RBA Consultation Response - CMSPI

About CMSPI

CMSPI is a dedicated, independent team of expert consultants and analysts who advise merchants on how to optimize and reduce the cost of accepting payments.

We work across all areas of consumer payments, our steadfast objective being to secure the best end-to-end solutions for our clients. We add significant value to current supplier arrangements by applying our unique insight, analysis and benchmarking experience, garnered throughout the consumer payments supply chain over 27 years.

Whether we're hosting events, publishing thought-leading content, or partnering with other merchant advocates, the needs and goals of the merchant community are always at the centre of our work. We pride ourselves on being merchant champions, and a large part of that is supporting, bringing transparency to, and educating the merchant community.

International Payments Regulation Forum

We believe a fair payments markets should be secure, transparent, innovative, competitive, accessible, and free from systematic risk – that's why we set up the International Payments Regulation Forum (IPRF) to drive collaboration between global merchant advocates. Since then IPRF has flourished and now covers a multitude of regions, industries, and interested parties. The group combine to pen expert white papers, deliver data insights, educate merchants, provide transparency for regulators, and fight for a fairer, more balanced industry.

CMSPI Response to the Reserve Bank of Australia (RBA)

CMSPI acknowledges the great work carried out by the RBA in the payments space, particularly with their efforts in attempting to ensure an efficient payments ecosystem that works for both merchants and consumers. CMSPI is delighted to respond to the consultation put forward by the RBA and the response presented focuses on the following key issues;

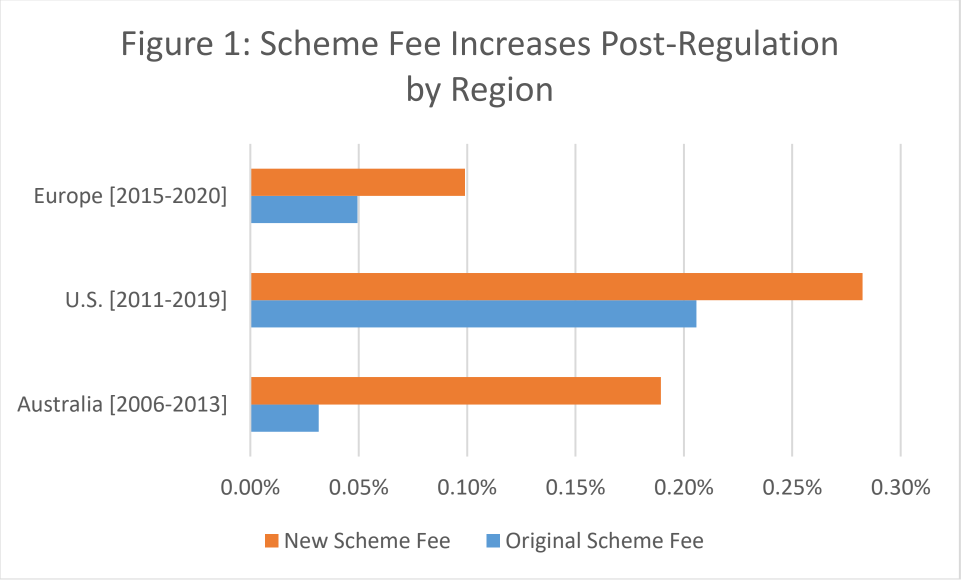
1. Scheme fee increases in Australia and why they should fall under the lens of regulation
2. The abolition of interchange fees
3. The opportunities Least-Cost Routing presents for competition and efficiency
4. The removal of weighted average interchange caps

CMSPI
Oxford Place, 61 Oxford St
Manchester, M1 6EQ
United Kingdom

+44 (0) 161 300 8767
info@cmspi.com
www.cmspi.com | @CMSpay

1. Scheme Fee Increases

Australian merchants have seen high levels of card scheme fee increases since interchange fees were regulated by the RBA in 2003. This experience is consistent with other jurisdictions following interchange fee regulation, particularly the U.S. and Europe. However, Australian scheme fee increases are worse than their peer group, with RBA data revealing Australian merchants incurred a six-fold increase in scheme fees between 2006 and 2013[1] (Fig. 1).



