

FEBRUARY 2016

Review of Card Payments Regulation

Submission to the Reserve Bank of Australia

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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INTRODUCTION

CHOICE appreciates the opportunity to provide the following comments to the Reserve Bank of Australia (RBA) in relation to the *Review of Card Payments Regulation Consultation Paper* released in December 2015.

CHOICE supports a number of reforms presented by the RBA in the consultation paper, many of which will encourage a fairer payments system, benefiting consumers. However, given that this is a rare opportunity for reform, CHOICE encourages the RBA to reduce interchange fees further. A simpler, fairer system including stronger enforcement mechanisms and increased transparency will help consumers navigate the complex system of card payments.

SUMMARY OF RECOMMENDATIONS

| | |
|---|---|
| Interchange fees and scheme payments | That the RBA reduces the weighted average interchange fee benchmarks and introduces a ceiling on individual interchange rates at the levels proposed in the options paper (combination of options two and three – interchange benchmarks and ceilings). |
| | That the RBA limits payments by card schemes to issuers (option two – scheme payments). |
| | That commercial cards are retained in the coverage of interchange standards (option one – commercial cards). |
| | That the RBA clarifies the definitions in the Bank’s standards to include transactions in Australia with foreign-issued cards (option two – foreign-issued cards). |
| | That the RBA formalise regulation for prepaid cards consistent with debit standards (option three – prepaid cards). |
| | The RBA adopts requires quarterly compliance for interchange benchmarks (option two – benchmark compliance). |
| Companion cards and pre-paid cards | The RBA regulates issuer fees and other payments to issuers for companion cards (option three - companion cards). |
| Surcharging | The RBA makes modifications to the cost of acceptance framework (option three – surcharging). |
| | The RBA and ACCC consult consumer advocates on how consumer reporting of excessive surcharging can best assist enforcement efforts. |

1. Interchange fees and scheme payments

CHOICE welcomes principle of the RBA's proposed cap on interchange fees at 0.8%; however alongside of this the average weighted interchange level should be lowered from 0.5% to 0.3%. CHOICE understands that opportunities for consultation and regulation of this nature are rare, and where an opportunity exists to enact major reform, that opportunity should be taken.

High interchange fees are detrimental to consumers

Consumers are disadvantaged by high interchange fees. High interchange fees flow on to merchants in the form of higher costs, which in turn are reflected in higher than necessary prices for goods and services. These higher prices are then paid not only by cardholders, but all consumers.

A direct result of the 2003 RBA reforms was that average interchange fees for MasterCard and Visa were reduced to around 0.5%, down from around 0.95%. This had a predictable flow on effect to merchants where service fees reduced, on average, from 1.44% for MasterCard or Visa transactions in March 2003 to 0.84% now.¹ Further lowering weighted interchange fees would mean that costs associated with accepting cards would reduce, benefiting consumers and merchants.

CHOICE does acknowledge that any move to lower the interchange rate will likely negatively impact the current business model for high cost rewards programs. However, this will be beneficial to the vast majority of consumers. High cost rewards schemes benefit a small subset of consumers while driving up costs for all card users. It would substantially increase the transparency of such programs if consumers who opted for high cost rewards programs saw the true costs reflected in annual fees, rather than submerged in opaque costs borne by all card users.

CHOICE is aware of a number of criticisms relating to further reduction in interchange fees.² Such criticisms are:

¹ Reserve Bank of Australia (2015), C5: Average Merchant Fees for Debit, Credit and Charge Cards, <http://www.rba.gov.au/payments-system/resources/statistics/index.html>

² CHOICE addressed these criticisms in further detail in a submission to the Senate Standing Committee on Economics in September 2015. See CHOICE submission 10.1: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Credit_Card_Interest/Submissions

1. Merchants haven't passed on savings to consumers, despite a significant cut in merchants' annual merchant service fee costs.

