

Review of the Regulatory Framework for the eftpos System: Consultation on Designation

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1. Introduction

The Payments System Board announced in September 2011 that it would undertake a review of the regulatory framework for the eftpos system to ensure the regulations continue to meet their objectives. This consultation paper marks the first public element of that review. It seeks views on an appropriate definition for the eftpos system, should a new designation be required to support future regulation of the system. The Board's view is that the current designation is no longer appropriate given the changes to the eftpos system that have occurred since it was first designated in 2004.

This consultation is a necessary precursor to a second consultation on the broader regulatory framework for the eftpos system that will be conducted later in the year. While the broader issues to be considered in the second consultation are not the focus of the current consultation, they may have some bearing on views about the approach to designation. The paper, therefore, also provides a brief indication of these broader issues.

Section 2 of the paper outlines the current regulatory framework for the eftpos system and explains the changes to the system that have taken place in recent years. Section 3 explains the reasons why a new designation is needed, how it would be implemented and possible options for defining the eftpos system in a new designation. As background, Section 4 provides information on the broader review of the regulatory framework for the eftpos system that will take place later in the year. Section 5 provides details of the next steps in the process.

2. Background

Current Regulation of the eftpos System

The Payments System Board originally designated the eftpos system in 2004 as the first step towards implementing reforms to interchange fees and access arrangements in that system. The Board's decision that designation would be in the public interest reflected its concerns that differences in interchange fees between the scheme debit and eftpos systems at that time would likely result in outcomes that would be harmful to the efficiency of the overall payments system. It therefore decided that interchange fees in the two systems should be considered at the same time, which required designation of both the eftpos and Visa Debit systems.¹ The Board also came to the view that improvements in access arrangements could be beneficial to competition in the eftpos system and therefore would be in the public interest. Designation would provide the Board with the ability to impose an access regime if industry initiatives being undertaken were to falter.

Following designation, the Reserve Bank introduced regulations in 2006 addressing the pricing and access concerns that had been identified by the Board. The Reserve Bank introduced a standard, *The Setting of Interchange Fees in the EFTPOS System* (interchange fees Standard), requiring a reduction in interchange fees on eftpos purchase transactions from around 20 cents to within a range of between 4 and 5 cents, paid to the acquirer.² The interchange fees Standard was updated in 2009 to distinguish between interchange fees agreed bilaterally and those set on a common multilateral basis by the new eftpos scheme, eftpos Payments Australia Limited (ePAL – see discussion on changes to governance arrangements below). Under the revised interchange fees Standard, the weighted average of multilateral interchange fees set by ePAL is capped at 12 cents flowing to the issuer, in line with the Visa Debit interchange fee Standard.

Concurrently, the industry developed an access code setting out a procedure for new entrants seeking access to the eftpos system to negotiate and implement bilateral connections with existing participants. This industry Access Code is complemented by an access regime, *Access Regime for the EFTPOS System* (eftpos Access Regime), imposed by the Reserve Bank. The eftpos Access Regime places a cap on the amount existing participants can charge new entrants to establish a new connection. It also contains 'no-discrimination' provisions designed to prevent incumbents from using negotiations over interchange fees to frustrate entry. The 'no-discrimination' provisions require existing eftpos participants to offer new entrants interchange fee terms that are no less favourable than those agreed with other existing participants.

1 At the time, Visa Debit was the only scheme debit system in operation in Australia. MasterCard's debit product was launched in Australia in November 2005.

2 The cap and floor of between 4 and 5 cents does not apply to purchase transactions with a cash-out component.

Recent Industry Developments

At the time that the initial designation and the regulation of the eftpos system were imposed, governance of the system was largely based on bilateral agreements between financial institutions, with certain rules set collectively via the Australian Payments Clearing Association (APCA). Specifically, interchange fees and connection arrangements were agreed bilaterally between individual participants in the system. There was no central body responsible for promoting the use of eftpos; making strategic decisions about the system, such as the development of new functionality; or adjusting pricing to better compete with other card payment systems. The bilateral governance structure made it difficult for the eftpos system to adapt to changing technology and the demands of end-users, and to compete effectively with the scheme debit systems.

