Coherent Economics

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Re: Comments in Response to the Preliminary Conclusions of the 2007/08 Review

Dear Michele:

On 21 April 2008, the RBA released the Payments System Board's Preliminary Conclusions of the 2007/08 Review and an accompanying press release inviting public comments. I have been asked by the Australian Merchant Payments Forum to respond to the RBA's invitation.[1]

Both in the Preliminary Conclusions and its earlier reports, the Board has identified some of the principal structural characteristics which impede the efficiency and competitiveness of payment card systems in Australia. Some of the Board's policy conclusions and proposals, however, are inconsistent with its own findings.

The Board has explained at length why it determined that competition in the payment card systems markets was dysfunctional and inefficient. Alternative payment methods, systems, and service providers (e.g., banks) do not compete independently on the merits based on price and quality; rather, payment choices have been distorted by a combination of:

(i) Centrally imposed and set interchange fees which, overall, significantly increase merchant costs and alter the relative profitability of alternative consumer payment choices to card issuing banks;

(ii) Restrictions on merchants' ability to determine, in competition with other merchants, their terms of trade, including freedom to select which payment cards they will accept (restricted by the "honour-all-cards rules," or "HACRs") and at what price (restricted by "no-surcharge" and "no-discrimination" rules); and

(iii) Structural issues, including restrictions on entry into acquiring (and the bilateral organization of the EFTPOS system, which the Board also views as problematic).

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1. These comments are mine and may not necessarily reflect all views of all members of the AMPF or any other party.

The schemes' restrictions and collective pricing agreements had the effect of increasing payment system costs and prices, and steering consumers towards use of more costly payment methods. The Board has also been concerned that the pursuit of interchange fee revenue would lead banks to neglect investment in and support of the relatively more efficient EFTPOS network, in favour of scheme debit systems.

As a result of these observations and concerns, the RBA undertook to use its regulatory powers to reduce interchange fees, eliminate restrictions on merchant pricing, partially relax the schemes' HACRs (so that merchants could, for example, choose to accept a scheme's credit cards but not its debit cards), and liberalize access to the schemes by specialist acquirers. This has been a lengthy and contentious process, and the RBA now seeks, in part, to reduce the need for continuing regulatory proceedings over the setting of interchange fees.

Prior to the RBA's intervention in the payment card marketplace, the card schemes themselves intensively and comprehensively regulated competition and pricing among their members, for the benefit of those member banks. Neither the Board nor the schemes now propose a deregulated marketplace; the question is rather the form of market regulation and the extent to which the Board regulates the payment card marketplace rather than the schemes – or the schemes in the shadow of Board supervision and potential direct intervention.

I will now address some of the Board's findings and proposals.

The Perpetuation of Interchange Fees

As the Board is aware, the card schemes warned that the MIF was set to establish a delicate balance, and that *any* reduction in the level of the MIF could cause the collapse of the schemes' card networks. According to this argument, lower MIFs would generate higher cardholder fees, and, because it is claimed cardholder demand to carry and use cards is very elastic, this would cause a significant decrease in consumer card usage. The schemes argued that, despite lower merchant fees, *fewer* merchants would accept the cards. The reduction in merchant acceptance would further erode consumer willingness to carry and use the scheme's cards, in what Visa called a "vicious circle" and MasterCard a "death spiral." Notwithstanding these warnings, the RBA reduced the average MIF very substantially – by about half since 2003.

There was no death spiral. Card holding and use continues to grow, with relatively less steering than before of cardholders towards credit card payments. Contrary to the death spiral warnings, reduced merchant fees did not cause merchants to *abandon* card acceptance. According to MasterCard consultants Robert Stillman, William Bishop, Kyla Malcolm, and Nicole Hildebrandt, who analysed internal MasterCard data, "The RBA's intervention does not appear to have had any significant effect on merchant acceptance of four-party payment cards."[2] In fact, they report a substantial *increase* in the number of MasterCard merchant acceptance locations – by about 40%, from roughly 500,000 before the merchant pricing and MIF reforms took effect, to 700,000 in early 2007.[3] Stillman et al. contend that this increase in merchant acceptance has nothing to do with the sharply

2. Robert Stillman, William Bishop, Kyla Malcolm, Nicole Hildebrandt, Regulatory Intervention in the Payment Card Industry by the Reserve Bank of Australia: Analysis of the Evidence, CRA International, 28 April 2008, p. 25.
3. Id., p. 26.

reduced card acceptance costs, but rather explain it as the continuation of normal growth trends, or as resulting from the fact that "customers regularly asked to use these cards." Although I do not find their argument that increased card acceptance was entirely unrelated to lower card acceptance costs persuasive, it hardly matters; the fact that more merchants are accepting cards (particularly if, as they argue, because customers asked the merchants to accept them) directly refutes the death spiral theory. The card schemes were not delicately balanced in a way which loss of interchange revenue would cause them to collapse, and the reduction of interchange fees was accompanied by a very substantial increase, not decrease in the number of places that cardholders could use there cards and in total card usage.

The easiest way for the Board to eliminate the need to revisit repeatedly the level of MIFs, and an important element of *deregulating* the card payment systems marketplace, is to eliminate the MIFs altogether, so that all banks will compete for cardholder and merchant customers based on their pricing to those customers, undistorted by what amounts to a regulated system of subsidies and taxes. In fact, the Board has noted the lack of evidence and support for the continued use of interchange fees:

- In the 2007 *Issues* paper, the Board cited the European Commission's finding that, in the Board's words, "many domestic payment systems operated without interchange fees."[4] In its Preliminary Conclusions, the Board similarly finds, "International experience suggests that debit card systems do not need interchange fees to operate effectively. Moreover, most other payment systems in Australia that draw on transaction accounts do not have interchange fees. This suggests a common fee of zero would be feasible and consistent with existing practice in other payment systems."[5]

- "[T]he Bank has stated a number of times that it did not see a strong case for *any* interchange fees in the EFTPOS system."[6] "The Joint Study… concluded that the case for an interchange fee in debit card systems on the grounds of balancing issuers' and acquirers' costs (as advocated by the card schemes) was not strong.[7] The Board notes that even *issuing banks* in Australia proposed to eliminate the MIF (or "set the fee to zero") on EFTPOS transactions.[8]