Typically, reports don't claim prices are not lower than they would have been without the reforms, just that there's no evidence to prove it. It is likely that some merchants operating in sectors that face little competitive pressure will not pass on the full amount of savings if their card acceptance costs are reduced. But this is a reason to investigate the state of competition in those markets, not to keep interchange at high levels. This issue comes down to an assessment of who do we trust to pass on savings to consumers: the highly concentrated banking industry currently making record profits or all other businesses consumers have contact with, some facing more competitive pressure than others.

2. Credit card reward programs have reduced in value and will continue to reduce in value.

Rewards programs only provide benefits to a small percentage of consumers.³ It is important to note that rewards schemes have never offered good value to most consumers. In 2003 consumers with a MasterCard and Visa rewards cards needed to spend an average of \$12,400 to get a \$100 voucher.⁴ This increased to \$14,400 in 2004 and \$16,000 in 2006.⁵ Today, the average spend required for a rewards credit card to receive a \$100 voucher is \$17,926.⁶

Even in 2003, the consumers most likely to get value from rewards points had high incomes and consistent cash flows. RBA statistics demonstrate that consumers in the top quartile of income are ten times more likely to have a premium credit card (with rewards points) than consumers in the lowest income quartile.⁷ CHOICE statistics support this, finding that only 19% of consumers earning under \$50,000 per annum strongly agree that they are more likely to use a card with rewards points, compared to 32% of consumers who earn over \$100,000.⁸

³ Stillman, Robert, William Bishop, Kyla Malcolm and Nicole Hildebrandt, 28 April 2008, Regulatory Intervention in the payment card industry by the Reserve Bank of Australia, Analysis of the evidence. CRA International, London, p.16

⁴ Stillman, Robert, William Bishop, Kyla Malcolm and Nicole Hildebrandt, 28 April 2008, Regulatory Intervention in the payment card industry by the Reserve Bank of Australia, Analysis of the evidence. CRA International, London, p.16.

⁵ Ibid.

⁶ See CHOICE, (2015) Submission to Inquiry into matters relating to credit card interest rates p.13.

⁷ Ibid p.5.

⁸ CHOICE, survey into consumer use and understanding of credit cards, July 2015. N=1679. For further information see CHOICE, (2015) Submission to Inquiry into matters relating to credit card interest rates p.13.

3. Credit cards have become more expensive because of a reduction in interchange fees and subsequent reduction in bank profits. If interchange is reduced, annual fees will rise and some card providers may be unable to offer low rate cards.

This claim appears unlikely. Claims that card providers will no longer be able to offer low-rate cards haven't proved true in the European Union. Currently, there are credit cards available with much lower interest rates than in the Australian market, despite reforms to lower interchange similar to the RBA proposal.⁹

It is also important to note that increasingly, the cost of providing credit has become less important while the cost of rewards cards and card scheme fees have grown. The Australian Bankers' Association (ABA) has noted that funding costs for credit cards have become less important. Credit card funding comprised over half of card costs in 2008 but this has fallen to only a third of costs in 2014 while rewards programs and scheme fees (payments to MasterCard, Visa etc.) have comprised a greater proportion of bank costs in recent years.¹⁰ The Commonwealth Bank also notes that the cost of funds only contributes to 22% of its credit card costs, with pricing risk, operating costs and rewards programs the other key costs.¹¹ CHOICE expects that should interchange be lowered to 0.3%, the current business model of high cost rewards programs will be affected. However this will not prevent schemes from marketing premium rewards cards to consumers with the costs of these programs more transparently reflected in annual fees, for example.

Measures required to lower interchange fees

CHOICE would like to see a combination of options presented in the RBA draft standards to reduce average interchange fee levels as well as the spread between the highest and lowest interchange fees.

Lower interchange fees will reduce the effect of consumers with lower rate cards or consumers paying by other methods such as cash subsidising the higher value schemes of a small group of premium card users.

The current interchange benchmarks of 0.50% for credit card transactions and 12 cents for debit card transactions need to be lower. CHOICE supports the proposal to reduce the

⁹ For example, cards with ongoing interest rates as low as 6.4% in the United Kingdom at <http://moneycompare.which.co.uk/credit-cards/everyday-credit-cards>

¹⁰ ABA (2015), *ABA response into the Inquiry into credit card interest rates*, pp. 14-15.

