

**Reform of Australia's Payments System:
Reserve Bank of Australia's
Preliminary Conclusions of the 2007/08 Review:
APCA Submission in Response
June 2008**

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1. Executive summary

1.1. The Australian Payments Clearing Association (APCA) strongly supports the deregulatory and pro-competitive orientation of the Reserve Bank of Australia's (RBA's) preliminary conclusions. Subject to some observations below, APCA supports Option 3. This approach is consistent with the great weight of earlier submissions, including APCA's.

1.2. APCA believes that:

- on the evidence available to the review, there is already substantial and growing competition in consumer payment instruments; and
- the conditions attached to Option 3 in the RBA paper are not the best possible means of further promoting competition in a way that maximises benefits to end users of the card payment system.

1.3. In relation to the conditions attaching to Option 3, APCA:

- acknowledges the structural importance of reshaping the business direction and governance of the EFTPOS system, which is already under way. At the next meeting of the interested parties on 16 July, APCA will recommend that the group engage in a continuing dialogue with RBA on the timetable and direction of the scheme work.
- believes that the proposal to further erode the international card Schemes' Honour All Cards (HAC) rules is not the best way to realise the Payments System Board's (PSB) pro-competitive intent. Having regard to current policy settings, the proposal is unnecessary and inefficient, particularly in terms of the potential adverse effects on consumers and small merchants;
- believes it is now possible and desirable to bring the main stakeholder groups (including merchants, schemes and financial institutions) together in a structured industry dialogue on supporting and strengthening competition in the payments system. This process could address the regular monitoring and assessment of competitive conditions in consumer payments (including disclosure of scheme and interchange fees), and be a forum for debate on structural proposals to enhance competition.

- 1.4. APCA's proposal to the PSB is to give the industry an opportunity to engage fully in the EFTPOS scheme and this structured industry dialogue (which subsumes within it the other conditions of Option 3) on the same timeframe as suggested in the RBA paper; that is, until August 2009. If both these initiatives have made substantial progress in that time, PSB should be prepared to step back from interchange fee regulation.

2. Introduction

- 2.1. APCA welcomes the opportunity to comment on the Reserve Bank of Australia's "Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review" paper (RBA paper), issued on 21 April 2008.
- 2.2. The main focus of APCA's submission is on the preliminary conclusions regarding regulation of interchange fees. The RBA paper sets out three options:
 - Option 1:* Maintain the regulatory status quo with certain technical changes;
 - Option 2:* Reduce interchange fees further (0.3% for credit cards, 5c positive for proprietary and scheme debit); and
 - Option 3:* Remove explicit interchange regulation on conditions designed to promote efficiency and competition in payment cards.
- 2.3. The PSB indicates a preference for Option 3, and proposes to allow the industry until August 2009 to show substantial progress towards meeting the conditions. If this does not occur, the paper indicates an intention to implement Option 2.
- 2.4. Section 3 of this submission provides an overall reaction to RBA's approach in the paper. Sections 4-7 explore the conditions attaching to Option 3 in more detail. Finally, proposed next steps if APCA's submissions are adopted appear in section 8.

3. APCA's view on the regulatory options for interchange fees

- 3.1. APCA strongly supports the deregulatory and pro-competitive orientation of RBA's preliminary conclusions. This approach is consistent with the great weight of earlier submissions, including APCA's.
- 3.2. The broader policy rationale for stepping back from direct interchange fee regulation is persuasive: greater competition promotes efficiency, flexibility, system investment and system innovation. Specifically, a fully competitive market for payment instruments presents consumers and merchants with choice and flexibility.

3.3. Conversely, fee regulation tends to distort market competitive behaviour and encourage costly gaming and avoidance behaviour. The RBA's preferred approach is the best interests of system users over the long term.

3.4. That said, APCA believes that:

- on the evidence available to the review, there is already substantial and growing competition in consumer payment instruments; and
- the conditions attached to Option 3 in the RBA paper are not the best possible means of further promoting competition in a way that maximises benefits to end users of the card payment system, particularly cardholders and smaller merchants.

