Competition and Co-operation in Retail Payments

Introduction

In its 2007/08 review of the card payments reforms, the Board indicated that it would be prepared to step back from interchange fee regulation if it was satisfied that the competitive environment was such that interchange fees would not rise in the absence of regulation. The Board reaffirmed this in August 2009, but concluded that, while progress had been made, at that time it was not sufficient to provide it with the necessary confidence to remove regulation.

In this environment, the industry has continued to focus its efforts on improving competition in the payments system. This chapter discusses some of the developments in competition between retail payment systems over the past year and outlines some of the key retail payments initiatives that are underway. Some initiatives, such as developments in the EFTPOS system and the MAMBO (Me at My Bank Online) project, have direct significance for competition between retail payment systems and, potentially, have a bearing on the future of interchange regulation. Others, such as the move to new network arrangements and the formation of a broad industry payments forum, are examples of industry co-operating on strategic issues while improving competition within payment systems.

The only regulatory change made by the Board during 2009/10 was aimed at supporting these industry efforts. Regulations on multilateral EFTPOS interchange fees were relaxed to place them on a consistent footing with the restrictions already applying to scheme debit systems.

The Competitive Landscape for Retail Payment Systems

Competition between debit card systems

The Board's preparedness to move away from regulation of card interchange fees following the 2007/08 Review was predicated on there being a sufficiently strong competitive environment to prevent interchange fees rising over time from their regulated levels. This requires not just strong competitors to the international card schemes, but for competition to work in a way that restrains interchange fees, rather than driving them up as has been the tendency overseas.

The main domestic competitor to the international card schemes is the EFTPOS system, which is well-established and relatively inexpensive to operate. However, two main factors have affected the way in which the EFTPOS system competes with the scheme products. First, although EFTPOS performs essentially the same function as a scheme debit system at the point of sale, its interchange fees flow from the issuer to the acquirer, the opposite to the scheme products. This provides quite different incentives for system participants and end users. Second, as a system based on bilateral agreements, EFTPOS historically has not had the strong centralised governance necessary to make strategic decisions in the interests of the system.

The difference in interchange fee flows has tended to result in card issuers favouring scheme debit cards and promoting them to customers, while merchants have tended to favour EFTPOS. This has been an important factor behind two significant recent developments. First, in the first half of 2009, Westpac mailed out a large number of scheme debit cards to replace its customers' EFTPOS cards. While most scheme debit cards presented at the point of sale can be processed either through the scheme networks or the EFTPOS system (depending on whether the customer presses 'credit' or 'cheque'/'savings') the Westpac cards carried a sticker encouraging the customer to press 'credit'. For the majority of cardholders this had little practical effect because the funds are drawn from the same account and, in most cases, the cardholder does not pay a fee for either transaction type (Westpac customers holding, for example, the standard *Choice* account do not pay per transaction EFTPOS fees). However, because of the different interchange flows, the cost to the merchant of the transaction is likely to be significantly higher if processed through the scheme networks and, correspondingly, the revenue to the issuer is higher even though the underlying transaction is identical.

A related development was the announcement by Woolworths in April 2010 that it would process all transactions on scheme debit cards in its stores through the EFTPOS system rather than the MasterCard and Visa systems – effectively turning off the 'credit' button for transactions on scheme debit cards.[6] This is intended to counter the growing cost to Woolworths of scheme debit transactions and once again has little practical effect on most cardholders beyond the need to enter a PIN.

In declining to accept debit payments through the scheme networks, Woolworths is making use of a freedom provided by the Board in 2007. At that time, the Board required that the card schemes remove their so-called 'honour all cards' rules as they applied to debit and credit transactions. These rules required merchants that accepted scheme credit cards to also accept scheme debit cards (and *vice versa*), regardless of whether merchants considered the cost of accepting the cards to outweigh the benefits. The Board considers merchants' ability to decline acceptance of individual payment types to be beneficial for both competition and the efficiency of the payments system. Woolworths is the first major merchant to have made use of this ability.

A widespread move by other issuers to follow Westpac's strategy without any additional merchant resistance could significantly alter the competitive environment for debit cards. The Board is watching developments closely and will factor these actions into its assessment of the competitive landscape.