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4. Issues for the 2007/08 Review, p. 16. Subsequently, in a competition law case, the Commission responded in detail to MasterCard's contention that five examples of debit card networks lacking a MIF identified by the Commission in that case were incorrect or inappropriate comparisons. See, Provisional Non-Confidential Version, Commission Decision of 19001/2007 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (COMP/34.579 MasterCard, COMP/36.518 EuroCommerce and COMP/38.580 Commercial Cards), pp. 154-169.
5. Preliminary Conclusions, p. 31.
6. Issues for the 2007/08 Review, p. 8 (emphasis in original).
7. Preliminary Conclusions, p. 2.
8. Issues for the 2007/08 Review, p. 8; Preliminary Conclusions, p. 3. Merchants opposed letting the banks eliminate the MIF for EFTPOS transactions rather than preserving the status quo in which the MIF flows towards the acquirer and its merchant. The Board now goes beyond even what the banks proposed by creating a subsidy to banks for EFTPOS transactions that even the banks themselves were willing to forego when they proposed their collective action to eliminate the MIF on those transactions.

- Moreover, "it remains unconvinced of the need for significantly higher interchange fees for credit card systems than for debit card systems."[9] The Board "remains unconvinced that interchange fees are needed in mature systems."[10] (The RBA and ACCC concluded as early as 2000 that "the credit card networks in Australia are now mature systems."[11])

These findings are logically consistent with a policy of eliminating, not perpetuating interchange fees. The speculative and unmeasured potential theoretical benefits interchange fees might provide if set at a precisely determined level, in practice, are neither worth the difficult and intense regulatory effort required to identify that level, nor is there any reason or evidence to believe that the schemes have any economic incentive to use, or, in practice use interchange fees primarily to attain payment efficiencies rather than as a way for banks to tax retail sales throughout the economy.

The very fact that EFTPOS has been widely adopted in Australia refutes any claim that issuing banks somehow need to earn MIF revenue to induce them to issue cards and consumers to use them. The main argument which has been offered by the schemes in support of the need for issuing banks to receive interchange fees is a claim that cardholder demand is elastic, with cardholders unwilling to pay fees, while merchant demand for card acceptance services is inelastic. If cardholders face the competitively determined costs of serving them, according to this argument, many would forego use of cards. This, it is claimed, would harm merchants, who are said to benefit significantly from card use (and therefore, according to this argument, merchants should logically *support* the payment of interchange fees).[12]

Aside from conceptual and policy problems with this argument which I addressed in my earlier submission and conference paper, it is worth noting that, in Australia, consumers widely adopted and continue to use EFTPOS cards despite not only the lack of an interchange fee payable *to the issuer*, but also the existence of an interchange fee payable *to the acquirer*. Banks throughout Australia offer their deposit account customers EFTPOS cards, and their customers accept and use those cards. There simply is no logical reason to believe issuers need to receive interchange fees on debit transactions when they have long issued those cards despite paying interchange fees. The fact that the schemes now offer the banks MIF revenue does not mean that MIFs are necessary to maintain banks' willingness to preserve the EFTPOS system, but rather that MIFs are unnecessary and harmful when banks collect them in scheme debit transactions. The obvious solution is to eliminate interchange fees on both types of debit card transactions so that investment

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9. Preliminary Conclusions, p. 31. The Board also states: "While the Board recognises that there may be a case for interchange fees in some payment systems, it has not been presented with any convincing evidence to suggest that the various externalities that might justify these fees are sufficiently different in the debit and credit card systems to justify substantially different fees in these systems." Preliminary Conclusions, p. 16.
10. Preliminary Conclusions, p. 25.
11. Reserve Bank of Australia and Australian Competition and Consumer Commission, Debit And Credit Card Schemes In Australia: A Study Of Interchange Fees And Access (October 2000), p. 54.
12. The fact that merchants both individually and collectively do not want to preserve interchange fees is easy to understand as a refutation of the schemes' claims, rather than evidence that merchants are all irrational.

decisions and encouragement to cardholders to use particular systems derives from costs and efficiency concerns, not in spite of them.[13]

As for the Board's concern that without an interchange fee, the EFTPOS system will "atrophy,"[14] I note that aside from this problem being cured if scheme debit interchange fees were also abolished, merchants have a clear economic incentive to preserve a well-functioning and efficient EFTPOS system, the continued existence and use of which generates savings for the merchants. If paying an interchange fee to the banks would be a critical factor in preserving EFTPOS (and if its costs remain lower), then merchants would tend to want to pay those interchange fees. It would not make sense for merchants to oppose payment of EFTPOS interchange fees, given whatever (higher) scheme debit interchange fees are permitted, unless the merchants were convinced that the EFTPOS system could nevertheless remain viable and popular, and hold down overall payment costs. It therefore makes sense to defer to merchants' judgment whether to pay EFTPOS interchange fees if the rationale is to preserve the viability and efficiency of the EFTPOS system.

The same logic which suggests eliminating interchange fees on debit cards applies as well to credit card transactions. The Board believes that credit card MIFs are too high, and that there is no rationale why credit card MIFs should significantly exceed debit card MIFs – which, in turn, the Board sees no rationale to exceed zero.

Notwithstanding its own scepticism about the need for MIFs, or the need for credit card MIFs to exceed debit card MIFs, the Board proposes that interchange fees should persist (and, universally now, be payable to issuers), with credit card MIFs continuing to exceed significantly debit card MIFs (for most transactions and overall, on average). The Board explains, with respect to debit interchange, that it considered the possibility "to set interchange fees in these [EFTPOS and scheme debit] systems to zero."[15] Instead, it considers it preferable to set "a small positive benchmark for the weighted-average fees." The Board suggests adopting "perhaps, a benchmark of around 5 cents capping the weighted-average fee in the various debit card systems."[16]

The only reason the Board gives for preferring a weighted average cap of 5 cents payable to the issuer, rather than the elimination of debit interchange fees, is that, it suggests, a small, positive fee "would allow the schemes some flexibility in setting different fees for different types of transactions. At the margin this may be useful, and could potentially allow the schemes to use interchange fees in a way that promotes innovation in the system."