3.5. Consistent with this view, APCA does not agree with the statement that there is a strong case for ongoing interchange regulation.¹ The main rationale for this view is the discussion of the "prisoners' dilemma" facing merchants, which concludes that merchants, as a group, will pay more for credit card acceptance than the benefit they receive, because they cannot act collectively.²

3.6. There are formal game theory arguments against the applicability of the classic "prisoners' dilemma" game to the circumstances of merchants in an ongoing multi-instrument payment system.³ But putting aside the theory, the key issue is that a coordination problem of the kind described cannot arise if merchant and consumer have a competitive choice of payment instruments. If merchants have an ability to influence consumer choice amongst a range of payment alternatives towards the instrument most advantageous to the merchant, and consumers have an ability to respond by choosing the alternative that best suits their needs, then no "dilemma" exists, and no merchant coordination is required – as in any market.

3.7. Accordingly, it appears that the PSB's conclusion that close oversight remains necessary must rest on a separate concern about an underlying lack of competition. PSB states that the impediment has been amplified by scheme rules relating to honour all cards and surcharging, but does not articulate whether the cause of this lack of competition is structural or inherent (which could justify ongoing regulatory oversight), or whether it is historical and will change over time.

3.8. APCA's view is that absent fee regulation, and with merchants now taking advantage of the ability to influence choice amongst competing payment alternatives, efficient competition has emerged and will continue to intensify,

¹ RBA Paper p39, summary paragraph 8.

² RBA Paper pp15-16.

³ For example, that repetition of the game changes the payoff matrix in favour of cooperation: see Axelrod, "The Evolution of Cooperation", 1984.

with corresponding welfare effects. There is evidence for this in the RBA paper in terms of increased surcharging, declining margins on merchant service fees, and successful competitive bargaining on interchange fees by large merchants.

- 3.9. Removal of interchange fee regulation will itself play a part in increasing competitive efficiency. The existence of a fee cap reduces incentives on merchants either to place competitive pressure on acquirers and cards schemes, or to use the range of tools available to them to influence the consumer's choice of payment instrument. The tools include steering, promotions, discounting, reward programmes and surcharging. The RBA paper suggests that such tools can be deployed to good competitive effect: "the available evidence strongly supports the idea that relative prices matter to consumer's choice of payment instrument."⁴
- 3.10. Against this background, APCA believes that an alternative package of measures in Option 3 would better support the explicit rationale for the Option 3 conditions: that "all feasible steps need to be taken to enhance the competitive environment".⁵ The main focus of this submission is to propose alternative arrangements that would give the PSB "reasonable confidence that strong competition exists between the various card-based systems and that the environment is conducive to ongoing strong competition."⁶
- 3.11. APCA proposes that, in order to make the PSB's preferred Option 3 work most effectively, the RBA and industry need to jointly address four specific issues:
- The **requirements for developing EFTPOS** need to be specifically agreed having regard to competition objectives, so that there are clear targets as to what must be achieved by August 2009;
 - The proposed **abrogation of "honour all cards"** (HAC) requirements will not materially enhance the position of merchants beyond the ability to differentially surcharge, and will have other significant adverse effects on end users, particularly consumers and smaller merchants;
 - The **industry-wide fee disclosure requirements** need to be established in accordance with a well-defined, competitively neutral and uniform standard; and
 - The proposed conditions generally need to be considered in light of **changing market dynamics**, to allow for future evolution and the inevitability of continuing change to the competitive landscape.

⁴ RBA Paper p18.

⁵ RBA Paper, p33.

⁶ RBA Paper, p32.

