consumers and financial institutions. While these other reform efforts are clearly of interest in the context of EFTPOS interchange fee reform, there are important differences in industry structure and product features between debit and credit cards. It is recognised that EFTPOS warrants a full consideration on its own merits. In addition, as with credit card interchange, any reform of EFTPOS interchange fees must allow for an appropriate degree of input and consultation with interested parties.

#### ***1.4 Overseas experience***

Although markets and products differ across countries, the structure and interchange fees of overseas debit card networks may provide a useful reference point for EFTPOS in Australia. With the exception of New Zealand, debit card networks in other countries are operated as formalised schemes. Generally, the scheme has responsibility for establishing various rules regarding operation of the debit card system, including in some cases, operational responsibility for the network itself and promotion of the brand. Limited information is available on the level of interchange fees. Only a few debit card interchange arrangements have been formally reviewed by competition authorities.

- **New Zealand** – Two interconnected EFTPOS networks exist in New Zealand; interchange agreements exist for switching transactions between the two systems. For several years prior to 1998 the interchange fee was zero, however an interchange fee of 6 cents payable from issuer to acquirer was reinstated for

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<sup>7</sup> See Reserve Bank of Australia, *Reform of Credit Card Schemes in Australia: A consultation document*, December 2001. <http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/CreditCardSchemes/index.html>

<sup>8</sup> Currently, interchange fees for VISA debit cards in Australia are the same as those for VISA credit cards.

certain inter-network transactions, apparently due to the threat of network interoperability being withdrawn.

- **United Kingdom** – Two debit card networks exist in the UK, the Visa Debit network and the Switch system. Switch operates via bilateral links between members of Switch. Authorisation and settlement are performed centrally through a third-party arrangement with a processor. Multilaterally set interchange fees exist in both networks and flow from the acquirer to the issuer. In the Switch system, the multilaterally set fee is a default fee that applies where parties cannot reach bilateral agreement. An independent arbitrator assists the parties in reaching binding agreement.
- **Canada** – Interac is an association that links together the proprietary ATM and EFTPOS networks of various financial institutions. There is no centralised switch in the Interac Direct Payment (EFTPOS) system. Interac facilitates bilateral communication between members by providing the connectivity software, setting rules and standards for communication and access within the system, and operating the systems and managing the brands for its members. There are no interchange fees in the Canadian system, although small switching fees (CAD 0.01 per transaction) are paid to Interac. In 1996, the Canadian Competition Tribunal issued a consent order that governs Interac's behaviour in relation to fees, access, governance, and new services.
- **United States** – There are numerous ATM/pin-based debit card networks in the United States, in addition to the signature-based debit card programs operated by the international card schemes. Networks are either bank-owned joint venture organisations or are owned by processing companies that operate the central switch facility, establish operating rules and membership requirements, and perform multilateral settlement. Interchange fees for EFTPOS transactions are generally set by the scheme or its members multilaterally and are paid from acquirers to issuers. Some smaller networks have zero interchange fees (interchange fees range from 0 to USD 0.45 per transaction, depending on the network and the transaction type). There has been a general trend toward increases in interchange fees as smaller networks consolidate and compete for issuers with regional and global networks. Networks also charge switching fees.
- **France** – Cartes Bancaire is an association of banks that operates the domestic debit card system. The association operates a network switch, although settlement may occur bilaterally. All cards are chip-enabled and a PIN is required at the point-of-sale. Interchange fees are calculated by the association and flow from acquirers to issuers.

