CUSTOMER OWNED BANKING ASSOCIATION

30 January 2020

Dr Tony Richards
Head of Payments Policy Department
Reserve Bank of Australia
Sydney NSW 2001

By email: pysubmissions@rba.gov.au

Dear Dr Richards

Review of Retail Payments Regulation: Issues Paper November 2019

COBA appreciates the opportunity to contribute to the RBA's latest review of payments regulation.

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $128 billion in assets, 10 per cent of the household deposits market and more than 4 million customers. Customer owned banking institutions account for around three quarters of the total number of domestic Authorised Deposit-taking Institutions (ADIs) and deliver competition and market leading levels of customer satisfaction in the retail banking market.

On behalf of the customer owned banking sector, COBA brings a card issuer (i.e. our members) and cardholder (i.e. our members' customers and owners) perspective to this regulatory policy debate.

We support the RBA's objectives of promoting the efficiency of the payments system and promoting competition in the market for payment services, consistent with overall stability of the financial system.

Key points:

- **The current interchange fee regime is operating effectively and should be left unchanged, providing stability for all stakeholders.**
- **Merchants are entitled to seek to reduce their payment costs but merchants taking advantage of least-cost routing (LCR) to reduce merchant costs should do more to facilitate consumer choice.**
- **Greater transparency of card scheme fees would promote a better understanding of the respective contributions and interests of all four parties in the network – cardholders, issuers, acquirers and merchants.**
- **Merchants offering buy now pay later (BNPL) arrangements should not be prevented from surcharging for this relatively expensive payment service.**

The RBA's interventions in interchange fee arrangements and card scheme rules have significantly benefited and empowered merchants at the expense of card issuers and cardholders. Australia now has a relatively low-cost payment system for merchants by international standards.

If the RBA considers that further intervention is warranted, we would like to see more weight given to preserving a healthy ecosystem of smaller players in the card issuing space.

Customer owned banking institutions are innovators and early adopters in meeting consumers' evolving needs in payments, as demonstrated by our sector's performance with digital wallets[1] and the New

[1] Apple Pay, Google Pay & Samsung Pay

Payments Platform.[2] Our sector's capacity to continue to deliver innovation and excellent customer service in consumer payments would be assisted by stability in regulation of interchange fees. Any further reductions in interchange fees would affect retail banking competition by having a disproportionately larger impact on smaller banking institutions who do not participate in the merchant acquiring market that is dominated by the major banks.

More broadly, any further proposals for interventions affecting the banking market should be considered against the challenging conditions that face all banking institutions. These conditions were described by APRA in its recent review of 2019:

> "Very low interest rates, while appropriate for the economy as a whole, added challenges for the financial sector. Coupled with subdued credit growth for banking institutions, profitability, and therefore capital generation – essential for balance sheet growth – faced additional headwinds in 2019, and will likely remain under pressure in 2020."[3]

This observation echoes remarks by APRA Chair Wayne Byres in September 2019:

> "A very low interest rate environment will see margins squeezed, adding to the headwinds from slow lending growth. Profitability, and therefore capital generation, will come under more pressure. And given their different funding profiles, these trends may well impact smaller banks more forcefully than larger ones, reducing the ability of the former to apply competitive pressure to the latter. But to be clear, neither group will welcome further rate reductions."[4]

The low interest rate environment appears likely to stay for some time, as indicated by the RBA's most recent monetary policy decision announcement:

> "The Board also agreed that due to both global and domestic factors, it was reasonable to expect that an extended period of low interest rates will be required in Australia to reach full employment and achieve the inflation target. The Board is prepared to ease monetary policy further if needed to support sustainable growth in the economy, full employment and the achievement of the inflation target over time."[5]

Interchange fees

The current interchange fee regime is operating effectively and should be left unchanged, providing stability for all stakeholders.

The current interchange standards which came into effect in July 2017 saw a one-third reduction in the weighted-average interchange fee benchmark for debit cards and changes to the assessment of the credit card benchmark to prevent upward drift in fees. These were further examples of RBA interventions to benefit merchants at the expense of card issuers and potentially cardholders.

Finding the right balance of fairness, competition and efficiency requires all stakeholders to bear in mind that interchange fees are a means for card issuers to recover some of the costs they sustain to provide benefits to merchants.