The Payments System Board noted these concerns about the bilateral arrangements in the eftpos system in its conclusions to its 2007/08 review of the payments system reforms.³ Reflecting these concerns, the Board pushed for the establishment of an eftpos scheme that could promote and make decisions in the interests of the eftpos system as a whole. The Board was of the view that an eftpos scheme would be best placed to strike a balance between the interests of merchants, issuers and cardholders, and would contribute to a more competitive environment for debit cards. The industry's response was the establishment of ePAL in April 2009.

ePAL is owned and funded by 14 member institutions, including two large merchants. Since its establishment, it has been active in promoting the use of eftpos and in positioning the system in a way that makes it attractive to the various participants in the eftpos system. ePAL has established scheme rules, which cover aspects of access and interchange fees, as well as technical operational and security rules for its members. A particularly notable strategic decision made by ePAL has been the introduction of a common multilateral interchange fee schedule for the eftpos system. This schedule, which came into effect in October 2011, reverses the flow of interchange fees in many cases; for most eftpos transactions, a multilateral interchange fee of 5 cents is paid to the issuer, whereas under bilateral arrangements, an interchange fee of between 4 and 5 cents is paid to the acquirer. The system is in the process of transitioning to ePAL's multilateral interchange fee schedule; for some participants, existing bilateral arrangements may remain in place until they expire or are terminated, or both parties agree to opt-in to the multilateral fee arrangements.

Alongside developments in the governance of the eftpos system, the underlying architecture of the eftpos system has undergone significant change. Since 2009, with encouragement from the Reserve Bank, the industry has worked on migrating to a Community of Interest Network (COIN) for message exchanges in the bilateral payment systems, including the eftpos system. The COIN simplifies links between participants by allowing each participant to connect to all other participants in the system using a single physical connection. Accordingly, the COIN potentially has implications for the cost and timeframe for new entrants to establish connections.

In light of these significant changes to the governance of the eftpos system, as well as changes to the underlying architecture of the system, the Payments System Board announced in September 2011 that it would undertake a review of the regulatory framework for the eftpos system. The aim of the review is to ensure that regulations for the eftpos system continue to meet their objectives. The first step in this review is consideration of the designation of the eftpos system, as discussed in the following section.

³ Reserve Bank of Australia (2008), *Reform of Australia's Payments System: Conclusions of the 2007/08 Review*, September.

3. Reviewing the Designation of the eftpos System

The Need to Review eftpos Designation

The Bank considers that a review of the designation of the eftpos system is required before a consultation on the entirety of the regulatory framework for the eftpos system can be undertaken.

Under the *Payment Systems (Regulation) Act 1998*, the Reserve Bank must designate a payment system, if it considers it to be in the public interest, before it can impose standards or an access regime. The current designation defines the eftpos system in the following way:

The EFTPOS system is the electronic funds transfer at point of sale payment system described in clause 1 of the CECS manual for the Consumer Electronic Clearing System and governed by the rules of that system set out in that manual, supplemented or modified by contracts, arrangements or understandings between individual issuers, acquirers and merchant principals (as that latter term is defined in the CECS manual) in the system. This system allows cardholders to use a debit card to pay for goods or services or withdraw cash at the point of sale.⁴

Since its establishment, ePAL has taken over most of the responsibilities for coordinating technical and other requirements for the eftpos system that had previously been managed by APCA, and has set up scheme and other rules for this purpose. As a result, a number of references to the eftpos system have been removed from APCA's CECS manual and replaced with reference to ePAL's rules. Some of these references, however, formed an important part of the definition of the eftpos system used in the eftpos designation. Hence, the eftpos designation no longer clearly or accurately defines the eftpos system.

More broadly, there is a case for updating the definition of the eftpos system to take into account industry developments, including the establishment of ePAL. The current designation relies on a definition intended to describe a system without a central governing scheme; that is, one that is primarily regulated by bilateral contracts between participants, with clearing and settlement arrangements set out in the CECS manual maintained by APCA. It may now be appropriate to update that definition to acknowledge the role of ePAL in the eftpos system.

