4

The payments system—reforms and other matters

4.1 In recent times the Reserve Bank of Australia (RBA), in its regulatory role, has been particularly keen to ensure that the payments system is both efficient and competitive. According to Dr Philip Lowe, Assistant Governor (Financial System), the RBA has assessed a number of conditions in pursuing the goals of efficiency and competition:

- relative prices reflect the relative resource costs;
- merchants are free to choose the price they charge for accepting payment instruments and are free to choose which instruments they accept;
- prices are transparent;
- restrictions on access are limited to those strictly necessary for the safe operation of the system; and
- there is competition within and between individual payment systems.[1]

4.2 Since 2000, the RBA has determined that the Australian payments system does not meet all of these conditions. Therefore, they have embarked on a series of reforms, which aim to rectify the areas of concern. The reforms have generally focussed on two key areas:

- The promotion of price signals to users of payments services that encourage efficient payment choices … [which] has largely, although not exclusively, involved the regulation of interchange fees; and

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1 Dr P Lowe, *Reform of the Payments System*, Speech to Visa International Members Forum, 2 March 2005.

- The removal of various restrictions in the payments system that effectively limit entry and stifle competition.[2]

4.3 Throughout the early stages of the 41st Parliament, the committee, through its mandate to oversee the activities of the RBA, has taken an interest in the RBA's reforms. Consequently, the committee decided to broaden its biannual review of the RBA to specifically investigate these matters. The committee heard from a number of interested parties—an individual, two academics, and a number of organisations and associations—both at public hearings and via written submissions. Unsurprisingly, the committee's evidence uncovered a wide range of views on the reforms.

4.4 The ensuing discussion will outline some of the key issues surrounding the RBA's reforms, as well highlighting a number of the opposing views the committee heard in its evidence. The committee will also make a number of observations.

2007 review of RBA reforms

4.5 The RBA has indicated that it intends to review its payments system reforms in 2007:

> When the credit card interchange fee reforms were introduced we indicated we would do a review of how things had gone four or five years afterwards. That is what we are planning to do.[3]

4.6 Some groups, however, question the appropriateness of the RBA reviewing its own reforms. They instead suggest that the 2007 review should be conducted by an independent body. For example, the Australian Bankers Association stated:

> The [banking] industry is advocating that the scheduled 2007 review of payment systems reforms is undertaken by an organisation independent of the reform process so far, such as the Productivity Commission.[4]

4.7 Similarly, ANZ Bank argued 'that the planned 2007 RBA review of the reforms be done by an independent body or reviewer.'[5]

2 RBA, *Payments System Board Annual Report 2005,* p. 1.

3 Dr P Lowe, RBA, *Transcript,* 17 February 2006, p. 38.

4 Mr D Bell, ABA, *Transcript,* 15 May 2006, p. 39.

5 Ms J Nash, ANZ Bank, *Transcript,* 16 May 2006, p. 35.

4.8 Mr Peter Mair agreed that an independent review of the payments system is necessary and that the Productivity Commission would be an appropriate group to conduct such a review.[6]

Committee conclusions

4.9 The committee is pleased that the RBA has foreshadowed the 2007 review of its payments system reforms. It is prudent that such significant reforms be reviewed to ascertain whether the objectives have been met.

4.10 The committee believes it is appropriate for the RBA to conduct a review of its own reforms. The RBA is well placed to conduct a review given the expertise it has built up throughout the reform process. The committee does not believe, at this stage, there is a need for an independent review.

Reducing four-party scheme interchange fees

4.11 The RBA stated that its interest in the credit card system stems from:

> The observation that from a cardholder's perspective, credit card transactions are typically priced much more attractively than EFTPOS transactions.[7]

4.12 From the RBA's perspective:

> This appeared to be somewhat paradoxical, given that the EFTPOS system has substantially lower costs of operation than the credit card system.[8]

4.13 The RBA also noted that:

> Cardholders who use credit cards purely as a payment instrument contribute least to the cost of credit card schemes and, in some cases, are effectively paid to use credit cards.[9]

4.14 The concern was that competition between payments providers did not ensure that the lower cost of providing EFTPOS transactions was reflected in a lower price to cardholders for EFTPOS. The lower cost system—

6 Mr P Mair, *Transcript,* 16 May 2006, p. 3.

7 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

8 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

9 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 59.