Card issuers are entitled to recover their costs. It is fair and efficient that at least some of the costs of benefits provided by card issuers to merchants can continue to be recovered from merchants rather than from cardholders.

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[2] See speech by RBA Assistant Governor Michele Bullock 16 May 2019: "One of the positive aspects has been the broad participation of many small financial institutions. Customers of around 50 small banks, credit unions and building societies were able to make and receive fast payments from Day 1 and that number has since grown to nearly 70. On a less positive note, we have been somewhat underwhelmed by the progress of some of the major banks."

[3] APRA 2019 Year in Review

[4] Speech by APRA chair Wayne Byres 13 September 2019

[5] Statement by RBA Governor Philip Lowe 3 December 2019

The alternative payment option for merchants, i.e. transacting in cash, imposes a range of direct and indirect costs on businesses and these costs are becoming more transparent, according to the Black Economy Task Force. They include security, storage, transport, fraud and theft.[6]

The RBA's interventions in interchange fee arrangements have significantly benefited and empowered merchants at the expense of issuers and cardholders. As the RBA says in the Issues Paper, "data on merchant service fees indicate that interchange fee regulation and surcharging have led to overall lower costs for merchants in accepting card payments. Australia now has a relatively low-cost payment system by international standards, most notably compared with the United States."

The RBA notes that "the effect of interchange rates on average merchant service fees is likely to be smaller than it was prior to the regulatory changes in the 2015-16 Review, which had the effect of significantly lowering the gaps between the strategic rates offered to large merchants and the high interchange rates on premium and corporate cards that feel disproportionately on smaller merchants."

The main beneficiaries of any further reductions in interchange fees would likely be the largest merchants and the four major banks. The four major banks acquire more than 90 per cent of the value of four-party card transactions.[7]

But as the RBA notes, any gains by merchants and acquirers could be temporary due to a potential shift towards more expensive three-party scheme cards.

Least-cost routing & dual network debit cards

COBA agrees with the RBA's observation that dual network debit cards (DNDCs) "enable competition between networks at the point of sale, facilitating both consumer and merchant choice."

Merchants are entitled to seek to reduce their payment costs but merchants taking advantage of least-cost routing (LCR) to reduce merchant costs should do more to facilitate consumer choice.

The interests of the merchant in implementing LCR may not align with the interests of cardholders. Cardholders should be given an informed choice in situations where the merchant has acted to optimise its own interests without regard to the impact on cardholders.

The RBA notes that merchants want access to LCR "to reverse the increase in payment costs that occurred with the shift to contactless transactions and the international schemes."

This perspective ignores the fact that tap-and-go is a highly valued innovation for merchants <u>and</u> cardholders that speeds up transactions and improves efficiency. The Productivity Commission has reported that when paying in person, consumers prefer payment methods that offer them speed, rewards and low cost. Merchants, similarly, choose their acquiring institutions based on dependability, speed, security, pricing and customer service. [8]

The international schemes were first to rollout contactless cards, in 2012, and until around 2016 contactless cards were only available through the international schemes, i.e. not through the eftpos network. Now that eftpos has tap-and-go functionality, LCR is a possibility for merchants. Adoption of LCR is a matter to be decided between merchants and acquirers but cardholders' interests must also be considered.

The RBA invites stakeholders to comment whether it should be for merchants to disclose the use of LCR or for issuers of these cards to advise their cardholders to make proactive choices regarding network selection.

As the RBA notes, where cards "provide certain additional benefits to cardholders when used in one network rather than another, cardholders may not be indifferent as to the routing of their transactions."

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[6] Black Economy Task Force Final Report May 2017

[7] RBA Issues Paper (section 3.2.2)

[8] Competition in the Australian Financial System, Productivity Commission 2018

All stakeholders should take steps to inform consumers about their options.

However, the critical moment is at the time of the transaction and if merchants have assumed the role of decision-maker for the cardholder, it seems reasonable that the merchant should be advising the cardholder what is happening.