4. Requirements for developing EFTPOS

- 4.1. The market analysis underlying Option 3 focuses on competition amongst card products, with some commentary on the competition for over-the-counter consumer payments represented by cash.⁷ This reflects the weight of submissions and argument from industry participants, and is consistent with the results of RBA's payment usage studies.
- 4.2. Nevertheless, the consequence is that when considering the conditions attaching to stepping back from interchange fee regulation, the PSB concentrates on the EFTPOS system as the source of competition for international scheme cards.⁸ The developments in EFTPOS sought by PSB are described in various ways on pp32 and 34, with explicit warning that while the PSB does not wish to be prescriptive, it does require tangible progress by August 2009.
- 4.3. APCA agrees that steps to improve governance and business development in the EFTPOS system are important industry objectives, and accordingly has for some time been coordinating substantial industry effort towards that end. RBA has been kept informed of these developments.
- 4.4. The goal is to establish a governance structure that gives EFTPOS the best prospects of long-term business success. It is inherent in this that EFTPOS must have commitment from EFTPOS issuers and acquirers, effective powers to direct the business activities of the system and the commercial freedom to compete effectively with the international card schemes. The external imposition on the new scheme of industry policy-driven business priorities is not consistent with this.
- 4.5. Alternative online payment instruments are a case in point. From a business-competitive perspective, it is not clear that this should be a priority *for the new scheme*. The RBA paper and the RBA's payment patterns study say relatively little about market trends in the online segment of the payments market. The study suggests that online payments are a very low proportion of payments generally, both in number and value terms.⁹
- 4.6. Evidence published elsewhere suggests that there is already substantial competition in online payments. Recent survey-based data¹⁰ finds that a little over 6 million Australians make some form of online purchase each

⁷ RBA Paper sections 5.1 and 5.2.4 (competitive pressure on interchange fees) and 5.2.9 (implications of cash usage).

⁸ RBA Paper p32.

⁹ Emery, West and Massey, "Household Payment Patterns in Australia" in Proceedings of the Payments System Review Conference, November 2007 (the payment patterns study), see Table 5 on p148.

¹⁰ The statistics in this paragraph are taken from "The Australian Online Retail Monitor", Q4 2007, by Nielsen Online. The Monitor has been published by eBay as part of its Notification to ACCC dated 11 April 2008.

month; and that amongst this community, 84% have used credit cards online, 62% have used PayPal online, 60% have used BPAY online and 57% have used direct deposit online. While credit cards are reported as the preferred method online, there is clear evidence of competition: PayPal is the fastest growing online payment method, and is preferred by around 1 in 4 online Australians.

- 4.7. This data is in no sense definitive. Nevertheless, there is room for debate about how best to promote payment competition online, and given the low reported volume and value of online payments, whether this is the highest priority in improving competition in Australian payment systems. Imposing a requirement on a newly formed EFTPOS scheme to invest heavily to enter a small and already competitive market segment, such as online payments, may not be the best way to promote long-term competitive success for the scheme.
- 4.8. These considerations reinforce the importance of clarity between industry and RBA as to what level of reporting, and what milestones, are required in relation to the EFTPOS scheme. APCA submits the focus must be on what is needed to maximise prospects of competitive success for the proposed scheme, rather than on influencing its business direction.
- 4.9. Discussions around the future business direction of EFTPOS are commercially sensitive, and cannot be shared publicly without affecting the competitive position of the new scheme. However, APCA believes that it is important to respond to RBA's preliminary views by providing to the RBA as much information and opportunity to comment as possible on the work to establish the new scheme. At the next meeting of the interested parties on 16 July, APCA will recommend that the group engage in a continuing dialogue with RBA on the timetable and direction of the scheme work.

5. Alternatives to HAC abrogation

- 5.1. APCA supports the intent of the conditions attaching to Option 3 – to identify measures to promote choice, flexibility and competition in consumer/merchant choice of payment instruments. However, APCA believes the proposal to remove HAC rules is not the best way to do this. Having regard to current policy settings and the evidence of their competitive effects, the proposal is unnecessary and inefficient.
- 5.2. Merchants can already differentially surcharge, which provides them with all the bargaining power of differential acceptance, but much more flexibility and discretion in how that power is used. Regardless of their size or bargaining power with the schemes, merchants can influence consumer payment choice to meet their own commercial best interests competitively, without any need for collective bargaining with schemes to obtain the best possible interchange rates. In addition, consumers enjoy maximum choice

of payment instruments and clear price signals. By contrast, differential acceptance operates in practice as a potentially expensive bargaining chip in negotiations with the schemes.