Banks routinely invest in efficiency enhancing payment innovations even in payment systems lacking a MIF, to provide good service to their customers in competition with other banks. Even if the Board is convinced that schemes might use their "flexibility" to set differential interchange fees to influence merchant behaviour in efficiency enhancing ways, it is clear that a major reason the schemes use differential interchange fees generally is simply

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13. As I previously noted to the RBA, "no interchange rate is applicable" to Visa scheme debit transactions in New Zealand. http://www.visa-asia.com/ap/nz/merchants/gettingstarted/interchange.shtml (visited 25 July 2007 – the web page appears since to have been removed).
14. Preliminary Conclusions, p. 34
15. Preliminary Conclusions, p. 31.
16. Id.

to implement profit maximizing collective price discrimination strategies unrelated to the efficient steering of merchants to use lower cost technologies or payment practices. At a minimum, the Board should consider whether there is any reason why any merchant following a reasonably defined set of "best practices" could not obtain pricing from banks undistorted by interchange fees for conforming transactions. If the Board is convinced that (i) there are cases in which a true transactional externality persists which cannot effectively be internalized between the issuer and cardholder or merchant and acquirer; (ii) that such externalities can effectively be internalized through the application of MIFs; and (iii) that the benefits resulting from such application of MIFs exceeds the costs and harm which may instead result, then an alternative might be at least to constrain the average MIF to zero. But, given the Board's own findings that MIFs are a blunt instrument which primarily transfers revenue between parties, and have historically been used to incentivise *inefficient* choices, it is unrealistic to assume that, going forward, the card schemes will now limit their use of MIFs to incentivise only efficient choices.

With respect to interchange fees for credit card transactions,

> [T]he Board assessed the case for setting interchange fees to zero, or at levels similar to those in the debit card systems. While it remains unconvinced of the need for significantly higher interchange fees for credit card systems than for debit card systems, it does recognise that there are some plausible arguments that might justify somewhat higher interchange fees in credit card systems. <u>In particular, merchants, in aggregate, may gain some short-term benefit from consumers using credit cards over debit cards, in that sales occur earlier than otherwise</u>. While the Board recognises this possibility, the current difference in interchange fees in the credit and debit card systems is significantly higher than could reasonably be justified by this argument.[17]

The Board therefore proposes an average credit card interchange fee of 0.30% (unless it adopts industry self-regulation, which I discuss below, and under which the Board appears willing to accept an average credit card interchange fee which doesn't materially exceed the current average of 0.50%).

The Board's reasoning is flawed and inconsistent. Even if it were true that merchants in the aggregate benefited from the *existence* of credit cards, this does not imply that merchants benefit at the point of sale, for a given transaction, from a customer's decision to use the credit card for that transaction instead of a debit card when both are available and accepted by the merchant, or that it is efficient to have merchants fund the cost of permitting a cardholder to purchase earlier – i.e., before having to fund the purchase or pay interest. If a consumer wishes to make a purchase early, and the credit card makes that decision possible, then the cardholder is a direct beneficiary of that service and will tend to choose to use the credit card with or without the MIF. The Board's logic can make sense only if there are a significant number of consumers who would make a purchase early using a credit card if the merchant pays a MIF, but who will choose not to use the credit card and delay the

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17. Preliminary Conclusions, pp. 31-32 (emphasis added).

purchase (say, because the availability of an interest free period is reduced) without the MIF.[18]

Even if credit cards provide a short-term benefit by accelerating some purchases, it does not follow that the MIF is beneficial or needed to fund any costs associated with the provision of those benefits. If the MIF were eliminated, it is unlikely that the (speculative) delay of some purchases by some cardholders due to the elimination of the MIF would harm *merchants* in the aggregate by 0.30% or 0.50% of the value of all credit card transactions.

A cardholder who purchases more today must repay the balance – with interest if carried over – and will purchase less in future periods. Given the relatively high interest rate applied to credit card balances, to the extent balances are carried over, the reduction in future purchases by the cardholder, discounted to the present by the merchant, will tend to exceed the increase the merchant's additional sales in the current period. The Board apparently agrees with this conclusion.[19] The Board's reasoning, therefore, must rely on the provision of the interest-free period, which the Board's explanation suggests merchants should continue to fund. Yet, the Board explicitly reaffirms that short-term benefits from the interest free period were permitted to be included as part of "eligible costs" only as a *temporary, transitional* matter.[20] To invoke essentially the same short-term benefits to the cardholder and characterise them instead as a benefit to merchants as the sole justification for retaining a MIF, makes little sense and reflects a significant internal inconsistency.

Self-Regulation of Interchange Fees

The Board has offered three options for how it might reduce the intensity of its interchange fee regulation. Briefly, under Option 1, the Board would largely freeze interchange fees at current levels, with some improvements to the weighting process, and would eliminate the EFTPOS cash-out interchange exemption. Option 2 would make further changes to interchange fees, with credit card transactions incurring an interchange fee reduced by another 20 bps, to a weighted average capped at 0.30% and payable to issuers,

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18. The only other possibility is that a significant number of consumers who desire the credit feature of a credit card stop carrying credit cards as a result of the elimination of the proposed 0.30% MIF. But the RBA's initial reduction of 0.45% was accompanied by an *increase* in the number of card accounts. Few consumers will choose to forego carrying a card altogether and thereby lose the option to use a credit card for any purchase (including foreign, Internet, travel and other purchases in which credit cards are commonly used), as the result of the elimination of the MIF. RBA data show that the percentage of card accounts lacking an interest-free period continues to decline, notwithstanding the reduction in interchange fees. (See statistical series RPS, at http://www.rba.gov.au/PaymentsSystem/PaymentsStatistics/ExcelFiles/RPS.xls.) The Board also reports that the average length of the interest free period has not changed significantly since the MIF reforms went into effect. Preliminary Conclusions, p. 17. These facts suggest that the banks' most relevant method of funding credit features like the interest-free period is through cardholder fees, including finance charges on carried over balances.
19. Preliminary Conclusions, p. 15 ("the Board does not accept the idea that in the long run, credit card acceptance by merchants significantly increases the aggregate value of spending (although it is likely to bring forward some spending)").
20. Preliminary Conclusions, p. 31, citing Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement, p. 37.

and all debit transactions (scheme debit and EFTPOS) an average fee capped at $0.05, also payable to issuers. This would represent a further reduction of scheme debit interchange fees, and a reversal of the net direction of flow of EFTPOS interchange fees.