While there is a stand-alone case for reconsidering the form of the designation of the eftpos system, in this case it is being considered as the first step in a broader review of the regulatory framework for the eftpos system. To the extent that the review may result in changes to the current interchange fees Standard or eftpos Access Regime, a formal consultation and gazettal of draft variations will be required. In order for such consultation to occur, there must be clarity about what is included in the system to which a varied interchange fees Standard or varied Access Regime applies. Therefore, the Bank is consulting now on the form of the designation so that

⁴ Designation No 2 of 2004.

it is in a position to put a new designation in place, if it determines it is in the public interest to do so, before it enters a wider consultation on the regulatory framework itself.

Process for Establishing a New Designation

While the Bank has explicit powers in the Payment Systems (Regulation) Act to vary access regimes and standards, subject to certain requirements, the Act does not provide the Bank with the power to vary a designation. Therefore, it is not possible for the Bank to simply vary the existing designation to take account of industry developments. The Bank does, however, have the power to designate a payment system or to revoke a designation of a payment system, provided that the designation or revocation is in the public interest. Therefore, variation of the designation of the eftpos system can be achieved only by revoking the existing designation and imposing a new designation in its place.

In determining whether the revocation of the existing designation and imposition of a new designation for the eftpos system is in the public interest, the Bank is to have regard to the desirability of payment systems:

- (a) being (in its opinion):
 - (i) financially safe for use by participants; and
 - (ii) efficient; and
 - (iii) competitive; and
- (b) not (in its opinion) materially causing or contributing to increased risk to the financial system.⁵

The Bank may also have regard to other matters relevant to assessing the public interest of imposing or revoking a designation.

While designation does not of itself create rights or obligations for a payment system or its participants, it is the first step in bringing a payments system under the Bank's regulatory control. The Bank may then impose standards or an access regime on a designated system where it determines that it is in the public interest to do so. As discussed above, a new designation would need to be in place prior to consultation on possible changes to the eftpos Access Regime and interchange fees Standard, to allow informed consultation on the effect of any proposed changes.⁶

Options

Given the changes that have occurred in the eftpos system, the Board is considering two options regarding the definition of the eftpos system to be adopted in a new designation should it be required to support future regulation of the system. Some of the issues that will be considered as part of a later consultation regarding future regulation are set out in Section 4; interested parties may find these issues relevant in considering the two options for defining the eftpos system set out below.

Option 1: A definition based on ePAL membership and rules

Under this option, the designation would rely on a definition of the eftpos system based on ePAL's rules and cover participants that are members of ePAL. Such a definition would clearly define the eftpos system and

⁵ Section 8 of the Payment Systems (Regulation) Act.

⁶ The Bank intends to also keep the current designation in place until the broader regulatory framework is resolved.

recognise the central role that ePAL has taken in the eftpos system. It would be similar to the form of the designations for the MasterCard and Visa credit card systems, and the Visa Debit system.

However, a definition along these lines may be restrictive. Some participants may not seek ePAL membership but may still wish to conduct eftpos transactions (given the history of being able to do so under bilateral agreements). The form of the designation may be critical to the position of these entities in the system.

Option 2: A broader definition

A second option is to adopt a broader definition of the eftpos system in order to capture those parts of the system that lie outside the scope of ePAL's membership and scheme rules. This might involve making reference to ePAL's scheme rules while also including other arrangements involving non-members or arrangements not covered by the scheme rules.

A definition along these lines would be more inclusive, although any definition under this option would still need to clearly define the scope of the eftpos system. More generally, taking this approach would be acknowledging, from a regulatory perspective, that the eftpos system can extend beyond the bounds of ePAL. This is not the case in the Bank's regulation of the MasterCard and Visa systems. The Board is therefore interested in any views on this possibility.