Regardless of the ultimate effect, these developments serve to demonstrate how important interchange fees are to the dynamics of the debit card market in Australia. While MasterCard and Visa have been able to use interchange fees to promote use of their products, EFTPOS historically has had little capacity to do the same because interchange fees have been negotiated bilaterally, with little scope for renegotiation. EFTPOS has also lacked centralised governance to set a strategic direction. EFTPOS interchange fees were lowered to between 4 and 5 cents (paid to the acquirer) in 2006, only as a result of a standard imposed by the Board.

The Board's desire to see more effective governance arrangements for the EFTPOS system led it to push for the establishment of an EFTPOS scheme that could promote and make decisions in the interests of the EFTPOS system. The Board was of the view that this would enable EFTPOS to strike the best balance between appealing to merchants, issuers and cardholders, and would provide a more competitive environment for debit cards. The industry has embraced this suggestion. Following initial work by APCA, EFTPOS Payments Australia Limited (EPAL) was established in April 2009. It is owned and funded by its fourteen member institutions,

6 This does not mean that customers cannot use credit cards at Woolworths, only that scheme debit cards cannot be processed through the scheme network.

including two large merchants. EPAL's board comprises eight directors appointed by the company's members and three independent directors, one of which is Chairman. The Chief Executive was appointed in March 2010.

While it has taken time, EPAL should now be able to promote the EFTPOS brand and position the system in a way that makes it attractive to the various players. In June 2010, EPAL made its first strategic announcement – that it will progressively convert EFTPOS cards to EMV chip between 2011 and 2014 to provide greater security and the potential for enhanced functionality.

At present, the EFTPOS system continues to operate with bilaterally negotiated interchange fees that have been constrained between 4 and 5 cents, paid to the acquirer. The Board has acknowledged that EPAL may wish to realign interchange fees in the interests of promoting the system. While the Board has a long-held view that there is little justification for interchange fees in a mature debit card system, it nonetheless sees the importance of placing EFTPOS on an equivalent regulatory footing to the scheme debit systems now that it has a greater decision-making capacity. The Bank issued draft amendments to the EFTPOS interchange fee standard for consultation in September 2009. These proposed a cap on EFTPOS interchange fees of 12 cents, meaning that interchange fees could be up to 12 cents paid to the issuer or any amount paid to the acquirer. After consultation, the Board decided to adopt this approach for the weighted-average of multilateral (that is, centrally set) interchange fees in the EFTPOS system, but to retain the current 4 to 5 cent range (paid to the acquirer) for bilateral interchange fees. The industry had argued that the capacity to renegotiate bilateral interchange fees might be disruptive and ultimately counterproductive. The revised Standard came into effect from January 2010. EPAL has yet to announce any intentions in respect of multilateral interchange fees.

The establishment of EPAL has meant that some broader changes in governance structures for consumer payments are required. Decision-making in relation to clearing and issues such as device standards have to date been made through APCA's Consumer Electronic Clearing System (CECS) and its management committee. CECS rules and procedures cover both the EFTPOS system and the ATM system. With decision-making in relation to the EFTPOS system now in the hands of EPAL, some recasting of the role of APCA needs to occur. APCA and EPAL are discussing these issues and APCA will be working on amending the CECS rules and procedures accordingly over the coming year.

Competition for online debit payments

The Board's conclusions to the 2007/08 Review also indicated that it saw greater competition in the online payments sphere as an important element of the competitive environment. While scheme debit (and credit) cards are readily used for online payments, the use of EFTPOS has been restricted to environments where the card can be physically swiped and a PIN entered in order to maintain transaction security. Therefore, if customers wish to make an online payment from a deposit account, they are currently restricted to using a scheme debit card, internet 'pay anyone' transactions – which are somewhat cumbersome – or a specialist online payment system like Paymate, PayPal or POLi.

The major banks indicated in a letter to the Bank in July 2009 that they intended to support a new system, operated by BPAY, which, among other things, would provide a bank-supported system to make online payments from a deposit account. Known as MAMBO, the system will provide a platform that could allow real-time confirmation of payments as required for online commerce. Work on building this capacity within BPAY has been underway for some time with development work within the banks now beginning. The major banks wrote to the Reserve Bank again in May 2010 confirming their commitment to the deployment of MAMBO by December 2011.