Option 3 is a proposal to return to industry "self-regulation" of interchange fees and related practices, albeit in the shadow of threatened re-regulation of the fees by the Board along the lines indicated in Option 2 should the level of interchange fees "increase materially," apparently from *current* levels.[21]

The Board's position with respect to re-regulation of the level of interchange fees is confusing. The Board believes that an average credit card MIF of no more than 0.30% is appropriate, and it is prepared to set that rate as a cap under Option 2. Moreover, if it relies on self-regulation "and average interchange fees in the credit card systems were to increase materially, the Board would consider reimposition of interchange regulation, probably along the lines of Option 2."[22] There is ambiguity about what the Board means by an increase in the average credit card interchange fee. If the Board means an increase from the *current* level, that would imply that the fee would be 0.30% if the Board must intervene directly, but can be up to a material amount above the current weighted average, which is capped at 0.50% but which the Board explains may already be exceeding that amount. In other words, if the schemes are given control of MIF regulation, under this interpretation, the schemes apparently can simply maintain the average credit card MIF at around 0.50% without triggering reimposition of the Board's 0.30% standard, notwithstanding the Board's conclusion that a MIF in excess of 0.30% would be too high.

The other possibility is that the Board was referring to an increase of the MIF materially in excess of the suggested new benchmark of 0.30%, which would make the Board's positions internally consistent and would imply that under either Option 2 or Option 3, credit card interchange fees will decline from current levels.

The Board explains its view that "the potential advantages of Option 3 are such that the Board is prepared to remove interchange regulation if industry takes further steps to improve the competitive environment."[23] The Board identifies the following potential "advantages" of self-regulation of interchange fees:

- "the prospect of a further improvement in the competitive environment;"
- "allow[s] schemes more flexibility in the pricing of their payment services" and "provide[s] the various card payment systems with the flexibility to compete directly with one another for both acceptance and use;" and
- "provides a way for industry to address the Board's public-policy concerns regarding interchange fees, rather than these concerns being addressed through regulation."

Aside from the Board's general policy preference to avoid direct intervention when unnecessary, the specific benefits it identifies are notably vague. The Board fails to describe the specific benefits resulting from "flexibility" in the setting of interchange fees, or examine whether those benefits might be achieved through other, less restrictive means.

21. Preliminary Conclusions, p. 38.
22. Preliminary Conclusions, p. 38.
23. Preliminary Conclusions, p. 37.

The Board justifies its continued oversight of interchange fees on the grounds that "The nature of the incentives facing merchants means that there is a significant risk that, in the absence of such oversight, interchange fees will be set at levels that distort payment patterns."[24] The Board explains:

> [T]he Board remains of the view that, in the absence of regulatory oversight, there is a significant risk that interchange fees in some systems will be set at levels that are too high from the point of view of the efficiency of the system. The main reason for this is that merchants find it difficult to exert sufficient downward pressure on interchange fees, largely as a result of the structure of incentives that they face. In essence, merchants face a co-ordination problem, and as a result are willing to pay more, in aggregate, for some payment methods than the aggregate benefit that they receive from accepting those methods. This difficulty is most apparent in the credit card system but, in principle, can arise in other payment systems as well…
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> In a sense, merchants are in a game akin to the 'prisoner's dilemma': they would be better off if they could collectively agree on the terms of credit card acceptance, paying no more than their collective benefit, but instead they act individually and, as a result, can in aggregate potentially pay more for credit card acceptance than the benefit they receive.[25]

While the schemes establish fees on behalf of all of their member banks, each merchant must decide independently whether to accept the cards or surcharge card transactions (and, if so, at what rate). Although the simplest, most logical and direct solution to this problem remains elimination of the interchange fee, another possible way to solve the "coordination problem" among merchants identified by the Board would be to establish a mechanism under which the merchants could act *collectively* to negotiate interchange fees with banks (or else *collectively* decline one or more cards), or establish *collectively* the level of card surcharges each merchant will charge for use of a particular type of card. As Philip Lowe recently noted, a similar approach is currently being considered by the U.S. House of Representatives and Senate.[26]

The fundamental market failure occurs because cardholders choose the payment methods, steered in part by MIF-induced issuer pricing, rebates and similar steering strategies, while merchants bear the resulting transaction fees and can, at best, only imperfectly surcharge or steer consumers to use lower cost means of payment. This market failure is an example of a principal-agent problem, and is similar economically to the way that commercial bribery of a purchasing agent can subvert the competitive process and allocative efficiency, and cause the principal to overpay. In the case of the card schemes, of

24. Preliminary Conclusions, p. 25.
25. Preliminary Conclusions, p. 15.
26. The Preliminary Conclusions Of The Payments System Review: Address by Dr Philip Lowe, Assistant Governor (Financial System), to the Visa Forum 2008, Hamilton Island, 4 June 2008, www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_jun08/Pdf/bu_0608_4.pdf.

course, this is all done openly and claimed to be efficient and procompetitive. Fundamentally eliminating this market failure so that intervention is no longer necessary requires addressing the structural impediments to efficient competition that generate the market failure in the first instance. The Board has made progress at reducing these impediments, particularly by eliminating no-surcharge rules, but it has not eliminated them.

Neither the Board nor the schemes propose a *deregulated* marketplace. (I discuss below some features of a deregulated market.) With respect to interchange fees, both the Board and the schemes propose continued regulation; the schemes seek to revert to scheme regulation of bank pricing of card issuing and acceptance services (through control of the MIF), while the Board proposes either Board regulation or, even in Option 3, scheme regulation of pricing under threat of renewed Board regulation.[27]

Despite its concern that the competitive process still does not work effectively, the Board suggests the possibility that "the combination of the reforms to date and some further changes would result in an environment sufficiently competitive that interchange fees would no longer be under continual upward pressure." The Board identifies the following previous changes that it believes have contributed to this possibility:

- The Board's previous relaxation of the honour all cards rules (HACRs) which, for example, permitted merchants to accept scheme credit cards without also accepting scheme debit cards;
- The Board's previous elimination of the scheme's no-surcharge rules and similar three-party system rules with no limitation on the amount of any merchant surcharges; and
- Previous RBA action to publish routinely data showing average merchant service charge rates for both the four-party and three-party card systems, in addition to the regulated weighted average interchange fee caps.