EFTPOS—actually costs consumers more. The RBA found that 'a major reason for the lower-cost system being offered … at a higher price is the existence of interchange fees.'[10] The RBA therefore sought to regulate and cut interchange fees.

4.15 The reforms, which came into effect from the end of October 2003, involved 'the adoption of an objective, transparent and cost-based benchmark which will be used as a basis for determining interchange fees in credit card schemes.'[11] The cost-based benchmark, which was determined by the RBA separately for each of the four-party schemes—Visa, MasterCard and Bankcard—was based on 'the costs of transaction processing, authorisation, fraud and fraud prevention and funding the interest free period.'[12] The benchmark does not include the costs of rewards schemes.

4.16 The reforms, according to the RBA, have:

- Cut the average interchange fee by around 40 basis points. Now when $100 is spent on a credit card the issuer gets, on average, around 55 cents, rather than around $1. The interchange fee has remained as a percentage of the transaction value.
- Also passed through to merchant service fees. The average fee is now a little under 1 per cent, compared with nearly 1½ per cent in early 2003 and around 1¾ per cent in the late 1990s. [13]
- Saved merchants and their customers around $580 million. [14]

Arguments against the RBA position

Savings have not been passed on to consumers

4.17 There are a number of groups who oppose the RBA's intervention. One aspect of this opposition is the argument that the savings from the reduction in interchange fees have been passed through to merchants, but not through to consumers. Visa, for example, asserted that 'there has been

10 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

11 RBA, *Reform of credit card schemes in Australia*, media release, 27 August 2002.

12 RBA, *Interchange fees for the Bankcard, MasterCard and Visa credit card schemes*, media release, 31 October 2003.

13 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

14 RBA, *Payments System Board Annual Report 2005,* p. 15.

no discernible benefit passed on to consumers from merchants, who are now paying significantly lower merchant service fees.'[15]

4.18 Similarly, the ABA claimed 'there is no evidence that [merchants] have passed those savings on.'[16] MasterCard also argue in similar terms to both Visa and the ABA. In support of their position, MasterCard cited a quantitative study which showed that 'of the 300 merchants … surveyed, the majority were unaware of reduced merchant service fee pricing.'[17]

4.19 When questioned about the purported savings to merchants, the Australian Merchants Payments Forum (AMPF) stated that the savings have 'flowed through' to consumers.[18]

4.20 The Australian Consumers' Association (ACA), in part, agreed with the AMPF, stating 'we have seen consumers benefit through lower prices in some areas.'[19]

4.21 While the RBA acknowledge there is no quantitative proof merchants have passed savings on, they maintained 'there is reason to have confidence that ultimately the lower costs [to merchants] flow through to lower prices … the link between costs and prices is a long one.'[20] Ultimately, the RBA believes merchants have passed savings on.

The removal of restrictive rules would have been sufficient

4.22 Some groups argued that the removal of the no-steering provisions, the honour-all cards rule and the no-surcharge rule would have been a sufficient solution to the RBA's concerns—in other words, they argue interchange fee reform was unnecessary. The ABA, for example, stated:

> If you can improve access so that people can access the system more easily—remove unnecessary restrictions and allow surcharging by merchants—we would ask whether we really need to cost base regulate the interchange fees.[21]

4.23 In response to these claims, the RBA made three points:

> The first is that interchange fees are not subject to normal competition, the second is that the EFTPOS system is a lower cost

15 Mr B Mansfield, Visa, *Transcript*, 15 May 2006, p. 84.
16 Mr D Bell, ABA, *Transcript*, 15 May 2006, p. 46.
17 Mr L Clapham, MasterCard, *Transcript*, 15 May 2006, p. 100.
18 Mr D Howell, Coles Myer, *Transcript*, 15 May 2006, p. 64.
19 Mr P Kell, ACA, *Transcript*, 15 May 2006, p. 77.
20 Dr P Lowe, RBA, *Transcript*, 15 May 2006, p. 9.
21 Mr D Bell, ABA, *Transcript*, 15 May 2006, p. 48.