The Black Economy Task Force noted this point and commented that:

> "The Taskforce recognises that there are sometimes small differences in the cardholder experience or terms and conditions depending on whether transactions are routed via the eftpos network or the MasterCard or Visa networks. If so, it would seem appropriate that the merchant should disclose it is using least-cost routing and that consumers should be able to 'override' a merchant's network preference. Accordingly, where a merchant chooses to exercise least cost routing for contactless transactions on dual-network cards it may be appropriate for them to display a sign along the following lines:
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>> 'At [Merchant Name] we care about holding down our costs so that we can hold down prices for our customers. Accordingly, we prefer to send contactless debit card transactions to customers' banks via Network X as opposed to Network Y or Z. If customers prefer that their debit transactions are instead sent via another network, they can insert/dip their cards and push the button or keypad for their preferred network.'
>
> "We consider that such a framework would be a reasonable balance between the rights of merchants and consumers, and that consumers would quickly become used to the concept that their transactions could be sent via different networks at different merchants."[9]

In Europe, retailers can install a default application choice in their payment terminals but must inform consumers who have the last say and can override with their own preference.[10]

COBA supports the approach suggested by the Black Economy Task Force.

Scheme fees

In principle and subject to any unintended consequences that may be identified by other key stakeholders, COBA supports the case for greater transparency in scheme fee arrangements and their effect on payment costs.

Scheme fees are paid by issuers and acquirers and are an important element of payment system costs. Increases in scheme fees for issuers could influence issuers' decisions whether to participate in particular products and networks.

As noted by the RBA, issuers may wish to avoid the extra costs associated with supporting a second network on a card, especially as new technologies lead to a rapid pace of change in card issuance. The RBA says that some small issuers have recently indicated to the RBA that it is costly for them to maintain two networks on their debit cards and to carry out largely duplicative activities such as regular upgrades of cards to the standards of both schemes and investment to enable both scheme networks in mobile wallets.

A decision to increase eftpos scheme fees in 2019 was the subject of considerable discussion by many COBA members. COBA understood that the changes were intended to improve the eftpos product offering to become more competitive with the international schemes. This underlines the importance of all stakeholders acknowledging the important contribution and interests of all four parties in the network – cardholders, issuers, acquirers and merchants.

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[9] Black Economy Task Force Final Report May 2017

[10] Competition in the Australian Financial System, Productivity Commission 2018

Greater transparency of scheme fees should promote a better understanding of these respective contributions and interests.

Buy Now Pay Later

The RBA notes that the Buy Now Pay Later (BNPL) providers charge merchants a “relatively-high” per-transaction fee, “often in the range of 3-6 per cent and is generally higher than the cost of accepting other electronic payment methods such as cards.”

Most BNPL providers also have rules that prevent merchants from levying a surcharge on the customer to recover those fees. The RBA notes that this may increase the cost of accepting payments for merchants that feel compelled to offer BNPL services as a payment option for competitive reasons but are unable to recoup the merchant fees from the customers that directly benefit from the service.

We agree with the RBA’s view that by helping to keep merchants’ costs down, the right to apply a surcharge means that businesses can offer a lower total price for goods and services to all of their customers.

The BNPL sector has experienced phenomenal growth and its impact on costs for merchants, and therefore on prices for all consumers, is likely to be significant. ASIC’s November 2018 report[11] on the sector said the market for BNPL arrangements was diverse, evolving and growing rapidly.

> “The number of consumers who used at least one buy now pay later arrangement has increased five-fold from 400,000 consumers during the 2015-16 financial year to over 2 million consumers during then 2017-18 financial year. This represents about 10% of the adult population in Australia.”

ASIC found that each BNPL provider “in our review contractually prevents merchants from charging consumers higher prices for using a buy now pay later arrangement.”

COBA’s view is that merchants offering BNPL arrangements should not be prevented from surcharging for this relatively expensive payment service.

While not directly relevant to retail payments regulation, stakeholders frequently comment on the fact that the responsible lending obligations in the National Credit Act do not apply to BNPL arrangements. As noted by ASIC in its 2018 report, this means that when providers decide whether to approve an application for an arrangement, they are not required to inquire into the consumer’s financial position, verify the consumer’s financial position or make an assessment as to whether the consumer would be able to repay the credit without substantial hardship.

The “light” regulatory treatment of BNPL may be a factor in the rapid growth of the sector and is therefore a legitimate matter for consideration in an examination of payment system costs and competition and efficiency in the payments system.

Please don’t hesitate to contact Luke Lawler on 02 8035 8448 of llawler@coba.asn.au to discuss any aspect of this submission.

Yours sincerely

MICHAEL LAWRENCE
Chief Executive Officer

[11] Review of buy now pay later arrangements, ASIC November 2018