SUBMISSION 13

Federal House of Representatives Economics, Finance & Public Administration Committee

Hearing on the Reserve Bank of Australia's reforms to the payment system

May 2006

Table of contents

Introduction

The Reserve Bank of Australia (RBA) is required under the *Payments Systems (Regulation) Act* (PSRA) to ensure the stability of, and to facilitate competition and efficiency in, the Australian payments system.

The RBA and ACCC released a Joint Study in October 2000[1] outlining a case for reform of the Australian interchange payment system for credit cards, EFTPOS and ATMs. The RBA's reform agenda focused on:

- making access easier for new entrants;
- more transparent pricing signals to customers in terms of the relative costs of credit and debit payment systems; and
- interchange fees to be more closely aligned to costs and regularly reviewed.

Interchange fees are wholesale fees which are paid between financial institutions when customers of one institution are provided with card services by another financial institution. Interchange fees are the mechanism used by financial institutions to allocate or share the costs of payment systems between the merchant and cardholder.

ANZ supported reform of the payment system that would liberalise entry, increase transparency and promote competition, while ensuring financial system safety and a 'level playing' field.

A number of issues have arisen as a result of the reform program that need to be addressed:

- it is open-ended and includes no merits review of the RBA's decision-making or periodic independent review of the reforms;
- it has distorted the market by excluding the AMEX and Diners 'closed' schemes. This has created an unlevel playing field in favour of closed schemes whose charges to merchants have not fallen significantly (compared to the open schemes) and whose market shares have grown following the reforms;
- in the case of ATMs, it has not proven a failure of market competition or the tangible benefits to consumers of direct charging reform.

ANZ suggests the Committee recommend:

- a merits review mechanism for RBA decisions made under the *Payment Systems (Regulation) Act 1998*;
- the planned RBA review in 2007 of the reforms be done by an independent body or reviewer;
- the reforms be made competitively neutral between 'open' and 'closed' card schemes; and

[1] Reserve Bank of Australia & Australian Competition and Consumer Commission, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, October 2000 http://www.rba.gov.au/PaymentsSystem/Publications/PaymentsInAustralia/interchange_fees_study.pdf

- the RBA to undertake a review of its proposed ATM reforms, before proceeding further with reform.

This submission is in three parts. First, it provides a high-level summary of the major components of the reforms of the credit, debit and ATM payment systems and ANZ's business response. Second, it identifies issues that have arisen because of the reforms. Third, it offers suggestions for improvements in the regulatory process for payment systems.

ANZ offers the following information for the Committee's information as it undertakes its review of the Reserve Bank of Australia's Annual Report 2005.

If further information is required please contact:

Jane Nash
Head of Government & Regulatory Affairs
ANZ
Level 22, 100 Queen Street
Melbourne VIC 3000
(03) 9273 6323
nashj@anz.com

Jenny Fagg
Managing Director Consumer Finance
ANZ
Level 10, 75 Dorcas Street
South Melbourne VIC 3225
(03) 9683 7382
faggj@anz.com

1. The RBA reforms - credit cards

In credit card networks, interchange fees are agreed between financial institutions that are members of the card schemes and are paid to the card issuer by the merchant's bank. These fees are a way of merchants contributing to the issuer's costs in return for the benefits they derive from being able to accept credit card payments. Credit card acquirers pass interchange fees and their own acquiring costs onto merchants through merchant service fees (MSF). The RBA's case for intervention was that:

- system members did not regularly review interchange fees on the basis of any formal methodologies;
- interchange fees were not cost-justified and there were no incentives for system members to bring these fees into line with costs;
- price signals were encouraging the growth of credit card usage at the expense of lower cost payment instruments, particularly debit cards and direct debits; and
- there were unjustified restrictions on the type of institution that could enter the acquiring or card issuing market.

The RBA reforms comprised:

- a standard for calculating interchange fees (the standard sets out 'eligible costs' that can be included in the interchange fee)
- the removal of the 'no surcharge' rule that prevented merchants from charging customers a fee to recover the costs of accepting credit cards; and
- the implementation of an access regime to remove restrictions on parties other than authorised deposit taking institutions from participating in card issuing or acquiring.

A key objective of the reforms was for credit card pricing to consumers to reflect the underlying, or 'true', cost of providing the credit card.

The RBA did not include closed schemes such as American Express and Diners in the reforms on the basis these schemes issue and acquire their own cards and as such there are no interchange fees that can be regulated under the powers granted to the RBA under the PSRA.

ANZ business response

The RBA eligible costs for the calculation of the interchange fee exclude most of the joint and common costs of running the system itself including statement production and distribution; operating risk capital; risk assessment; payment processing; card plastic (except for lost or stolen cards); core operating systems costs; a return on the cost of capital invested in providing the system; and regulatory and compliance costs.