> system—yet the configuration of interchange fees discourages the use of EFTPOS—and the third is that surcharging was unlikely to become sufficiently commonplace to send the appropriate price signals to card holders.[22]

The costs included in the cost-based methodology are flawed

4.24 The ABA argued that the costs included in the cost-based methodology that the RBA has used to calculate interchange fees are flawed:

> The range of eligible costs allowable by the Reserve Bank is arbitrary and excludes costs that would normally be considered legitimate costs, such as the cost of capital … Without a strong academic underpinning, the cost based methodology used by the Reserve Bank will remain vulnerable to arbitrary change. For the banks this means continued uncertainty.[23]

4.25 While MasterCard agreed that a cost-based approach was the best way to determine interchange fees, they differed with the RBA on what should be 'the component parts of the cost based formula.'[24]

4.26 ANZ Bank were equally critical of the eligible components which make up the cost-based formula:

> Costs of running the system, including statement production and distribution, operating risk capital, risk assessment, payment processing, card plastic, except for lost or stolen cards, core operating system costs and a return on the cost of capital invested in providing the system and regulatory and compliance costs [are] no longer eligible to be recovered from merchants [through interchange fees].[25]

4.27 Against the claims of the four-party card schemes and the banks, the RBA argued that their cost-based approach is 'objective' and 'transparent'.[26]

The effect of the reforms has been 'neutral'

4.28 Prior to the reforms, Professor Joshua Gans argued that the RBA's interchange fee reform would have a 'neutral' effect:

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22 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 41.

23 Mr D Bell, ABA, *Transcript,* 15 May 2006, p. 40.

24 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 106.

25 Ms J Nash, ANZ Bank, *Transcript,* 16 May 2006, p. 34.

26 RBA, *Reform of credit card schemes in Australia,* media release, 27 August 2002.

> What neutrality means is that even were the interchange fee to change dramatically, other prices in the system would adjust (particularly if surcharging was permitted) so that consumers and merchants faced exactly the same decision regarding whether to make use of credit cards or not. For example, a lower interchange fee would tend to lead to increased card fees for consumers (and lower loyalty rewards). However, it would also lead to a lower merchant service fee. So merchants would be more encouraging of consumers to use cards to offset the direct impact of higher fees on those consumers. In the extreme, these changes would balance out and we would see little change in historic patterns of card use.[27]

4.29 In terms of the actual effect of the interchange fee reforms, Professor Gans argued that his hypothesis has largely proven true. He told the committee 'on a causal look at the data, [the] effect does not appear there.'[28] Similarly, Dr Ric Simes argued 'I think we have seen a redistribution within consumers but little net effect on consumers overall.'[29]

4.30 Evidence given by the RBA contradicts the proposition that the reforms have had a neutral effect. They told the committee that the reforms have had a substantial effect—reducing costs for merchants and consumers, and improving price signals for cardholders.

Three-party schemes have been given a competitive advantage

4.31 Both Visa and MasterCard argue that these reforms have given the three-party schemes—American Express and Diners Club—a significant competitive advantage. This issue is discussed in detail below under *Non-designation of three-party schemes*.

Interchange fees should be set at zero

4.32 Both Peter Mair and the AMPF argued that interchange fees should be set at zero, instead of being reduced. This issue is discussed in detail below under *Zero interchange fees.*

Reduced interchange fees result in reduced incentive to invest

4.33 Several groups argued that the reduction in credit card interchange fees has (and will in the future) resulted in less incentive to invest in new

27 Prof J Gans, *Submission no. 2,* p. 2.

28 Prof J Gans, *Submission no. 2,* p. 2.

29 Dr R Simes, *Transcript,* 15 May 2006, p. 33

technology. This issue is discussed in detail below under *Payments system techonology.*

Committee conclusions

4.34 The committee acknowledges there are differing perspectives on the issue of credit card interchange fees. On the one hand, the RBA argues interchange fees must be regulated because they are not subject to competitive forces and they have a pervasive effect on the price cardholders pay. The RBA asserts its reforms have delivered merchants, and consequently consumers, a $580 million saving. They also contend cardholders now face more appropriate price signals when using credit cards.