## 2. EFTPOS Interchange Options

### 2.1 *Objectives in evaluating alternative interchange arrangements*

In developing possible reforms to the current EFTPOS interchange fee arrangements, the following general objectives should be considered:

- Flexibility – Interchange fee levels should be responsive to market conditions and the costs of providing services.
- Customer acceptance – Any industry-wide changes to interchange fee arrangements should consider the impact on end-users.
- Efficiency – Reforms of interchange fees should be consistent with productive, allocative, and dynamic economic efficiency considerations. This may include use of lower cost payment systems, pricing to end-users that reflects costs, and an appropriate level of investment in improvements to the payment system given the level of public benefits.
- Competition – Interchange fee arrangements should support vigorous competition between providers of payment services and should address any Trade Practices Act issues.
- Access – Interchange fee arrangements should be consistent with fair and open access to the EFTPOS network.
- Sustainability – Interchange fees should be consistent with continued provision of EFTPOS services over the long term and investment in new technology needed to maintain and upgrade the network.
- Practicality of implementation – The up-front and ongoing administrative costs of implementing any proposed reforms to interchange fees should be considered.

It should be noted that different participants in the EFTPOS network may have differing views on how best to achieve these objectives.

### 2.2 *Alternative interchange structures*

The following three categories of interchange fee arrangements summarise the basic options for EFTPOS interchange fee reform that have been identified.

#### **Option 1: Bilateral interchange agreements**

The industry could choose to retain or modify the existing bilaterally negotiated interchange fee structure. Both short-term “circuit breaker” and longer-term reforms can be considered, including the following options.

##### Option 1a: “Circuit Breaker”



A short-term solution could include:

- An initial percentage reduction in interchange fees;
- A percentage reduction in interchange fees over a number of years based potentially on an agreed methodology, as discussed below in Option 2, below; and / or
- Movement (immediate, or over time) to a zero interchange fee.

#### Option 1b: Longer-Term Approach

Over the longer term, bilateral interchange agreements could be amended to provide for:

- An agreed methodology or framework between bilateral parties for setting interchange fees; and
- An agreed timeframe for resetting interchange fees in accordance with the agreed bilateral methodology.

Alternatively, bilateral agreements could be amended to provide for:

- Contractual requirement whereby either party can request renegotiation after an agreed timeframe and a contractual commitment that the other party cannot deny the request; and
- In the event that agreement as to the level of interchange fees, or methodology, cannot be reached, recourse to an independent arbitration process with the power to determine the interchange fees, potentially in conjunction with a default fee or fee methodology, similar to Option 2a, below.

#### Rationale

The primary benefit of retaining a bilateral interchange fee regime is the element of market competition between EFTPOS participants in the setting of interchange fees, which at least in theory, should lead to economically efficient outcomes. Modifying the existing bilateral arrangements could be the simplest option in terms of administrative changes and may minimise administrative costs on participants, although some variants could be relatively complex to implement.

#### Implementation Issues

Both Option 1a or 1b could raise Trade Practices Act issues. Even if there were no collective setting of prices involved, an agreement to take a particular course of action among industry participants could be open to challenge by the Australian Competition and Consumer Commission (ACCC) or a third party. Legal advice would be required on Trade Practices Act implications. Some variants on Option 1 could also involve

further analysis and coordination efforts among EFTPOS participants that would have administrative and implementation costs.

The possibility of implementing nominal charges to reimburse acquirer switching costs (including cost of unsuccessful transactions), concurrent with a reduction or elimination of interchange fees, could also be considered as part of a bilateral option. Since switching is performed by different entities in the network to varying degrees, this would add some complexity to the current fee arrangements.

## **Option 2: Multilateral interchange fees**

The current regime could be replaced with one or more standardised interchange fees applied on a multilateral basis. This is the approach taken by most major overseas networks, although most have a much more centralised structure than the Australian system. Two primary options are discussed below.

### Option 2a: Standard multilateral interchange fee

EFTPOS interchange fees could be standardised across all issuers and acquirers through a common bilateral interchange agreement or reference to network rules. Fees might vary according to the type of transaction, if appropriate, based on a particular pricing methodology adopted (discussed in section 3: Multilateral pricing methodologies, below).