The result is that these costs are now recovered from cardholders rather than merchants. The reforms required product changes by ANZ that were not popular with affected credit card customers including increasing annual fees for credit cards and reducing the benefits of loyalty programs (and offering more expensive ones).

ANZ offers a full suite of credit cards including a 'plain vanilla' option (low interest rate, low annual fee and no loyalty program). Across the industry there has been an increase in the 'vanilla' products as a result of the reforms. This is consistent with the outcome sought by the RBA:

> In the Bank's view, the cut in reward points, the increase in annual fees and the use of credit card surcharges are important steps towards better aligning relative prices and costs, and thus making the payments system work in the best interest of all its users.[2]

Closed schemes

The closed schemes, because they are outside the interchange reforms, can offer more favourable loyalty programs than credit card issuers. Three-party schemes, particularly Amex, have leveraged this advantage to grow their business via attractive loyalty programs, e.g. *Amex Rewards Maximiser* offers 1.5 points per $1 spend, and the *Qantas Amex* up to 2.5 points per $1 spend. Other card issuers cannot profitably match the unregulated schemes, for example ANZ's *Frequent Flyer Visa* card offers 1.0 points per $1 spend up to $1500 and 1.0 point for $2 spend above $1500 (capped at $5000).

To minimise the impact on rewards programs for most ANZ credit card customers, ANZ adjusted its credit card offerings effective in October 2003 and entered into a commercial arrangement with the unregulated Diners closed scheme for customers seeking a high rewards program. The ANZ Diners Card offers an uncapped 1.0 point per $1 spend, including frequent flyer points. ANZ's alliance with Diners to offer a card with loyalty program is based on sharing any profit or loss created by the co-brand program. No fees are paid between Diners and ANZ and there is no payment similar to interchange – in fact there is no guaranteed payment what so ever, which makes it a very different arrangement to those existing under interchange.

Savings to merchants

Credit interchange fees fell from 95bps average in 2003 to 54bps average in 2005[3]. As a result the Merchant Service Fee (MSF) has fallen significantly with data reported in the PSB Annual Report 2005[4] showing that the average merchant service fee for credit cards in the June quarter 2005 was 0.92 per cent. This compares with 1.40 per cent immediately prior to the

---

[2] Payment System Board (PSB) Annual Report 2005, p15 http://www.rba.gov.au/PublicationsAndResearch/PSBAnnualReports/2005/Html/credit_charge_cards.html
[3] PSB Annual Report 2005, p4
[4] PSB Annual Report 2005, p10

standard on interchange fees becoming effective. It is also considerably lower than merchant fees in most other countries. The PSB concludes that banks have fully passed through to merchants the fall in interchange fees and that over the 12 months to June 2005, merchants' costs were around $580 million[5] lower than they otherwise would have been.

2. The RBA reforms – debit cards

In debit card networks, interchange fees are negotiated bilaterally and are paid by the card issuer to the merchant's bank (the acquirer). These fees arose as a way for acquirers to recoup the costs of debit card infrastructure from card issuers. The payment of fees in this direction is unique to Australia. Elsewhere in the world the fees pass from the merchant to the card issuer, or there are no fees at all.

The RBA was concerned that cardholders face higher effective prices for EFTPOS transactions than they do for Visa Debit or credit card transactions due to the level of interchange fees, despite the EFTPOS system having lower operating costs. The RBA has introduced changes (to be implemented later this year) aimed at achieving more attractive pricing of EFTPOS to cardholders relative to other higher cost payment forms.

Interchange standard - In the October 2000 Joint Study, the RBA argued that it could not see a compelling case for EFTPOS interchange fees in either direction between banks and merchants. The RBA has now imposed a floor and a cap around the interchange fee. The RBA will recalculate the cap every three years based on eligible industry-wide costs of those acquirers that make up 90% of transactions. Interchange fees will be in the range of 4-5 cents paid to the merchant's financial institution compared to the current fee of around 20 cents. The RBA has decided to exempt EFTPOS transactions involving the provision of cash by merchants to cardholders from the benchmark cap. Issuers and acquirers can negotiate a separate interchange fee for these transactions.

ANZ business response

The wholesale EFTPOS Interchange fee paid by ANZ to the merchant's bank will fall to around 4 to 5 cents per transaction. The merchant pays a separate fee for debit card transactions and this will also be affected by the reforms. Some large merchants currently receive a rebate for the large volume of EFTPOS transactions they process. These rebates are currently funded by interchange revenue and are unlikely to be continued as that revenue will no longer be available.