As already indicated, however, the Board finds that those changes have not yet altered conditions sufficiently to generate an effectively competitive marketplace. Previous reforms to the HACRs and merchant pricing restraints, and existing levels of disclosure, are insufficient either to reduce further the level of scheme interchange fees or even to maintain those fees at current levels:

- "[T]he Board has expressed a concern that… competition [between schemes] could push up interchange fees, and <u>this concern remains</u>."[28]
- "[A]verage interchange fees are still pushing up against the benchmarks, suggesting that <u>upward pressure on these fees remains</u>."[29]
- "[T]here is <u>little evidence to suggest that surcharging has put direct downward pressure on interchange fees</u> in the four-party schemes."[30]

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27. Preliminary Conclusions, p. 32 ("Given its underlying concerns about the competitive forces in the payments system, the Board has ruled out the option of stepping back unconditionally.").
28. Preliminary Conclusions, p. 35 (emphasis added).
29. Preliminary Conclusions, p. 21.

- "[T]he benchmarks set by the Board are binding and there is no suggestion that competitive pressure is leading to average interchange fees being set *below* the relevant benchmarks. Indeed, confidential data provided to the Bank suggest that average interchange fees are currently above the relevant benchmarks. Although large merchants have had some success in bargaining down interchange fees, these lower fees have tended to be offset by higher interchange fees for other categories of transactions, in particular interchange fees faced by smaller retailers. This experience suggests that despite some increased competitive pressures at the margin, the more important factor keeping interchange fees low is the regulatory caps."[31]

For competitive pressure to constrain interchange fees, then, the Board must rely on the possibility that the incremental reforms it proposes will be the critical factors which reverse the dysfunctional situation in which rivalry among payment card schemes tends to lead to increases in interchange fees and merchant fees. But the only additional reforms which the Board suggest might make the critical difference to the viability of self-regulation are:

- Additional publication of "scheme fees and average interchange fees, as well as the fees and procedures that apply if an acquirer wishes to bypass scheme switches."
- Additional relaxation of the HACRs to permit merchants to decline any scheme card based on the level of interchange fee applied to that card; and
- Additional "strengthening" of the EFTPOS system.[32]

The Board also cites the "increased willingness of merchants to surcharge" as a reason why "looking forward, the threat of surcharging could reduce the upward pressure on interchange fees."[33] But, although "increased willingness" of merchant to surcharge is useful both to intensify constraints on interchange fees (and possibly scheme fees) and improve price signals to the banks' cardholder customers, there is no evidence that the ability to surcharge is sufficient to constrain interchange fees to the current cap, let alone drive the schemes to reduce those fees to the Board's suggested new target of 0.30%. Indeed, the logical reason why the schemes seek to eliminate their existing interchange fee caps is not

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30. Id.
31. Preliminary Conclusions, pp. 21-22.
32. The Board describes the following as examples of ways to strengthen EFTPOS: "(i) the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make decisions about multilateral interchange fees; (ii) the creation of effective arrangements to promote the development of the system; (iii) reform of current access arrangements; and (iv) the development of alternative payment instruments for use in on-line payments (either by the EFTPOS scheme or through another channel)."
33. It is unclear whether the survey data trend towards more surcharging cited by the Board reflects merchants surcharging all transactions, or only the more costly three-party card transactions.

that those fees are likely to fall due to surcharging, but instead that without the caps the schemes will increase their average MIFs.[34]

It is unlikely that the incremental structural changes proposed by the Board will alter this situation. For example, although there is merit to the Board's suggestion that merchants should have enhanced discretion over which card payments to accept, it is premature at best to assume that merchants' ability to refuse the highest fee cards might somehow cause the schemes to hold their MIFs at or below the current cap (aside from the prospect of renewed direct MIF-setting by the Board). If the schemes simply established a fixed MIF of 0.60% for their lowest tier card, for example, the ability to reject cards selectively based on the level of interchange fees could not reduce a merchant's effective average fee below 0.60%. On the other hand, merchants should have the ability to reject particular types of cards based on whatever criteria they want. Otherwise, card schemes can introduce new, less desired cards at the same interchange fee as important existing cards, and compel merchants to accept the new cards.

While publication of interchange fees, average merchant fees, and scheme fees is helpful and likely to generate reduced average merchant fees, that transparency alone will not logically compel the schemes to maintain or reduce their MIFs so long as issuers receive the MIF, merchants fund the MIF, and cardholders choose both the payment method and the scheme, the fees of which will apply to the transaction. At best, increased transparency can reduce the acquirer margin, but there is no logical reason to think it will put incremental pressure on the schemes to reduce interchange fees. Similarly, the ability to bypass scheme switches is useful and can constrain scheme processing fees, but not interchange fees or other fees mandated by the schemes whether or not the scheme switch is used.

With respect to strengthening of EFTPOS and the creation of a scheme to establish MIFs for EFTPOS transactions, it is difficult to see how this might constrain the level of MIFs to current (or reduced) levels for debit cards, let alone credit cards. Indeed, in the United States, MasterCard and Visa operate their signature-authorized debit card schemes alongside alternative, PIN-authorized debit networks, and the same, dysfunctional competition has occurred, which has led to dramatic increases in PIN debit interchange fee rates from former their mostly par (zero) level.[35] U.S. banks routinely encourage cardholders to choose more expensive and less efficient scheme debit transactions over more efficient and lower cost online PIN debit transactions even when both are available on the same card, in another demonstration of the fact that banks pursue interchange revenue irrespective of efficiency concerns, not to *achieve* efficiencies.[36]

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34. If, say, merchants were *obligated* to surcharge cardholders by the amount of the interchange fee, this would solve the merchant coordination problem and the interchange fee would have the same arithmetical effect as direct charges by card issuers to their own cardholders. This could overcome the market failure described by the Board, but this hypothetical scenario also illustrates why it makes more sense simply to eliminate the interchange fee.
35. Lloyd Constantine, The Need for Federal Reserve and Antitrust Intervention in the Failed U.S. Debit and Credit Card Markets, in Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?" Federal Reserve Bank of Kansas City (2005), pp. 159-60.
36. On the other hand, creating an EFTPOS scheme the governance of which is open to *merchants* along with banks, and ensuring that the banks continue to accept EFTPOS transactions, might be a useful development.