### Option 2b: Bilateral fee agreements with multilateral default rate

A second multilateral option would be for the industry to retain bilateral interchange fee agreements with a “default” interchange fee that would prevail if no agreement could be reached on a bilateral basis. An interim interchange fee which would prevail while parties were in the process of agreeing on a fee together with binding arbitration if agreement could not be reached could be components of this approach as well. There are two possible variants on this approach:

- No constraints on bilateral fees – participants would be free to negotiate whatever interchange fee they preferred by mutual agreement. In practical terms, bilateral fees might not ultimately deviate significantly from the default fee, although the possibility of added flexibility would exist.
- Constraints (i.e., upper and lower bounds) on the permissible level of bilateral fees could be imposed – This option would add administrative complexity and does not appear to have significant advantages over the unconstrained option.

### Rationale

An advantage of moving to a multilateral interchange fee would be to introduce a more transparent, cost-reflective basis for interchange fee levels, which may help ensure that end-users face appropriate pricing incentives across payment instruments. Regular review of the multilateral fee could ensure that fees are responsive to trends in costs

and market conditions. A multilateral fee would help to address concerns about the impact of market structure on interchange fee levels, and would also help to address access concerns, as potential new entrants would not need to negotiate interchange fees in order to obtain access to the EFTPOS network.

### Implementation Issues

Given the decentralised, bilateral structure of the EFTPOS network, significant costs could be incurred in the administration needed to establish a multilateral interchange fee, including gathering and analysing cost and other data. Implementation hurdles would include the need to reach industry consensus on the methodology and ultimate fee levels adopted, as well as practical implementation issues, including any necessary technological changes.

Establishment of a multilateral fee among issuers and acquirers for EFTPOS transactions may require ACCC authorisation under the Trade Practices Act and, if so, would be required to satisfy a net public benefit test.

### **Option 3: No interchange fees**

A third option would be to eliminate EFTPOS interchange fees altogether. This option would effectively impose a standard interchange fee of zero; however the underlying conceptual, administrative, and legal basis of a no-interchange fee regime could be very different than that of a calculated multilateral fee of zero.

#### Option 3a: Eliminate interchange fee clauses

A no-interchange fee regime could be implemented by deletion by all participants of interchange fee clauses in existing bilateral contracts.

#### Option 3b: Eliminate bilateral interchange agreements

Another approach would be the elimination of bilateral interchange agreements altogether. Terms and conditions currently embodied in bilateral agreements would need to be incorporated into industry operating rules or some other operating framework.

### Rationale

The rationale for a no-interchange regime would be to establish a “middle-ground” fee level (zero) with ongoing simplicity of administration. The Reserve Bank and ACCC Joint Study concluded they did not see “a continued need for an interchange fee in the debit card network”.<sup>9</sup> A number of overseas ATM/debit card networks have no (or zero) interchange fee for EFTPOS transactions. Some other payment instruments (cheques and direct entry) do not have interchange fees, although their legal and

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<sup>9</sup> Joint Study, p. 71.

operational structures are different. A no-interchange option would most likely raise the least *Trade Practice Act* concerns and may or may not require ACCC authorisation, although further legal advice would be required on this question. Ongoing administration costs would also be minimal.

A drawback of a no-interchange regime would be lack of flexibility if it were to be determined either now or in the future that issuers or acquirers should be compensated through a non-zero interchange fee. This could have implications for the long-term sustainability of the network, and the need for continued investment in the existing secure EFTPOS network.

### Implementation Issues

Approaches to implementing this approach might range from altering APCA rules to more fundamental legal or operational changes, some of which could require a significant implementation period. Changes to bilateral interchange contracts would be needed at a minimum; however, ongoing costs would be minimal.

## **3. Multilateral pricing methodologies**

The following discussion focuses on refining the approaches to determining a multilateral fee under Option 2, although no determinations have been made to pursue that option.

### **3.1 Pricing models**

Under Option 2, there would be several general approaches to setting multilateral interchange fees. One approach would be to set fees through a process of business judgement, adjusting fees on an ongoing basis in order to maximise incentives for both issuers and acquirers to participate. Another approach would be to set fees competitively relative to interchange fees in competing payment instruments and networks. A third approach would be to adopt an explicit economic methodology for calculating fees, recognising that there will inevitably be some degree of imprecision. Given the current policy deliberations and competition considerations, an explicit and transparent methodology for any multilateral interchange fees would seem desirable.