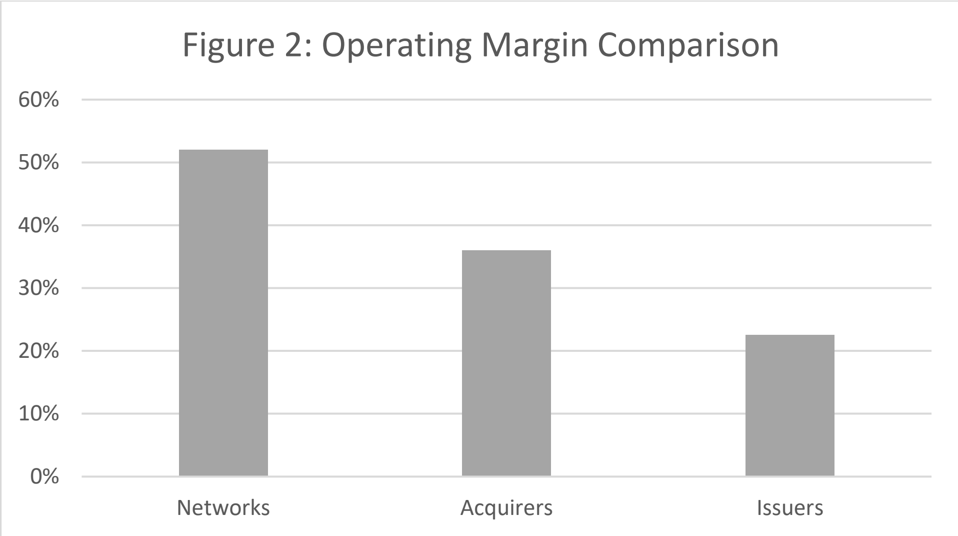
<u>What do scheme fee increases fund?</u>

Scheme fee increases would be acceptable if they went towards delivering the six industry characteristics we mentioned above – innovation, accessibility, transparency, competition, security and prevention of systemic risk. For example, short term or one-off fees to merchants associated with the development of an improved version of 3D Secure could perhaps be justified.

However, CMSPI analysis clearly shows that scheme fee hikes are primarily funding Visa and Mastercard's corporate profit, rather than genuine product development. The card schemes

[1] Percentage fees calculated using average transaction value of card spend in Australia from Euromonitor. Australian scheme fee data from: https://www.rba.gov.au/publications/rdp/2014/pdf/rdp2014-14.pdf

regularly publish profit margins in excess of 50%, higher than acquirers and issuers, and far higher than merchants (Fig. 2).



Despite these fee increases, there are plenty of shortcomings in the current card system. The Nilson Report revealed that global card fraud reached $27.85 billion in 2018, an increase of 16.2% from 2017[2]. The study also revealed that the great majority of this fraud - $24.86 billion - was incurred on global card brands, and that local card brands have a much lower rate of fraud than global card brands[3]. We would also argue that there is very little true innovation in the card industry, if we compare Visa and Mastercard products to WeChat and Alipay mobile payment solutions popular in China, where the payments function has been integrated into a lifestyle app.

On this basis, we think scheme fees need to be brought within the scope of the RBA's interchange fee review. There is precedent – in 2002, The People's Bank of China (PBOC) imposed their "8:1:1 rule" cap, setting the division of the merchant fee between interchange, switch fees and acquirer fees respectively[4].