The EFTPOS reforms have been imminent for several years and ANZ had already re-designed and re-priced its transaction accounts, which are market-leading products. The pricing structures of ANZ's two main transaction accounts are designed to be simple for the customer to

[5] PSB Annual Report 2005, p11

understand and do not specifically price for EFTPOS transactions as a stand-alone transaction type. The accounts are as follows:

- ANZ's *Access Advantage* account offers unlimited transactions for a fixed monthly Account Service Fee (i.e. transactions are not charged on an individual basis).
- ANZ's *Access Select*, provides a limited number of "self service" transactions with a significantly lower monthly Account Service Fee. Any additional transaction is priced simply at a flat rate of $0.50 per additional ATM, EFTPOS and telephone transaction (with no charge for Internet and direct debit transactions). ANZ does not plan to introduce complexity to the account's pricing by altering the existing fee structure.

The simplicity of the pricing structure is a competitive selling point for the accounts and ANZ's products are already some of the most competitively priced in the market.

3. The RBA reforms – ATM foreign transactions

In ATM networks, interchange fees are negotiated bilaterally and are paid by the card issuer to the ATM owner. They are designed to reimburse the ATM owner for costs incurred in providing the ATM service to the issuer's customers. Interchange fees are usually passed on to the cardholder when they use another institution's ATM in the form of 'foreign ATM fees'. The RBA objects to the fact that bilaterally negotiated ATM interchange fees appear not to have changed over time, that foreign ATM fees appear too high relative to underlying costs and that they are not transparent to customers. The RBA sought reform of these issues in its October 2000 Joint Study. However, the RBA in November 2005 issued new directions to the ATM industry including asking the industry to develop:

- an access regime;
- a common interchange fee; and to
- remove any barriers to those institutions that wish to direct charge customers.

ATM interchange reform has not been progressed despite several years of concerted industry work on the issues. An ATM Industry Steering Group (AISG), comprising banks, credit unions, building societies and independent ATM owners, was established in 2002 to consider alternative 'direct charging' models for ATM transactions in place of the current system of bilateral arrangements for foreign ATM transactions.

Under a 'direct charging' model the institution that owns the ATM would charge the customer directly for a foreign ATM transaction - the cost would be displayed at the time of the transaction so the customer could choose not to proceed. The issuer would also be able to charge a fee. In this way, the components of the existing foreign ATM fee (issuer fee for processing the transaction and interchange fee to the ATM owner) would be unbundled and charged directly to the customer by the card issuer and ATM owner. The PSB has acknowledged the industry's concern that "where direct charging has been introduced in other countries it has often met with consumer opposition."[6] This is a matter of concern to financial institutions that maintain an on-going customer relationship.

While the industry is continuing genuine attempts to address the RBA's concerns, we are unsure there would be a net public benefit from the introduction of direct charging in Australia or that interchange fees are too high given the rising costs of providing the service. Customers also have the choice of using their own bank's ATM or some other cash out option such as EFTPOS - there are now 518,000 EFTPOS terminals across Australia.

In regard to access, since ATMs were first introduced in 1977 the number of ATMs in Australia has grown from approximately 4,600 in 1990 to more than 21,000 today. Much of the recent growth of ATMs reflects an increase in the number of ATMs operated by Independent ATM Owners (IAOs), which are not financial institutions and do not have cardholders of their own. This suggests a largely open system that in practice has a number of access options for those parties wishing to become an ATM owner/operator. This growth would not have occurred without network reciprocity established by the financial institutions through bilateral interchange arrangements and underpinned by consumer demand for convenient access to cash.

Switch providers have also facilitated the entry of IAOs as the switch facilitates linkages between the IAO and the financial institution. This type of arrangement has also allowed for an increasing number of participants in the market, demonstrating that barriers to entry as an IAO are low.

The RBA has placed the onus of proof on the ATM industry to show that there is not market failure and that there is not a problem with access to the ATM network for new entrants.

There are also a number of challenging technical issues associated with complying with the RBA's direction to remove barriers to direct charging. In the Australian ATM environment, if direct charging is to work, all bank, credit union and building society systems must be reengineered. The industry has scoped out the work that would be required and it is estimated it would take at least 18 months to complete. There are also problems with fee disclosure to customers under the existing requirements of the EFT Code where card issuers (such as banks, credit unions and building societies) who are not in any way involved in the imposition of a direct charge at the ATM are nevertheless held responsible for disclosing the direct charge on customer statements.

The original RBA reforms are based on 1999 data, which is now out-of-date, and the RBA has itself changed its position on what reform might be required, which was announced in November 2005. Now would be a good

[6] PSB Annual Report p31

time for the RBA, in consultation with the various industry and consumer stakeholders, to take a fresh look at ATM interchange reform.