The recent debate regarding credit card interchange fees indicates a range of different interchange fee pricing models. Economic theories have been proposed that advocate interchange fees based on an optimal economic welfare calculation, incorporating balancing of issuer and acquirer costs as well as merchant and consumer demand considerations and network effects. Because of the difficulties in operationalising economic models that incorporate unobservable components (such as consumer and merchant welfare), the practical interchange fee methodologies that have been proposed are all based on some form of cost recovery or cost sharing between issuers and acquirers. Unlike credit cards, the most significant costs in the EFTPOS network are likely to be related to fraud and the funds guarantee, including costs of

maintenance of the secure network, authorisation, PIN-capable point-of-sale terminals, encryption, PIN administration, and other security-related and processing costs.

Three basic models for cost-based fees in an EFTPOS context have been identified, as follows:

**Option A: Issuer costs** – The interchange fee could reflect issuer costs only and thus flow from acquirer to issuer.<sup>10</sup> The rationale for an issuer-cost model would be that acquirers and merchants receive benefits from the payment guarantee and other payment services provided by issuers that outweigh any benefits provided by acquirers to cardholders and issuers. An issuer-cost model may also implicitly assume that costs are more easily recouped from merchants than from cardholders directly.

An issuer-cost methodology would be consistent with various proposed credit card interchange fee methodologies, including those proposed by the Australian banks, and with overseas and global scheme debit interchange fees. The Reserve Bank's draft credit card interchange cost model also includes only issuer costs that benefit merchants.

An issuer-cost fee model would reduce overall issuers' per-transaction costs in participating in EFTPOS transactions. This could lead to reduced per-transaction charges for cardholders, which may encourage card usage. On the other hand, it could also result in an increase in merchant costs, which could in turn be passed on to cardholders or to consumers more generally. The impact on network investment by the owners of the components of the EFTPOS network would also need to be assessed.

Categories of issuer costs could potentially include card production and delivery; authorisation; transaction processing; settlement; fraud investigation and write-offs; dispute management and exception processing; centre management; statement production; customer service; overhead allocation; and capital costs (related to investments in EFTPOS services). This is not necessarily an exhaustive list of costs and may contain costs that are ultimately not determined to be appropriate to include in an interchange fee. Further work would be needed to refine the cost categories.

**Option B: Acquirer costs** – In this model, the interchange fee would reflect acquirer costs only and thus flow from issuer to acquirer.<sup>11</sup> The rationale for an acquirer-cost model would be that cardholders receive a benefit at the point of sale by being able to access their funds over a secure network, the costs of which are largely borne by

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<sup>10</sup> According to the Joint Study (p. 65), these costs were around \$0.15 per transaction, including overhead and other joint costs; however, these figure have not been updated and were not prepared for purposes of calculating interchange fees.

<sup>11</sup> According to the Joint Study, these costs averaged around \$0.26 per transaction, including overhead costs; however, these figure have not been updated and were not prepared for purposes of calculating interchange fees.

acquirers and merchants. Cardholders can also withdraw cash through the EFTPOS network in some instances, similar to an ATM withdrawal. An acquirer-cost model may also implicitly assume that certain costs are more easily recouped from direct cardholder fees than from merchants. This cost model naturally leads to lower acceptance costs for merchants relative to other interchange fee models and may encourage merchant acceptance of EFTPOS transactions and greater investment in the EFTPOS network; however, cardholder fees may be higher than they otherwise would be. An acquirer-based cost model appears more consistent with the current flow of EFTPOS interchange fees.

Categories of acquiring costs could potentially include: merchant account opening and maintenance; transaction capture and routing; settlement; dispute management and exception processing; fraud costs; customer service; overhead allocation; and capital costs (related to investments in the EFTPOS system). Like the list of issuer costs, above, this is not necessarily an exhaustive list of costs and may contain costs that are ultimately not determined to be appropriate to recover from cardholders and issuers. Further work would be needed to refine the cost categories included.