In addition to the PBOC's approach, there are several different methodologies the RBA may take to address excessive scheme fees, including:

1) Setting scheme fees in the same way as interchange fees were capped – i.e. through a cost-based methodology as used by the RBA in 2000

[2] Nilson Report #1164
[3] Local brands average 2.01 bps of fraud, versus 7.37 bps for global brands
[4] https://www.kansascityfed.org/~/media/files/publicat/psr/dataset/pub-auth_payments_var_countries_august2017.pdf

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2) A total cap could be applied to the sum of both the scheme and interchange fees, potentially introducing an interesting dynamic whereby the schemes have to balance both without damaging their own profits or their issuer relationships
3) A free market solution would be to expose credit cards to co-badging by encouraging new networks to enter the credit card space

Finally, we would like to note that the RBA's macro scheme fee data for Australia is only available up until 2013, demonstrating the need for more transparency and faster and more robust data collection.

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2. Abolishing Interchange

CMSPI applauds the work the RBA has done on reducing interchange fees, helping merchants and consumers save billions of dollars over a period of 17 years. The RBA's ongoing work has continued to deliver new value for merchants – for example, the 2016 cap reduction on the debit side has directly resulted in lower fees for merchants, as evidenced by Graph 4 of the RBA's consultation paper.

However, we agree with the Australian Productivity Commission's (APC) 2018 recommendation that interchange fees should be abolished entirely and we think this is something the RBA should reconsider.

Globally, there is increasing scrutiny over the legality of interchange fees. For example, there is an ongoing interchange litigation case in the UK - which has reached the Supreme Court - where merchants have argued that interchange fees are illegal in their entirety on the basis that they violate Article 101 of the Treaty of the Functioning of the European Union by causing a restriction of competition in the merchant acquiring market[5]. We understand a separate group of merchants is also filing claims against the schemes based on Article 102, on the basis that the schemes are guilty of an "abuse of a dominant market position".

There are some key points to consider on the necessity of interchange fees. Firstly, our analysis suggests that issuing is profitable without interchange fees[6]. Secondly, the great majority of issuing revenue is from consumer overdraft fees on debit cards and interest fees on credit cards. These revenue streams are reliant on merchants accepting card payments, and it suggests that issuers don't need interchange fees to encourage them to issue cards. We would be happy to share any of our analysis in this area with the RBA.

There would be exogenous benefits to abolishing interchange fees. As RBA evidence has consistently shown, there is a strong link between Visa and Mastercard credit card merchant fees and American Express (Amex) fees. We believe this is because lower Visa and Mastercard fees give merchants more bargaining power when negotiating fees with Amex. Therefore, abolishing Visa and Mastercard interchange fees would likely put severe downwards pressure on Amex fees, again benefitting Australian merchants and consumers.

[5] https://www.supremecourt.uk/cases/uksc-2018-0156.html

[6] Our analysis suggests interchange fees constitute around 15% of an issuer's income, while their profit margins are typically 20-25%.

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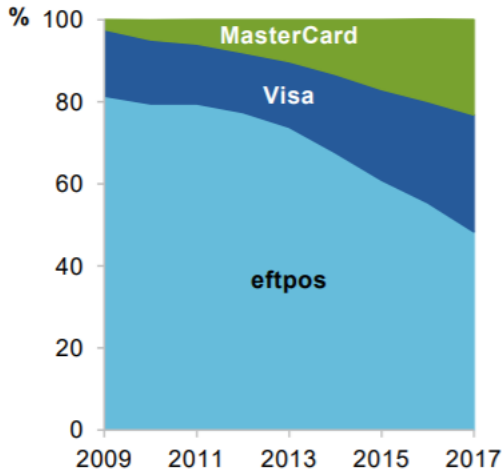
3. Contactless Routing

Contactless card payments benefit both consumers and merchants by allowing quicker face-to-face payments.

However, potentially for technological reasons, contactless transactions have historically all been sent to Visa and Mastercard rather than the local eftpos scheme, leading to a significant decline in eftpos' market share[7] (Fig. 3). The issue for merchants was that Visa and Mastercard typically have higher fees than eftpos.