4.35 On the other hand, those who oppose the reforms—predominantly banks and four-party card schemes—generally argue the RBA's intervention was never actually required. They also disagree with the way in which the RBA has calculated the interchange fee benchmark. Essentially, those who oppose the reforms argue that the RBA has unnecessarily interfered in the credit card market, and there is no proof consumers are any better off.

4.36 The committee is not wholly convinced by either perspective. While there is no proof merchants have passed savings through to consumers, equally, there is no proof they have not passed savings on.

4.37 The committee does, however, have some general observations on credit card interchange fee reform. In terms of the promotion of more appropriate price signals, the committee generally supports the RBA's philosophy. The committee accepts that interchange fees are not set in a highly competitive market and that they have a pervasive influence on the price cardholders pay for payments products. Further, the committee agrees that consumers should not be excessively subsidising credit cardholders' free transactions and reward schemes. This is particularly true given that 45 per cent of consumers do not have credit cards.

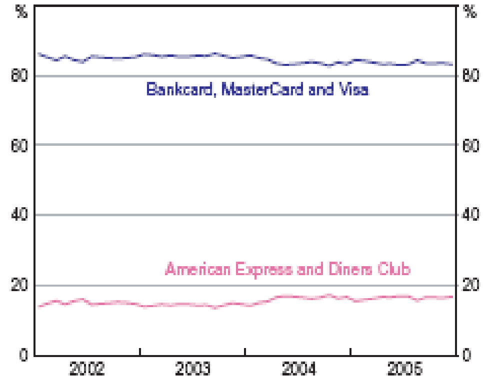
Non-designation of three-party schemes

4.38 As mentioned above, three-party card transactions do not involve interchange fees. Therefore, the three-party schemes have not been subject to the RBA's reform of interchange fees, nor have they been formally subject to any of the RBA's recent reforms. There are concerns that because three-party schemes are not subject to fee regulation, they have a competitive advantage. The RBA stated:

> The fact that this decline in [three-party schemes' merchant] fees has been less than that in the credit card schemes has led to periodic calls for the Bank to regulate American Express and Diners Club in the same way as it regulated the other schemes.[30]

4.39 Furthermore, there has been an evident increase in the three-party schemes' market share following the reforms of four-party schemes' interchange fees. Three-party schemes have increased their share from 14.6 per cent to 16.5 per cent.[31] (see figure 4.1 below)

Figure 4.1 Market shares of card schemes by value of purchases



Source *P Lowe, The evolution and regulation of the payments system, Speech to the Payments System Conference 2006, 14 March 2006.*

4.40 The RBA argues that three- and four-party schemes' different business structures mean that it was 'simply not possible to regulate American Express and Diners Club in the same way, as there were no interchange fees in these schemes.'[32]

4.41 However, American Express credit cards are now issued by two Australian banks, and therefore some American Express transactions now involve interchange fees. The RBA considered whether these fees should be regulated, but decided that there 'was not a strong case to do so.'[33] The RBA's reasoning behind this decision was:

> A reduction in these [interchange fees] through regulation would be unlikely to cause a decline in American Express' merchant fees. This is the contrary of the situation with the credit card schemes

30 RBA, *Payments System Board Annual Report 2005,* p. 15.
31 RBA, *Payments System Board Annual Report 2005,* p. 16.
32 RBA, *Payments System Board Annual Report 2005,* p. 15.
33 RBA, *Payments System Board Annual Report 2005,* p. 16.

> where regulation of interchange fees saw merchant fees decline immediately. This difference reflects the fact that … American Express is the sole acquirer of transactions on its cards. This means that unlike in the credit card schemes, the causation runs from merchant service fees to interchange fees, not the other way around.[34]

4.42 The schemes have, however, agreed to a number of voluntary changes after discussions with the RBA:

> In 2002, they agreed to remove the no surcharge clauses from their merchant contracts and in 2005 to remove anti-steering provisions from their contracts. The schemes have also agreed to publish their average merchant fees and their combined market share.[35]

4.43 The RBA argues that these voluntary reforms have been significant:

> As a result of these changes, merchants now have a greater range of options, and better information, when negotiating with American Express and Diners Club.[36]