Cash-Out On EFTPOS Transactions

The differences between the way interchange fees sometimes are applied in ATM and debit card transactions, like differences between EFTPOS and scheme debit transactions, illustrates the arbitrariness and inefficiency surrounding the entire institution of interchange fees. In the formative years of shared ATM networks, it may have seemed sensible that a bank offering its costly ATM services to customers of another bank needed to be compensated for those services to induce it to join the network. Of course, terminal owners, like owners of vending machines that dispense other products, can simply set their own fees in competition with other terminal owners. It is possible that this was technologically difficult in the early years of ATM technology, but whether or not directly charging customers for accessing an ATM was a viable solution a quarter century ago, it has certainly now long been a possible (and sensible) decentralized competitive solution which avoids any need for an interchange fee.[37] In any event, ATMs operators in Australia are now adopting a no-MIF, direct charging model.

The RBA earlier exempted the cash-out portion of EFTPOS transactions from its interchange fee regulation on the grounds that ATM interchange fees were not regulated by the RBA. The RBA offered as its rationale the fact that ATM withdrawals were close substitutes for EFTPOS cash-out, and, because it was not regulating ATM interchange fees, the cash-out portion of EFTPOS transactions likewise should not be regulated. "For these transactions," the RBA decided, "issuers and acquirers are able to negotiate an interchange fee that differs from the interchange fee on purchase-only transactions."[38]

"Since that time, however," the Board now writes,

> [T]he ATM industry has agreed to reform involving the removal of interchange fees in ATM networks. Given this development, the exemption for cash-out transactions could beneficially be removed. Doing so would simplify the setting of interchange fees in the EFTPOS system with correspondingly lower costs for industry participants and easier access, and would be unlikely to have any detrimental effect related to relativities with the ATM system. The Board's preliminary conclusion is, therefore, that if interchange regulation is maintained the

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37. When networks enabled point of sale debit transactions in addition to ATM transactions, the same logic underlying the original funding of terminal owners could be applied to merchant transactions as well, with an interchange fee reimbursing merchants for costs incurred to deploy, maintain and operate point of sale terminals. Of course, as with credit card transactions, banks knew that merchants had another revenue source – their retail customers who made purchases. Many networks thus eliminated their interchange fees for point of sale debit transactions. Banks, however, could profit from reinstituting an interchange fee payable to themselves (in their card issuing capacity). Thus, bank controlled schemes mandated interchange fees payable to issuers on debit transactions.
38. Reform Of The EFTPOS And Visa Debit Systems In Australia, Final Reforms And Regulation Impact Statement – April 2006, http://www.rba.gov.au/PaymentsSystem/Reforms/DebitCardSystemsAus/ImpactStatementApr2006/imple_review.html#f34.

> exemption for cash-out transactions in the EFTPOS interchange fee Standard be removed.[39]

While ATM pricing is being deregulated, however, EFTPOS pricing is not; instead, the Board proposes that merchants should now pay a scheme- or Board-regulated interchange fee to card issuing banks. Parallel treatment between cash-out and ATM transactions would imply no interchange fee on cash-out transactions. Although merchants might prefer to continue receiving interchange fees, the simplest, most deregulated approach remains to eliminate interchange fees wherever possible, including cash-out. Of course, the same logic should apply, at a minimum, to all debit transactions as well. At the margin, if the Board decides to implement the proposed debit interchange fee payable to issuers, it probably makes sense at a minimum to eliminate the interchange fee on purely cash-out transactions (so long as the debit interchange fee on purchases remains a flat amount). This would generate appropriate incentives for merchants to either dispense cash on EFTPOS or encourage consumers to use no-interchange ATMs, in some cases located on the merchants' premises. But Banks routinely issue both ATM and debit cards without receiving any interchange fee subsidies, and the simple and preferable solution is to eliminate interchange fees on all debit transactions.

Deregulating Payment Card Markets

The Board's ultimate goal, of course, is a decentralized, competitive marketplace no longer requiring regulatory intervention by the Board. A competitive payments marketplace ideally constrains prices not only to reflect relative costs, but also the marginal costs associated with those payments.

Such a scenario requires that regulation of competition *by card schemes* be limited to those areas truly necessary to facilitate payments (e.g., standard setting arrangements not used for anticompetitive purposes). In a competitive and efficient payments marketplace, parties required to pay fees for payment services would be able to select from among competing providers of those services, and the fees would be set by independently competing suppliers, not on the basis of centrally established interchange fees or equivalent payments. Standardized, interoperable payments is what led to the *competitive* elimination of interchange fees once charged on cheque payments in the United States; a competitive market for the transportation and presentment of payment claims to the issuing banks developed which was thwarted only by monopoly banks and cartels in some regions.

In card payments, too, competition can constrain payment fees if the payers of those fees can choose from among competing suppliers. Transaction processing fees charged to the merchant would likely be modest and the services efficient if the merchant could choose the network or otherwise arrange for the electronic presentment of claims to issuing banks using standardized, interoperable networks (or, for some large merchants, self-provided network infrastructure). If banks were required to accept transactions presented over any network certified as meeting published standards and protocols, then deregulation could proceed to completion.

The Board recognises that, in order to "remove the existing interchange regulation… further steps would need to be taken to improve the ability of merchants to put downward

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39. Preliminary Conclusions, p. 45.

pressure on interchange fees."[40] Although incrementally helpful, none of its previous or proposed reforms eliminate the fundamental principal-agent problem which causes merchant card acceptance fees to be too high: issuers strongly influence cardholder payment choices based on the profitability of those choices to the issuers – increased artificially by interchange fees and other scheme payments to issuers – but merchants must pay the resulting higher fees.