4. Issues arising from the reforms

The following issues have arisen as a result of the reforms. They are included here to demonstrate the need for a merits review mechanism to be a part of RBA payment system decision-making and the need for the planned 2007 review of the reforms to be conducted by an independent reviewer.

4.1 No opportunity for merits review of RBA decisions

Decisions of the RBA in relation to payment systems regulation are subject to a judicial review but not a merits review. Under judicial review the issue is solely whether it is a lawful decision, whereas under merits review the issue is whether a decision is the right one.

Merits review is complementary to judicial review and is the most appropriate form of review where regulatory decisions may impact upon property rights, freedom to contract and revenue streams. As a matter of principle, merits review is widely supported as a feature of regulatory best practice as it adds rigor to the process, imposes greater accountability on regulators and permits the correction of decisions. Implementing a merits review process would be consistent with the findings of the Regulation Review Taskforce that regulated entities should have timely access to third-party review on the merits of key decisions.[7] Specifically:

> Merit review by an independent third party not only enhances the accountability of regulators, it can also promote better decision-making over time and increase business confidence.[8]

4.2 Closed schemes excluded from the reforms

The RBA designation is not competitively neutral as it does not include closed schemes. Excluding Amex and Diners closed (three-party) credit card schemes from the interchange reforms has created an unlevel playing field.

The RBA has required some reform of these schemes including the removal of the 'no surcharge' rule, removal of anti-steering provisions and publishing their average merchant fees and combined market share data. However these have had only a limited impact on the average fees charged by the schemes to merchants. Further, by remaining outside the interchange reforms, the closed schemes can offer more favourable loyalty programs than other credit card issuers.

---

[7] *Rethinking regulation: Report of the Taskforce On Reducing Regulatory Burdens on Business*, January 2006, pvi, http://www.regulationtaskforce.gov.au/finalreport/regulationtaskforce.pdf
[8] op.cit. p163

The closed schemes' market shares continue to grow at the expense of those covered by the RBA regulation. The result is a distortion in the market, evidenced by the 2.3% increase of Amex/Diners share of transaction numbers since the reforms were adopted in October 2003 and a 1.8% increase in their share of transaction dollars. With the total credit card transaction market having approximately $170b in turnover in 2005, a 1.8% movement in market share is approximately $3b in annual turnover. This outcome was not foreseen by the RBA:

> Objections to reform … - that it would give a "free kick" to the relatively smaller, higher cost three party card schemes or that gains to merchants would not be passed onto consumers … is a view that the Reserve Bank does not share.[9]

In relation to the MSF, the Payment System Board in its Annual Report 2005 found:

> … the reforms have put some downward pressure on the average fees that American Express and Diners Club charge merchants although the decline in fees has been less than expected … in the case of American Express it has been around 0.15 to 0.20 of a percentage point to 2.36 per cent, while in the case of Diners Club it has only been around 0.05 of a percentage point to 2.3 per cent.[10]

To ensure a level playing field, the reforms should be made competitively neutral between open and closed schemes.

4.3 Cost methodology for the interchange standard

The RBA has taken a narrow view on which costs can be included in the interchange standard. For example, the standard does not allow for a return on the cost of capital invested in providing the system, which is important to ensure the on-going investment in more efficient technology and security upgrades.

ANZ would be concerned if the review of the reforms in 2007 was used to further eliminate eligible costs such as the interest-free period that is one of the key features of credit cards – the 'buy now, pay later' benefit for the consumer and the 'sell now, be paid now' benefit for the merchant.

4.4 Reforms conceived as a package but implemented separately

The RBA reforms were conceived as a package but were implemented separately - there will be a three-year delay between the credit card and EFTPOS reforms being implemented. This approach has meant that the

---

[9] Reserve Bank of Australia, *Reform of Credit Card schemes in Australia – A consultation document*, December, 2001, p.ix
http://www.rba.gov.au/PaymentsSystem/Reforms/CCSchemes/IAConsultDoc/index.html

[10] PSB Annual Report 2005, p11

impact on the various stakeholders of the credit card reforms has not been offset by the impact of the debit reforms.

5. Suggestions for an improved regulatory process

The following suggestions are offered to the Committee on ways to improve the regulatory process for Australia's payment system:

- Amend the *Payment Systems(Regulation) Act 1998* to include a merits review mechanism for RBA decisions made under the PSRA;
- The planned RBA review in 2007 of the reforms to be done by an independent reviewer;
- The reforms to be made competitively neutral between 'open' and 'closed' card schemes; and
- The RBA should undertake a review of its proposed ATM reforms, in consultation with stakeholders, before proceeding further with reform.