Arguments against the RBA position

4.44 Both MasterCard and Visa argued to the committee that the two three-party schemes—American Express and Diners Club—have been advantaged by the regulation of interchange fees. A major concern of the four-party schemes is that three-party schemes' merchant service fees have fallen by much less than their own. MasterCard highlighted this point, stating:

> The average merchant fee payable for a MasterCard or Visa transaction was 0.98% for the December 2005 quarter, down from 1.45% in September 2003 and 1.8% in 1999. In comparison the average merchant fee payable to the unregulated American Express was 2.33% for the same period, down from 2.7% in 1999. The gap between American Express merchant fees and those chargeable for MasterCard, Visa and Bankcard transactions has grown from 0.90% in 1999 to 1.35% in December 2005 or, expressed in a different way, American Express fees are now 138% higher than those applicable to regulated schemes.[37]

34 RBA, *Payments System Board Annual Report 2005,* p. 17.
35 RBA, *Payments System Board Annual Report 2005,* p. 28.
36 RBA, *Payments System Board Annual Report 2005,* p. 28.
37 MasterCard, *Submission no. 5,* p. 3.

4.45 Visa and MasterCard argued that as a result of this difference in merchant fees it is much easier for three-party schemes to offer their cardholders generous rewards, and therefore increase their market shares. Consequently, they argued that American Express and Diners Club have been significantly advantaged.

4.46 Visa and MasterCard argued that the three-party schemes' increase in market share, which some describe as modest, is in fact significant. MasterCard contended:

> The combined share of unregulated schemes grew immediately from 13.7% to 16.9%. This represents a shift of more than $4.5 billion in spend from the regulated to the unregulated schemes—costing merchants an additional $63 million in merchant fees per annum.[38]

4.47 Likewise, Visa asserted:

> According to the RBA's own data, Amex have achieved already around a 20 per cent lift in its market share since the regulations were enacted. Again, a number of submissions presented to the committee identify that this alone is more than a $4.3 billion increase in revenue alone. What is more, it is further $40 million to $50 million increase in merchant service fees, which in some respects are eroding some of the benefits that the merchants have enjoyed from the significantly reduced merchant service fees for Visa and MasterCard.[39]

4.48 Conversely, the RBA asserted that three-party schemes' increase in market share has been small, stating:

> Our assessment to date—and people present the numbers differently—is that the movements in market share are relatively small. So, despite the more generous reward schemes being offered by some of the cards, there has not been a wholesale migration from the four-party schemes to the three-party schemes.[40]

4.49 Professor Joshua Gans also argued that the increase in three-party schemes' market share has been 'slight'. In addition, Professor Gans argued that 'it is not clear [increased market shares for three-party schemes] would not have been happening that way anyway.'[41]

38 MasterCard, *Submission no. 5,* p. 4.
39 Mr B Mansfield, Visa, *Transcript,* 15 May 2006, p. 84.
40 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 54.
41 Professor J Gans, *Transcript,* 15 May 2006, p. 27.

4.50 The RBA has previously conceded that the reform of four-party schemes' interchange fees has not necessarily resulted in competitive neutrality:

> While in an ideal world regulation would be competitively neutral, designing such regulations is problematic when the various card schemes have different structures and are subject to different competitive dynamics.[42]

4.51 However, the RBA also noted that 'if [competitive neutrality] is going to be the pre-eminent principle then we do not have any regulation of interchange fees.'[43] Instead of looking at competitive neutrality as the principle underpinning reform of the payments system, the RBA commented that 'the parliament has said we have to take the public interest into account, and that is really what we have done.'[44]

4.52 When asked at what point they would consider that competitive distortions had outweighed the public benefit, the RBA stated:

> There is no magic point here. The observation that I would make would be that if the market shares of the three-party schemes were to increase significantly and at the same time … there was no reduction in the average merchant service fee of those schemes, then that would raise the issue of whether the competitive positions of the different schemes were starting to undermine the benefits of the reforms. But you would need to see both of those things, because there is nothing wrong with American Express increasing its market share. That may well be the outcome of a competitive marketplace. It would concern us more if we thought that that outcome was the result of the regulatory reforms, and one sign that that could be occurring is if the average merchant service fee that they charge did not fall any further.[45]

4.53 Overall, the RBA's approach to the different structures of three- and four-party cards schemes has been:

> To focus its efforts on those areas where it has judged that competition is not working appropriately. For the credit card schemes this has primarily involved the regulation of interchange fees, while for American Express and Diners Club it has primarily involved ensuring that merchants are not unnecessarily restricted in their negotiations with the schemes. This approach has

42 RBA, *Payments System Board Annual Report 2005*, p. 17.

43 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 54.