**Option C: Net of issuer and acquirer costs** – This approach would reflect a cost-balancing approach whereby only the excess amount of overall costs that are borne by the issuing or acquiring side would be passed through to the other. This approach could also be consistent with a “user pays” model, in which the issuer effectively compensates the acquirer/merchant for secure network access, cash-out services, and other services and the acquirer reimburses the issuer for authorisation, processing, and payment guarantee functions, with only the net amount paid per transaction reflected in the interchange fee.

The rationale for this approach would be that both cardholders and merchants receive benefits in the EFTPOS system, and that the benefit is roughly proportional to net costs. This approach may result in zero interchange fees or small fees either to issuers or to acquirers, depending on the relative costs. Although several overseas debit networks have zero interchange fees, it is not known whether these fees result from a net-cost model.

## **4. Governance and Other Implementation Issues**

Most of the options discussed above involve some degree of implementation costs. Some of the implementation issues are discussed below.

### ***4.1 Implementation of multilateral interchange fees***

Implementing a multilateral interchange fee under Options 2a or 2b would require a centralised governance structure to establish the fee methodology, calculate the fee, and review the fee level and methodology on an ongoing basis. An audit and review mechanism would be needed to verify the accuracy of the data and calculations, and to provide for regular reviews. For example, the fee calculation may need to be

recalculated every 2-3 years, and the fee methodology itself might require review every 5-10 years.

Under any of the options, a phase-in or transition period could be established to minimise market disruptions. A phase-in period of 2-5 years has been used in other contexts to implement significant changes to interchange structures. However, consistency with other interchange reforms, such as that of credit cards and global scheme-based debit cards, would also need to be considered.

Options 2 or 3 would require potentially significant changes to bilateral interchange contracts between institutions, as well as changes to merchant contracts in many cases. Implementation of a standard interchange fee could be achieved through modifications to existing bilateral contracts and reference to a common multilateral fee agreement. An existing common set of standards, such as APCA's CECS rules, which set out technical specifications for participation in the EFTPOS network, could be used for this purpose. This would obviate the need to continually change bilateral contracts when the multilateral interchange fee was changed.

Alternatively, bilateral agreements could be eliminated entirely, with industry rules and/or the legal framework modified to incorporate all terms, conditions, and fees relating to EFTPOS interchange between issuers, acquirers, and merchant principals. An additional step would be to establish a formal centralised membership structure to set and enforce rules for the EFTPOS system or even to operate the network itself. Further analysis and legal advice would be needed to explore the costs and benefits of these options.

#### ***4.2 Impact on end-users***

Changes to existing interchange fee arrangements may lead to changes to financial institutions' fees or other product features for debit cardholders and for merchants. The nature and impact of any changes would depend on the level of interchange fees ultimately adopted. If interchange fees currently paid to acquirers were to fall or even to switch direction, merchant acquiring contracts may need to be renegotiated, and merchants may need to reassess the economics and terms of EFTPOS acceptance. Merchants are not prohibited from charging a fee to cardholders for EFTPOS usage, but increased costs to merchants could also be passed on to all consumers indirectly. Similarly, if cardholder fees or product features were affected by changes to interchange fee level or direction, terms and conditions of deposit accounts and debit card usage may need to be revised, with financial institutions providing adequate disclosure and notice to cardholders.

#### ***4.3 Competition implications***

Any agreement to implement a more standardised interchange fee structure could raise Trade Practices Act considerations and may require authorisation by the ACCC, unless the fee was set in accordance with a standard promulgated for a designated payment

system by the Reserve Bank under the *Payment System (Regulation) Act*.<sup>12</sup> It is not clear if Option 3, elimination of interchange fees, would require authorisation. Even if authorisation were not required, collective agreements could potentially be open to challenge by a third-party. In relation to a “circuit breaker” approach under Option 1, it should be noted that an agreement to change bilateral contracts could raise Trade Practices concerns.