- 5.3. Evidence to the review confirms that incidence of surcharging is increasing,¹¹ which of itself will have a significant effect. Differential surcharging provides the opportunity to let market forces work, rather than force collective bargaining amongst schemes and merchants.
- 5.4. The RBA paper suggests that so far, there is little evidence that surcharging has put direct downward pressure on interchange fees, but there is anticipation that the threat of surcharge could in the future reduce upward pressure.¹² It is however acknowledged that large merchants (i.e. those with the greatest bargaining power) have in fact obtained substantially lower fees.
- 5.5. To date, the evidence indicates that in general, smaller merchants are yet to take full advantage of surcharging. It also suggests that this is changing over time. APCA's understanding is that competitive pressures on acquirers are such that major acquirers are upgrading their terminal fleets to permit easier surcharging and, if merchants wish to do so, differential surcharging, as a service to merchants.
- 5.6. APCA's conclusion on the available evidence is that the current policy settings of limited relaxation of the HAC rule with wide freedom for merchants to surcharge and otherwise influence consumer payment choices is providing an environment in which payment instrument competition is flourishing. The challenge in formulating the conditions for Option 3 is to select measures that further promote this trend.
- 5.7. Whether or not HAC abrogation would in fact enhance competition more than the current policy settings, it undoubtedly has adverse side effects:
 - **Consumers** would be presented with a much more complex, and less attractive, value proposition: without the guidance of scheme branding, they would need some means to identify the footprint of retailers accepting their chosen card; when deciding on a card, much more time and effort would need to be spent on establishing its acceptance footprint. They would also need to make judgments about how that footprint is likely to change in the future.
 - For **Merchants**, the "all or nothing" nature of differential acceptance poses significant costs and risks. It forces merchants into complex risk/return calculations, with little flexibility for adjustment or fine-tuning. A merchant must calculate how much business from

¹¹ RBA Paper p18.

¹² RBA Paper p21.

premium card-holders could be lost by non-acceptance, versus the cost savings of refusal. Once the calculation is done, there is limited capability to review and adjust, given substantial disruption to the merchant and customer created by changes to payment arrangements.

5.8. There are other conceptual problems with the proposal:

- Smaller and non-traditional issuers will be concerned that differential acceptance will be a tool for potential discrimination against them. Ensuring this is not possible is likely to complicate the formulation of the requirement.
- The RBA acknowledges that a majority of merchants currently receive blended pricing from acquirers.¹³ If, because of acquirer pricing practices, differential interchange on cards has no impact on the merchant, it is not clear how differential acceptance would assist the merchant in placing downward pressure on interchange fees.¹⁴
- Additionally, it seems at least possible that the costly cycle of circumvention and response mentioned by the RBA in relation to interchange fee regulation could equally be expected if differential acceptance is mandated.¹⁵ Schemes could potentially respond through adjustments to scheme and interchange fee schedules, card branding and so on. It has to be questioned whether this is conducive to efficiency.

5.9. For all these reasons, HAC abrogation is not the best policy choice for promoting competition. It appears that the PSB, APCA and many market participants share the view that competition is developing, but perhaps differ in their views of how far this process has already advanced.

5.10. APCA's proposal is that there is sufficient evidence for substantial and increasing competition that further direct regulatory intervention is not needed at this stage. However, as a practical matter the PSB's need to continue to monitor the situation closely is acknowledged. Accordingly, industry and RBA should focus on developing a strong, shared view of competition indicators, and an understanding of competitive dynamics and the ongoing effectiveness of competition. This is explored further in Sections 7 and 8 below.

¹³ RBA Paper p11.

¹⁴ The RBA acknowledges the competitive nature of the acquiring market on p22. There is no suggestion that price blending is a competitive impediment.

¹⁵ See RBA Paper p36.

6. Industry-wide fee disclosure requirements

6.1. APCA believes that if scheme and interchange fee benchmarks are to be disclosed, some industry-wide principles need to apply:

- The disclosure obligations need to apply fairly across all schemes (including EFTPOS, when it becomes relevant);
- Commercial confidentiality needs to be consistently protected;
- Calculation of benchmarks needs to be consistently applied, so as to ensure an “apples for apples” comparison, so far as possible.