Further Considerations

The Payments System Board is seeking views on the appropriate approach to defining the eftpos system as set out in the two options above. These options are relevant should the Bank consider that ongoing designation is in the public interest. As noted above, a new designation would need to be in place before consultation on any specific changes to the interchange fees Standard and eftpos Access Regime could be undertaken. However, as discussed in the next section, one possible outcome of the review of the broader regulatory framework is that regulation of the eftpos system may no longer be required. Were this approach preferred, consideration would be given to revoking the current designation of the eftpos system at the appropriate time, without replacement.

4. Review of the Regulatory Framework: Access and Interchange Fees

Collectively, the developments outlined in Section 2 mean that the regulatory framework for the eftpos system, including the designation, the eftpos Access Regime and the interchange fees Standard, along with the industry Access Code, may no longer be meeting their original objectives. While the current review is focused on the appropriate form of designation for the system – should ongoing designation be considered to be in the public interest – knowledge of the possible approaches for future regulation may help interested parties in forming their views about designation. Accordingly, this section outlines the likely scope of the broader review as background. The Bank is not seeking views on the broader regulatory framework during the current consultation; as discussed, this will be the subject of a consultation later in the year.

The issues that the broader review of eftpos regulation are likely to consider include:

- The implications of the establishment of ePAL for the current system of access, including the Bank's eftpos Access Regime and the industry-administered Access Code. This may include consideration of the role ePAL should play in governing access to the eftpos system for new entrants. It may also consider whether the access framework should continue to support entry outside the ePAL framework; that is, where entrants do not wish to become members of ePAL.
- Whether there is a continued need for the 'no-discrimination' provisions in the Bank's eftpos Access Regime. These provisions are aimed at preventing participants from using negotiations over interchange fees to frustrate access to the system. Given that ePAL has now established a common multilateral interchange fee schedule, new entrants are able to gain access to the system on the same terms as existing members, without the need for negotiation over these fees.
- Whether provisions in the Bank's interchange fees Standard that govern bilateral interchange fee agreements remain appropriate given the introduction of a multilateral interchange fee schedule. In particular, should bilaterally negotiated fees continue to be regulated in the current manner; be regulated according to a different benchmark to the current cap and floor, including potentially being placed on a similar footing to multilateral fees (a 12 cent cap, paid to the issuer); or be removed from the regulatory framework?
- Whether there is continued need for regulation of multilateral interchange fees.⁷
- The implications of the move to the COIN for the exchange of eftpos messages in terms of connection costs and timeframes for access.

⁷ The Bank indicated in its September 2011 media release that multilateral interchange fee provisions would not be part of the review: see Reserve Bank of Australia (2011), 'Payments System Issues', Media Release No 2011-18, 2 September. These provisions will only be considered to the extent that ongoing regulation may no longer be necessary; there will be no reconsideration of the level of the multilateral interchange fee benchmark as part of the broader review.

While there are many possible outcomes from deliberation of the above issues, one option would be the removal of all regulation of the eftpos system. This option might result in the removal of the eftpos designation. All other options would involve consultation on changes to the current interchange fees Standard or eftpos Access Regime, for which gazettal of draft variations will be required; a new designation needs to be in place before this consultation can occur. A detailed discussion of the effect of recent industry developments on the current eftpos regulatory regime and the options for future regulation will be set out in a consultation document to be released by the Bank later in the year.

5. Next Steps

The Board invites comments on the two options proposed in Section 3 for defining the eftpos system in a designation. The current designation is unclear because of amendments to the CECS manual and needs to be reconsidered in light of developments in the industry, including the establishment of ePAL. At this time, the Board is not seeking comments on the broader regulatory framework that the designation might underpin. A separate consultation document reviewing the broader regulatory framework will be made available later this year, after the form of the designation has been resolved. The Board will seek views on these aspects of the regulatory framework at that time.

Formal written submissions regarding the review of designation for the eftpos system should be provided by no later than 20 April 2012 and should be sent to:

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001
or
pysubmissions@rba.gov.au.

Submissions provided by email should be in a separate document, in PDF, Word or equivalent format.

In the normal course of events, submissions will be posted on the Reserve Bank's website and those making submissions will be provided with an opportunity to discuss their submission with the Bank. ✎