The CECS rules have previously been authorised by the ACCC; however, these rules address only technical operating requirements and not commercial terms of interchange fees, network access, or participation. CECS rules could be amended to address interchange fees and an additional ACCC authorisation sought. Further legal analysis would be needed to explore the options for compliance with competition requirements.

Under ACCC authorisation, a proposal for a multilateral fee or other form of collective agreement would need to meet a net public benefit test. The net public benefit test weighs any detrimental effect on competition of the proposed action against the public benefits generated, such as greater economic efficiency, transparency, and more open access. Authorisation could be a lengthy and time-consuming process, particularly if a more complex interchange fee methodology were proposed. There is also no certainty of approval and the outcome is open to appeal to the Australian Competition Tribunal.

#### **4.4 Access**

Given the technical structure of the EFTPOS network as a series of linked proprietary networks and the lack of a central switch, access arrangements are not as transparent as in centralised networks. For example, in payment systems with no interchange fees (e.g. cheques, direct entry) as well as those with standardised interchange (e.g., card schemes), access issues generally do not arise as common terms and conditions govern entrance to the network.

As noted above, CECS rules address the technical requirements for network access but not the commercial terms of participation. As a result, smaller institutions reportedly have difficulty entering the EFTPOS network on reasonable terms given their relative negotiating power in interchange fee arrangements. The ACCC, in its August 2000 authorisation of the APCA CECS rules, noted concerns regarding access to the network, but did not directly address terms of access, noting that these issues may be better addressed under the *Payment System (Regulation) Act*, if appropriate.<sup>13</sup>

Interchange reform options that move toward a more uniform and transparent interchange fee regime could help to address access concerns. Further analysis may be needed to determine if other steps can be taken, outside of (or in addition to) interchange fee reforms, to enhance EFTPOS network accessibility.

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<sup>12</sup> The EFTPOS network has not been designated by the Reserve Bank.

<sup>13</sup> ACCC Authorisation, p. 42.



A related issue is gateway access. Some institutions provide a gateway for others to access the EFTPOS system. A smaller participant may not wish to establish interchange agreements and connections itself. Instead, it may contract with another institution to exchange transactions on its behalf. This is a common arrangement in other areas of correspondent banking, and can be expected to continue regardless of the interchange fee arrangements. Even under any EFTPOS interchange fee reform ultimately adopted, fees for such gateway services may continue to be appropriate provided they are competitively negotiated.

## **5. Issues for Consideration**

The foregoing discussion identifies the options and major issues involved in EFTPOS interchange fee reform, but without wider input not all advantages and disadvantages can be established. At this time, there is no conclusion in regard to the best or most appropriate option. As a result, input from interested parties is sought on the following issues:

1. Are the objectives for assessing options for reform appropriately defined? Are there other considerations that should be included in assessing the merits of any interchange fee options?
2. Are the three general interchange fee options clearly and appropriately defined? Are there other options that should be considered?
3. Are there other advantages or disadvantages of the three options that should be taken into account?
4. Are the three cost-based models associated with a multilateral interchange fee appropriately defined? Are there other cost models that should be explored?
5. Are there other advantages or disadvantages to the cost models that should be taken into account?
6. What other issues involving access to the EFTPOS network should be considered? What options should be considered to address these issues?
7. Are there other implementation issues that need to be considered?

The industry working group is seeking both written and oral comments from interested parties over the next month. The Reserve Bank of Australia will collect written submissions on behalf of the industry working group. Interested parties wishing to make oral comments may contact the Reserve Bank to arrange a meeting with representatives of the industry working group. Submissions will not be considered confidential, will be shared with industry participants and others, and should therefore

not include any confidential information. Written submissions are requested to be sent to the Reserve Bank by 13 September 2002 at the following address:

Payments Policy: EFTPOS Reform  
Reserve Bank of Australia  
GPO Box 3947  
Sydney, NSW 2001

or via e-mail at: [EFTPOS@rba.gov.au](mailto:EFTPOS@rba.gov.au).