If merchants could choose the payment network and pay fees set by a network only when using that network, and there were sufficient competition among alternative networks (and self-provision of network bypass services), then any attempt to charge anticompetitively high, inefficient payment fees to merchants could be defeated by switching to an alternative network services supplier (or an acquirer using such a supplier). The Board accepts that "In theory, this would exert pressure on interchange fees and scheme fees because the merchant would tend to select the cheaper network. Such a change would be expected to have a very significant effect on the competitive dynamics in the payments system" and that "such changes could have a profound effect on competition."[41] Yet, the Board does not seek to compel such a solution through this regulatory process.

The Board is concerned that "a move in this direction… would require costly adjustment in existing systems and may well have significant unintended consequences."[42] Yet multi-network cards are in wide use; their use, however, is restricted by the international card schemes so that directly competing credit card networks, for example, cannot be accessed from the same card.

Had scheme rules not forbid it, it is likely that multi-network credit cards would have evolved competitively. This is what happened with debit cards in the United States, and as banks sought an acceptance and usage advantage as the networks were growing, the banks would have had an incentive to offer multiple-branded credit cards linked back to a single account. At a minimum, then, the Board should consider eliminating scheme rules which prohibit access on a card by a competing network, even if it is unwilling to consider requiring such access. At worst, no banks will choose to issue such cards, but it might be an attractive option for differentiating a card program for a smaller issuer or entrant.

This idea is merely a more effective extension of bypass competition endorsed by the Board. The problem with bypass competition as it stands now is that it requires the agreement of issuing banks, which have little incentive to accept a lower interchange payment than that mandated by default by the network. Requiring acceptance of "bypassed" transactions would competitively constrain (and likely eliminate) interchange fees if the fee applied to the transaction was set by the network used to process the transaction; at least *permitting* issuers to offer multi-scheme cards could improve the current situation.

Update on Three-Party System Merchant Fees

The Board has described in some detail the evidence concerning the effects of the reforms, which I also addressed in my previous submission and paper. I here merely wish to make a few brief comments updating the evidence about the trend in merchant service charges for four-party versus three-party card schemes and the implications of that trend for the viability of banks issuing MasterCard and Visa credit cards.

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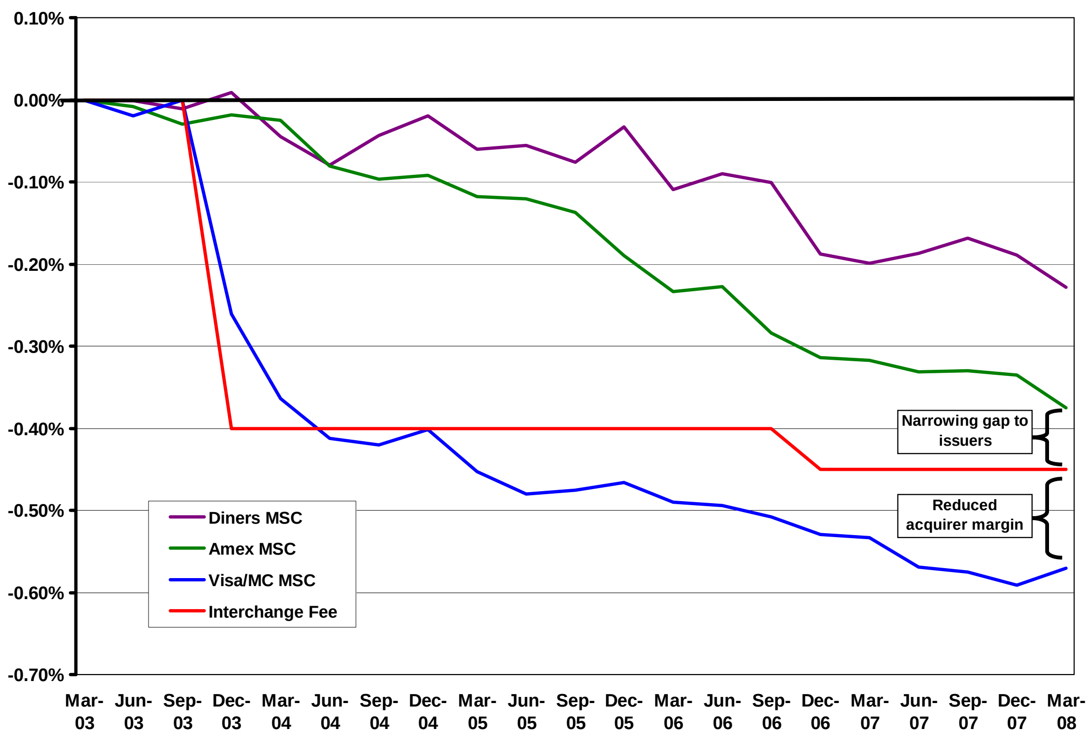
40. Preliminary Conclusions, p. 33.
41. Preliminary Conclusions, p. 29.
42. Id.

Merchants, on average, pay significantly higher fees to accept American Express cards than they do to accept MasterCard and Visa transactions. MasterCard and Visa, and their consultants, have argued or suggested that the reforms have left them at a significant competitive disadvantage to American Express and Diners Club because those three-party card schemes collect relatively more revenue from merchants from which they can fund rewards programs offered to cardholders and fee payments to bank issuers than they did prior to the reforms.[43] But merchants paid more to accept three-party cards than four-party cards even before the reforms.