Figure 3

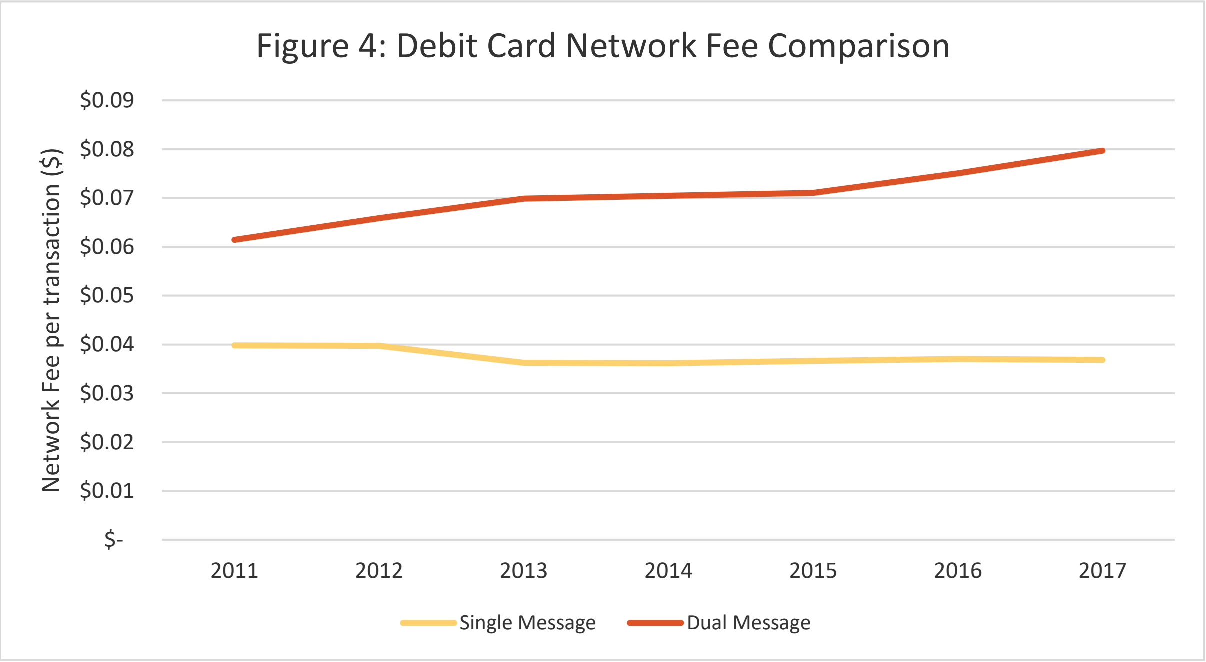


On this basis, we are pleased that the RBA has decided to enforce the APC's recommendation to protect merchant transaction least-cost routing choice as contactless payments grow in popularity in Australia. We see no reason why the introduction of contactless cards should come at the expense of competition, and ultimately harm consumers.

Evidence from around the world shows that co-badging cards to allow Least-Cost Routing successfully introduces competition into the otherwise highly concentrated payments industry. A key example of this is in the U.S., where rules to introduce co-badging were introduced as part of the Durbin amendment to the Dodd-Frank Wall Street Reform Act in October 2011.

[7] https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf

However, in the U.S., co-badging laws were only extended to the single message debit market, and not the dual message debit market[8]. In the dual message market, Visa and Mastercard continue to be the only network included on the card so Least-Cost Routing is not possible for merchants. What we have seen is dual message exempt interchange and network fees increase since Durbin, while single message exempt interchange and network fees have decreased (Fig. 4 & 5). In fact, dual message transaction fees are now more than double single message fees. Quite simply, we think this huge pricing differential reflects the difference between a competitive and a non-competitive market.



[8] Single message refers to transactions where authorisation and settlement take place at the same time. Dual message refers to transactions where authorisation and settlement take place separately, with settlement typically taking place one day after the transaction is authorised.