¹¹ Commonwealth Bank, (2015), *Submission: Senate Economics References Committee Inquiry into matters relating to credit card interest rates*, p. 7.

weighted-average benchmarks to 0.30% for credit and 8 cents for debit. The RBA has gathered more than sufficient evidence for these benchmarks in the current review as well as the 2007-08 review of card payments. In addition, these levels would bring Australian regulation largely in line with measures being implemented in the European Union.¹²

In order to ensure that average MasterCard and Visa debit and credit fees do not continue to drift above the average weighted benchmark, the RBA should also require a maximum or ceiling rate for individual interchange rates. CHOICE supports the proposed ceiling levels of 0.80% for credit and 15 cents or 0.20 % of transaction value for debit.

Anti-circumvention measures

Measures are also required to prevent circumvention of regulation, particularly by international card schemes. Because of this, it is essential that standards limit payments or benefits given by payment schemes to card issuers. Failing to capture scheme payments would create a shadow interchange-like system that would continue or exacerbate problems RBA standards are designed to address. In addition CHOICE recommends that commercial cards are retained in the coverage of interchange standards and that foreign-issued cards acquired in Australia are covered by the interchange standards.

Given that the RBA has noted that the current quasi-regulatory approach has resulted in interchange rates of pre-paid cards staying at similar levels to debit cards, CHOICE supports formalising regulation of prepaid cards consistent with debit interchange standards. Formalisation is unlikely to place any further financial burden on issuers, while increasing transparency and long-term certainty for merchants and consumers.

Benchmark compliance

CHOICE welcomes the RBA's proposal to monitor compliance of interchange fees on a quarterly basis. It is clear that the current system of three-year compliance cycles for both credit and debit cards has not kept interchange fees at the required benchmark. This has in turn meant higher costs for merchants and consumers

¹² See http://ec.europa.eu/competition/sectors/financial_services/payments_en.html

Typically, average interchange fees have remained above the benchmarks for MasterCard and Visa schemes. CHOICE notes that this has not been the case for ePAL, where the eftpos system has consistently remained below the benchmark.

Given the disparity in interchange fees across schemes, CHOICE believes that significantly shorter compliance cycles (i.e. quarterly) are necessary to ensure that schemes do not exceed a cap or weighted average.

The RBA has noted that it does not believe this approach will amount to significant financial burden for scheme providers.¹³ CHOICE believes that any costs associated with extra regulatory burden are in the public interest and will increase transparency and efficiency in the card scheme market.

Recommendations

- That the RBA reduces the weighted average interchange fee benchmarks and introduce a ceiling on individual interchange rates at the levels proposed in the options paper (combination of options two and three – interchange benchmarks and ceilings).
- That the RBA limits payments by card schemes to issuers (option two – scheme payments).
- That commercial cards are retained in the coverage of interchange standards (option one – commercial cards).
- That the RBA clarifies the definitions in the Bank’s standards to include transactions in Australia with foreign-issued cards (option two – foreign-issued cards).
- That the RBA formalise regulation for prepaid cards consistent with debit standards (option three – prepaid cards).
- The RBA adopts requires quarterly compliance for interchange benchmarks (option two – benchmark compliance).

2. Companion cards

CHOICE notes the growing share in the market of companion cards, specifically American Express companion cards. CHOICE supports a move to bring American Express under the

¹³ See Reserve Bank of Australia (2015), *Review of Card Payments Regulation, Consultation Paper*, Reserve Bank of Australia, Sydney.

same regulatory framework as MasterCard and Visa, with the intention that this will reduce overall costs to consumers at the point of sale.

As noted in the consultation paper, the combined share of transactions by American Express cards has grown significantly from the early 2000s to today. Along with Diners Club cards, they now account for 19 per cent of the market. This growth can be attributed to the introduction of bank-issued companion American Express rewards cards in Australia's major banks from 2004.¹⁴

High interchange rates on American Express companion cards and their increasing growth in the market contributes to higher overall costs for consumers. Bringing American Express under the same regulatory framework as MasterCard and Visa would ensure both reduced costs to the consumer and reduced complexity for businesses when accepting card payments. Regulation needs to prevent any 'interchange-like issuer payments' in order to prevent card schemes circumventing regulation.