Change in Interchange Fee and Merchant Service Charges, by Brand



As shown in the accompanying chart, it is true that, so far, the decline in MasterCard and Visa merchant service charges has exceeded the decline in American Express and Diners Club merchant service charges. (Diners Club's average fee declined by less than that of American Express, but started at a lower level, so that Diners Club's average merchant fees are now the same as those of American Express.) But, as the Board points out, some of the decline in the MasterCard and Visa fees have come at the expense of the merchant's acquiring bank. In their card issuing capacity, banks earn only the interchange fee, which has declined by 0.45% (of the transaction amount). American Express' merchant service charge has declined by 0.38% and is still declining. So, as an integrated scheme/acquirer, the amount of revenue American Express has from which to pay issuing banks or fund cardholder rewards has declined by almost as much as for MasterCard and Visa issuers. On the other hand, the decline in American Express' average merchant service charges has taken longer than for MasterCard and Visa transactions, and has not benefited merchants to the same extent. But there is no support for claims that American

43. See, for example, Stillman, et al., p. 24.

Express has gained a significant new advantage over MasterCard and Visa or threatens to take over the market. In any event, as the Board notes, the combined three-party scheme share remains only very slightly elevated over the level prevailing before the reforms went into effect.

Effect on Retail Prices

The schemes and their consultants continue to claim or suggest that none of the savings to merchants in Australia have been reflected in lower retail prices to consumers.[44] I have previously addressed this claim (and its irrelevance to the very "two-sided market" defence argued to be appropriate by the schemes, which treats the sum of cardholder plus merchant fees as the claimed relevant price measure). Given the market-wide reduction in merchant fees documented by the RBA, well established fundamental principles of economics, and empirical learning in analogous situations,[45] it is appropriate for the Board to continue to assume that reduced interchange fees have resulted in lower retail prices. In fact, in the face of high oil and retail gasoline prices, Visa Inc. on 26 June 2008 announced that it was reducing interchange fee rates for retail fuel purchases. According to Visa executive Bill Sheedy, "by lowering our rates, we hope to see oil companies pass these savings along to their stations and ultimately to consumers."[46]

Conclusions

In the Preliminary Conclusions, as in its earlier reports, the Board has identified many of the fundamental economic forces which have generated uncompetitive and inefficient payment card markets in Australia. The Board should pursue its reforms to their logical conclusions. To summarize:

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44. Unlike MasterCard itself, its consultants Stillman, et al. do not claim outright that merchants "pocketed the savings," but instead merely recite that "Merchants… have not presented any empirical evidence documenting the extent to which reductions in merchant service charges have been passed through to consumers, and neither has the RBA or anyone else." The absence of evidence concerning retail price effects in Australia still is not evidence that no such effects occurred.

45. See, for example, Simon J. Evenett, The Empirical Evidence On The Pass-Through Of Firm-Specific Cost Changes To Prices: What Implications For Merger Reviews? University of St. Gallen Law School, Law and Economics Research Paper Series, Working Paper No. 2008-09 Feb 2008, p. 6, citing Johan Stennek and Frank Verboven, Merger Control and Enterprise Competitiveness: Empirical Analysis and Policy Recommendations. Study prepared for the European Commission, (2001) ("<u>It seems fair to say that the literature on the effects of excise taxes and intermediate goods prices finds that pass-on is close to 100 percent, at least when one considers a sufficiently large time horizon (10 weeks or more)</u>") (emphasis added).

46. "Visa to Help Ease Pain at the Pump: Lower Interchange Rates and Processing Changes Can Make Buying Gas Easier for Consumers and Benefit Gas Stations," Press Release, Business Wire, June 26, 2008.

1. The Board was correct to doubt the need for *any* interchange fee in debit card systems. Such fees should be abolished for both EFTPOS and scheme debit card transactions.[47]

2. The Board was correct that: (a) there is no justification for credit card interchange fees to exceed debit card interchange fees; and (b) there is no justification for the continued funding (or rationalization based on the cost) of the interest-free period through an interchange fee. Yet, that is the only remaining logic offered by the Board for continuing to permit a credit card interchange fee. The credit card interchange fee therefore should be abolished.[48]

3. Continued symmetric treatment with ATM transactions implies no MIF for EFTPOS cash-out transactions even if the Board persists in its proposal to continue requiring the payment of interchange fees on debit transactions.

4. The Board is correct to conclude that there is no support for the restoration of no-surcharge rules. In fact, as I explained in my conference paper, both MasterCard and Diners Club explain in detail in their Review submissions how merchants' ability to surcharge has had important procompetitive effects which have constrained the fees of the highest cost schemes. Nor is there any reason to restrict the amount of merchant surcharges to the amount of the merchant service charge; the schemes have provided no compelling justification to regulate this aspect of competitive merchant pricing.

5. Increased transparency of interchange fees and average merchant service charges has likely had an important beneficial effect in the marketplace and should continue. Additional disclosure of fees, including scheme fees, would be a sensible additional reform.

6. Enhancing opportunities for merchant steering can further help alleviate the ill effects from the principal-agent problem at the heart of payment inefficiencies which have motivated the Board's reforms. It would be useful to permit merchants freedom to selectively accept or decline any type of card, but, at a minimum, the Board's proposal to permit merchants to decline types of cards based on the level of the interchange fee attached to those cards is likely to enhance merchant constraints on card acceptance fees, assuming the Board permits the schemes to preserve their interchange fee systems.

7. Opportunities for fundamental network level competition should be pursued. Merchant steering is perhaps most effective when multiple payment networks can be accessed from a single payment card. Even if the Board is unwilling to compel mandatory acceptance of transactions over competing networks (applying

47. Should the Board decline to abolish debit card interchange fees, it should review again in a few years whether preserving an interchange fee payable to the issuing banks achieved any benefits related to the "flexibility" described in the Preliminary Conclusions. If there are no such benefits, or if flexibility is used primarily for other purposes which do not relate to the attainment of efficiencies, the Board should abolish debit card interchange fees.

48. Should the Board decline to abolish credit card interchange fees, it should likewise review again in a few years whether any ill effects have resulted from the further reduction it proposes. If not, the Board should continue to phase out these interchange fees.

fees established by whatever network is used), the Board should, at a minimum, consider abolishing scheme rules which prohibit multi-branded credit cards.

8. Without more fundamental reform, it is highly unlikely that competitive pressure will now be sufficient to maintain or reduce credit card or scheme debit card interchange fees from current levels, so that "self-regulation" will achieve the Board's stated goals.

9. Notwithstanding continued claims and suggestions to the contrary, the existing reforms have not launched a death spiral, but instead benefited the Australian public.

Thank you for the opportunity to comment on your Preliminary Conclusions and the proposals contained therein.

Regards,

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