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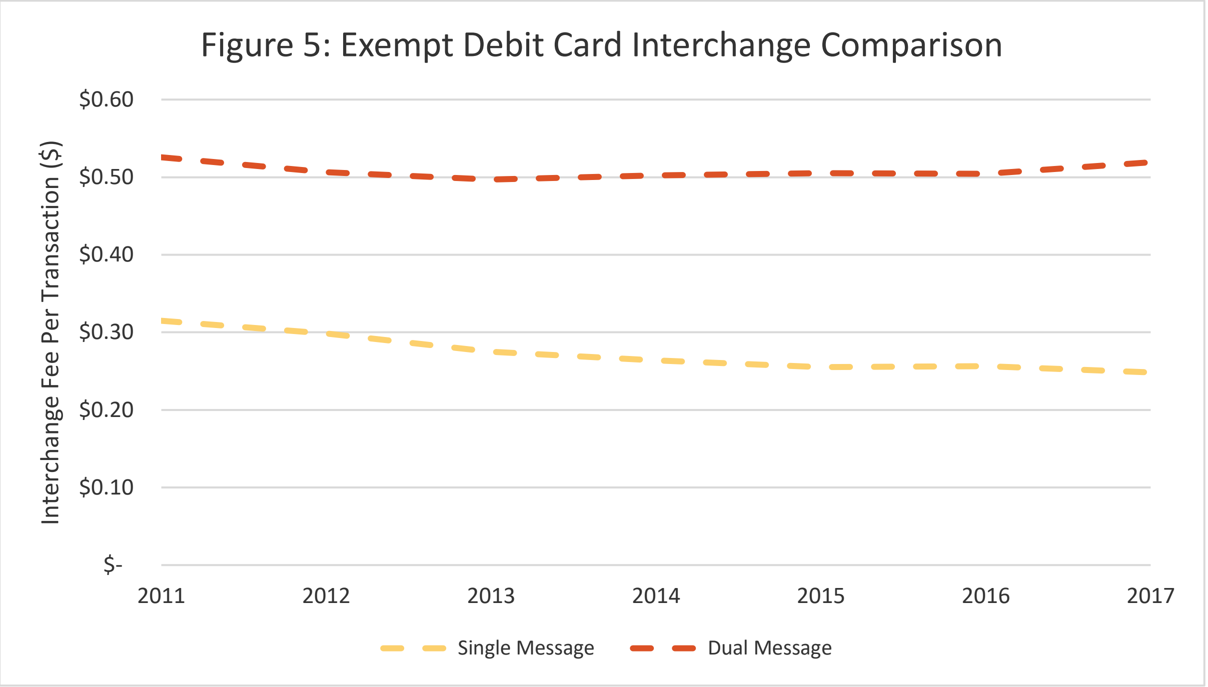

There are other, indirect benefits of Least-Cost Routing. For example, we have been informed that Visa and Mastercard have slashed their debit card scheme fees in Australia in response to the rules opening up contactless routing – at least for certain merchants. Of course, this partially addresses the issues in point 1, but would need to be extended to credit cards to become a definitive solution. We think the RBA should consider this possibility.

On this basis, it is clear that the eftpos scheme needs protecting. Eftpos is one of a number of national debit card schemes across the world that is vulnerable to the market power of Visa and Mastercard, including the numerous U.S. local networks, Girocard in Germany, Carte Bancaire in France, BankAxept in Norway and Interac in Canada. These schemes generally offer merchants more competitive pricing than Visa and Mastercard, and typically have not-for-profit business models and pricing based on cost recovery.