Other options for companion card regulation presented in the RBA paper will lead to poor consumer outcomes. Option one, retaining current arrangements, will continue to undermine current regulation and perpetuate higher overall costs for consumers. Option two, removing interchange regulation, will lead to the pre-2003 situation of high and hidden costs for consumers through high interchange fees.¹⁵

Recommendations

- The RBA regulates issuer fees and other payments to issuers for companion cards (option three - companion cards).

3. Surcharging

Surcharging can improve the efficiency of the payments system when it provides accurate price signals to consumers. Surcharges should always reflect the costs incurred by the merchant.

¹⁴ Ibid.

¹⁵ See Reserve Bank of Australia (2015), *Review of Card Payments Regulation, Consultation Paper*, Reserve Bank of Australia, Sydney.

CHOICE has become increasingly concerned at instances of excessive surcharging in several industries and continues to advocate for reduced surcharging where it does not accurately reflect the costs associated with processing payments. It has become increasingly obvious that some businesses, particularly in the travel, tourism and entertainment industries, are charging excessive surcharges for credit card payments – well beyond the cost incurred for receiving the payment.

This is particularly reflected in industries that charge a fixed dollar surcharge, such as airlines, where the surcharge will often not accurately reflect the cost of processing the payment.

Airline excessive credit card surcharging in 2016

| Airline | Ticket cost¹⁶ | Booking fee | Likely average fee incurred by merchant¹⁷ | Percentage mark-up |
|----------------|---------------------------------|--------------------|---|---------------------------|
| QANTAS | \$200 | \$7 | \$1.56 | 348.72% |
| Virgin | \$135 | \$7.70 | \$1.05 | 633.33% |
| Jetstar | \$85 | \$8.50 | \$0.66 | 1187.88% |
| Tiger | \$95 | \$8.50 | \$0.74 | 1048.65% |

CHOICE does not believe that a “no surcharge” regime would be beneficial to consumers, and supports initiatives from the RBA, ACCC and the Federal Government that will lead to fairer surcharging.

Any return to a “no surcharge” regime would shift the costs from consumers who choose a specific payment type to all consumers, as costs are absorbed into the overall price of goods and services. Such a change would disadvantage consumers using lower cost payment methods like eftpos or cash while subsidising users of higher cost credit cards.

With the expected finalisation of the *Competition and Consumer Amendment (Payment Surcharges) Bill 2015* CHOICE hopes that enforcement action against businesses engaging in

¹⁶ Flights selected were SYD to MEL morning commuter flight on Monday 29 February. Cheapest flight before 9am selected. Flights costs and booking costs reviewed between 11:00 and 11:15 on Tuesday 02 February 2016.

¹⁷ Percentage mark-up calculated on RBA 2015 MasterCard/Visa average merchant service fee of 0.78%, see: <http://www.rba.gov.au/publications/annual-reports/psb/2015/pdf/retail-payments-developments.pdf>, p. 19

excessive surcharging will be swift.¹⁸ This, along with the recommendations proposed by the RBA in its consultation paper, will provide merchants and banks with a framework for fairer surcharging.

CHOICE still believes that there may not be enough avenues for consumers to report merchants engaging in excessive surcharging and would encourage a robust and accessible reporting system for consumers, either to the RBA or to the ACCC directly.

CHOICE will be pursuing the issue of consumer reporting of excessive surcharging and how such a system may assist the ACCC in enforcing new regulations around excessive surcharging, as well as how a system may engage consumers in reporting unfair behaviour.

Recommendations

- The RBA makes modifications to the cost of acceptance framework (option three – surcharging).
- The RBA and ACCC consult consumer advocates on how consumer reporting of excessive surcharging can best assist enforcement efforts.

¹⁸ See: http://www.apb.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bld=r5579