Network Architecture

While developments with EFTPOS and MAMBO may ultimately be important in shaping competition between retail payment systems, active competition between participants within payment systems – in most cases financial institutions – is also important for an efficient payments system. In addition to making governance difficult, the bilateral structure of some of the main retail systems in Australia has tended to dampen competition between participants. This occurs because a new direct participant must establish business arrangements and physical connections with each existing participant to be able to participate fully. The more existing participants there are, the greater the cost to a new entrant and the less likely they are to join the system.

While there have been some efforts to simplify the negotiation of business arrangements, for example via the EFTPOS and ATM Access Codes, the hurdle of physical connection also presents difficulties. Access Regimes imposed by the Bank have capped the cost that existing participants in the EFTPOS and ATM systems can charge new entrants (at $87 776 for the EFTPOS system and $76 700 for the ATM system), but the cost is still large when multiplied across the numerous connections required. The significant barriers to entry imposed by these arrangements were noted by the Board in its December 2008 Consultation Document on the ATM Access Regime. The Board expressed a strong desire for the architecture to be changed to overcome these problems.

The cost of moving to a different network architecture combined with the different investment cycles of participants has in the past made consideration of a wholesale change to a more efficient architecture difficult. However, the technology underpinning many bilateral links is dated and will shortly no longer be supported by its providers. Many participants using the older technology are, therefore, being faced with the need to renew their connections at around the same time. This has presented a once-in-a-generation opportunity for the industry to move to more access-friendly system architecture. During 2009, the Bank embarked on a process of garnering consensus on a move to such arrangements. The industry, through APCA, is managing this process, setting out detailed plans to migrate the industry to a Community of Interest Network (COIN) for message exchanges in the cheque, direct entry and ATM and EFTPOS systems.

The new network architecture and arrangements allow a participant to communicate with every other participant by establishing a single connection to the COIN, which takes the form of a network 'cloud'. The Reserve Bank is also offering a facility to switch messages between the SWIFT system and the COIN where required. The network began carrying live payments traffic in February and the target is for messaging in the direct entry and cheque systems to migrate entirely to the COIN by June 2011 and for ATMs and EFTPOS to migrate by December 2011. By August 2010, 11 pairs of institutions had migrated messaging for direct entry and cheques to the system and a number of migrations had already been completed for ATMs and EFTPOS.

For consumer electronic payments an additional layer of complexity exists in current arrangements because, even when participants have the ability to exchange messages with one another, participants can have slightly different requirements for the form of those messages, once again complicating access for a new participant. This was highlighted by the Board in its Consultation Document for the ATM Access Regime. In response, the industry has established standard messaging and security specifications for the benefit of new participants.

The Board believes that these developments, once fully in place, will represent a significant step forward in making direct participation in some of the key retail payment systems more accessible.

Industry Co-operation

Another way in which the industry has responded to the Board's call for industry-led improvements to the competitive environment has been the formation by APCA of the Australian Payments Forum (formerly the Card Payments Forum). While APCA has for many years provided a forum for co-ordination between the participants in payments clearing and settlement, its membership is relatively narrow – reflecting its clearing and settlement mandate – and its focus has tended to lean towards operational issues. The Australian Payments Forum has a broader membership, including the international card schemes and other stakeholders, and focuses on ways to promote innovation and system evolution over the long term, while ensuring healthy competition. One of its objectives is to generate co-operative industry solutions where a need is identified by Forum participants. The Forum has identified: network connectivity; message and interchange standards; system integrity and fraud prevention; system innovation; and public policy engagement as areas where industry collaboration could enhance the payments system and provide a better platform for competition. Most recently the Forum has called for the establishment of a financial fraud risk centre of excellence, which could collect and disseminate data and research related to fraud prevention.

Separately, the Board announced in May that it would undertake a strategic review of innovation in the payments system. The project will identify areas in which innovation in the Australian payments system may be improved through more effective co-operation among stakeholders and regulators. It will take a medium-term perspective, looking at trends and developments in overseas payment systems and potential gaps in the Australian payments system that might be addressed through innovation. As part of this process, the Bank will be conducting a second survey on the use of payment instruments by consumers and will be drawing on its relationships with other central banks to assess innovative developments in other countries.

There will be a number of opportunities for consultation with all stakeholders, including participants in the payments system, consumers, businesses and government. The Board anticipates releasing a consultation document during the current financial year and finalising its conclusions by the end of 2011.