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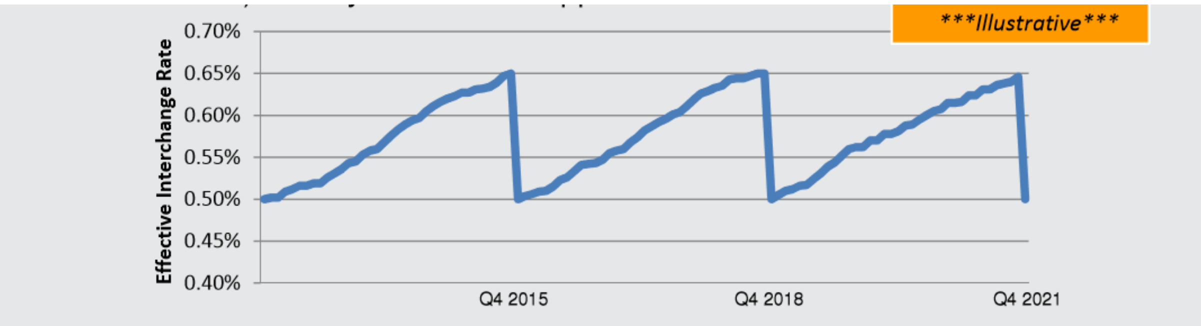
4. Weighted Average Interchange

The Australian credit card interchange caps have been imposed on a weighted average basis since 2003, meaning that card schemes are free to impose higher individual interchange fees than the caps (which are currently 50 bps) as long as the weighted average interchange fee across the entire card scheme does not exceed the overall cap (i.e. 50 bps). Actual rates are subject to calculation and adjustment every three years.

We have two main concerns with weighted average interchange fees. First, we think interchange (and card fees in general) suffer from unnecessary complexity and weighted average fees play a part in that. Second, we have reservations about compliance with the cap.

On this second point, the RFI Group[9] refers to the "premiumisation" that weighted average interchange fees have caused the Australian credit card market, whereby issuers are likely to issue an ever-higher proportion of high interchange card products over time. Only when rates are adjusted in readiness for a three-year review is the weighted average actually fulfilled (Fig. 6).

Figure 6



There are examples of this problem in other jurisdictions. In Europe, the European Commission has allowed individual Member States to implement its 0.2% debit card cap on a weighted average basis[10]. Most Member States have not exercised this option, but the UK temporarily did, allowing Visa to set interchange fees of 0.2% + £0.01 (capped at £0.50 per transaction) for secure consumer debit card transactions immediately after the IFR was

[9] https://www.rfigroup.com/content/rba-investigates-card-fees-surcharges

[10] Although its 0.3% credit card cap does not allow for a weighted average

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introduced in December 2015. However, from September 2016 debit card interchange fees in the UK have all been set according to a flat 0.2% following complaints from merchant advocates including CMSPI, who did not believe that these fees were compliant with the weight average cap[11] .

Additionally, in Canada a commitment from Visa and Mastercard to keep weighted average credit card interchange fees at 150 bps from April 2015 has not been fulfilled, as a review has determined that actual average interchange fees in Canada are higher[12] .

Advocates of weighted average interchange fees often cite the role higher interchange fee categories have in funding consumer reward programs. However, there should be no net positive position for issuers against a flat cap. Additionally, in Europe, where the IFR credit card cap is a flat 0.3% (which is 0.2% lower than the RBA cap), we still see credit card reward programmes functioning.

Perhaps to address concerns related to weighted average interchange fees, the RBA introduced a credit card cap for an individual transaction of 80 bps in 2016[13] . However, we do not believe this fully addresses the issue of honouring the cap and believe weighted average credit card interchange caps should be abolished as part of the RBA's next review into interchange fee regulation.

[11] https://www.bobsguide.com/guide/news/2016/Mar/14/the-interchange-shake-up-why-benefitting-from-new-card-transaction-fee-caps-may-not-be-as-straightforward-as-hoped-for-merchants/
[12] https://www.canada.ca/en/department-finance/news/2018/08/backgrounder-new-voluntary-commitments-from-payment-card-networks.html
[13] https://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/pdf/review-of-card-payments-regulation-conclusions-paper-2016-05.pdf