6.2. This will require some coordination across schemes.

7. Changing market dynamics

7.1. A particular challenge arising from Option 3 is that, on any view of the RBA review evidence, market dynamics in consumer payments have changed markedly since the original reforms, and are likely to continue to change. RBA itself acknowledges that the market has become more competitive in important respects, that structural changes such as scheme commercialisation will have significant effects, and that an EFTPOS development scheme would change market dynamics. On top of these acknowledged factors, APCA submits that fraud patterns, technological development, changing consumer spending habits, new entrants from offshore and increased consumer mobility are all likely to affect the competitive dynamics of the Australian consumer payments market in the next 5 years.

7.2. In this rapidly changing environment, RBA proposes major regulatory changes to remove fee regulation and enhance competitiveness in a particular market segment, but adds the warning that “if Option 3 were implemented 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.”¹⁶ It is not clear what level of increase is material, nor when, how and how often this assessment would be made.

7.3. Given the range of external stimuli outlined above, APCA believes that a change in interchange fees (rise or fall) cannot, without analysis, be taken as evidence that competition is not working. If, for example, card schemes sought to offer added value services for acquirers and/or merchants in exchange for higher interchange, the price increase is not of itself evidence of absence of competition. Similarly, if surcharging becomes widespread and accurately passes interchange costs on to card holders, then increases

¹⁶ RBA Paper p38.

in interchange are not of themselves evidence of lack of competition: the cardholder is able to choose between competing payment products.

- 7.4. Given the large costs and risks associated with each change in regulatory direction, it will be very important to ensure that the industry clearly understands the PSB's expectations and benchmarks for competitive effectiveness, and that the PSB has access to all relevant information in deciding whether to change direction. APCA submits that there needs to be structured and ongoing dialogue between industry and RBA as market conditions change, so that respective views of the competitive dynamics are clearly understood.

8. Next steps

- 8.1. APCA submits that the above analysis supports the need for an effort by industry and RBA to define and agree the measures to be established to promote competition and, as a consequence, to allow RBA to step back from interchange fee regulation. RBA's paper has been valuable in narrowing the scope for debate and providing a clear pro-competitive policy framework for the discussion.
- 8.2. APCA believes it is now possible and desirable to bring the main stakeholder groups (merchants, schemes and financial institutions) together in a structured industry dialogue around a focused pro-competitive agenda. The objectives of this dialogue could be:
- identifying, monitoring and publishing the indicators of competition in consumer payment instruments (levels of surcharging, interchange fees, merchant service fees, product innovation etc.);
 - Identifying and debating structural opportunities to enhance competition and/or increase efficiency in the consumer payments system; and
 - Providing the locus for industry discussion with RBA and PSB on the ongoing need for regulatory oversight.
- 8.3. It is not intended that this structured process would have regulatory or binding authority; regulatory power necessarily remains with RBA. Rather, this provides a forum and framework for joint industry exploration and debate on industry and competition policy issues. An example is the Chip Payments Programme for Australia Steering Committee, which has been funded and attended by FIs, schemes and large merchants for the purpose of coordinating rollout of EMV cards in Australia.
- 8.4. Such a process would provide a structured framework for promoting the success of RBA's Option 3. It could coordinate the disclosure of scheme and interchange fee levels suggested in Option 3, provide transparency and

certainty around whether and when risks of reregulation suggested by RBA emerge, and also provide the venue for addressing other structural concerns identified by RBA, such as levels of access and innovation associated with underlying system structure.

- 8.5. The proposal is in part derived from APCA's thinking in the "Reinventing Coregulation" white paper, which is acknowledged in the RBA paper. The PSB also gives in principle support to an industry framework to directly address issues of competition and efficiency.¹⁷
- 8.6. The success of such a proposal in materially improving policy outcomes rests on the level of commitment it receives from industry stakeholders. APCA is committed to working with the industry to facilitate this proposal, and has received positive initial indications from its own larger members of their willingness to engage. With their support, APCA will convene an initial meeting of the broader stakeholder community (including smaller FIs, schemes and merchants) to explore the proposal in more detail as soon as possible.
- 8.7. APCA's proposal to the PSB is to give the industry an opportunity to engage fully in the EFTPOS scheme and this structured industry dialogue (which subsumes within it the other conditions of Option 3) on the same timeframe as suggested in the RBA paper; that is, until August 2009. If both these initiatives have made substantial progress in that time, PSB should be prepared to step back from interchange fee regulation.

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¹⁷ RBA Paper p33.