44 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 54.

45 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 52.

> delivered significant benefits for consumers, and these benefits are likely to grow through time as merchants use the full range of tools now available to them.[46]

Committee conclusions

4.54 The committee acknowledges that, once again, there are divergent views on this issue. The RBA claims that any advantage to the three-party schemes has been small, which it argues is proven by the relatively modest increase in their market share. Moreover, the RBA claims its reforms are justified on the grounds of a significant public benefit. Conversely, Visa and MasterCard are of the view that Diners Club and American Express have been advantaged by the RBA's reforms. They see the increase in three-party schemes' market share as significant, rather than modest.

4.55 Once again, the committee is not wholly convinced by either side of this argument. The claims of the three- and four-party schemes are, as one would expect, self serving.

4.56 The object of the RBA's reform was to fix the problems it saw within each scheme. The fact is three-party schemes do not have multilaterally set interchange fees, and therefore it is not possible for the two schemes to be regulated in the same way. The RBA was only able to address the problems it saw within each scheme. For three-party schemes the problems were the no steering rule, the no surcharge rule and the publication of merchant fees. For four-party schemes the problem was predominately the collectively set interchange fee.

4.57 The committee acknowledges that three-party schemes have been advantaged when compared to the pre-reform situation. However, it must be remembered that the pre-reform situation was one in which four-party schemes had built a dominant market share operating with centrally set, unregulated interchange fees. The RBA has subsequently found that the operation of a centrally set, unregulated interchange fee is inappropriate—a finding with which this committee generally agrees (see above under reducing four-party scheme interchange fees)—and as such has moved to regulate it.

4.58 One of the effects of this regulation has been to provide some kind of 'advantage' to three-party schemes. However, it is only an advantage when compared to the pre-reform situation—a situation which has subsequently been found to be inappropriate. The other effect of these

46 RBA, *Payments System Board Annual Report 2005*, p. 17.

reforms has been to provide structure and transparency in the setting of interchange fees—fees which are centrally set between organisations that are in direct competition. In the committee's view the latter effect outweighs any alleged advantage.

4.59 In the post-reform situation, if a four-party scheme wishes to offer its customers significant rewards in an effort to compete with three-party schemes, then it can charge its customers high annual fees, just as three-party schemes do. It is true, however, that four-party schemes now have less revenue available from merchants to provide reward schemes. This is because their charges to merchants, which are transferred through interchange fees, are now considerably lower. This actually advantages four-party schemes in some respects. For example, because their product is cheaper for merchants, a lot more merchants accept it. Therefore, in terms of accessibility, their cards are considerably more attractive to consumers. Essentially, the committee believes that the main advantages and disadvantages of each scheme lie within their fundamentally different business structures, not in the RBA's reforms.

Reducing debit card interchange fees

4.60 As noted above, the EFTPOS system has lower operating costs than the credit and scheme debit card systems but costs cardholders more to use. The RBA has attempted to address this imbalance through regulation of credit cards, and have now also introduced changes to the debit card system—both for EFTPOS *and* for scheme debit.

4.61 Prior to the reforms, when a person made a scheme debit card transaction their bank (the issuer) *received* an interchange fee from the acquirer of, on average, 40 cents. Conversely, when a person made an EFTPOS transaction their bank *paid* an interchange fee to the acquirer of, on average, 20 cents.[47]

4.62 These arrangements resulted in a 60 cent interchange fee differential between the two systems. The RBA's concern was:

> The structure of [debit card] interchange fees creates a strong incentive for financial institutions to promote the Visa Debit system over the EFTPOS system, despite the EFTPOS system having lower operating costs.

4.63 The RBA argued:

47 RBA, *Payments system reform,* media release, 24 February 2005.

> If the [debit card] arrangements were to remain unchanged, it is highly likely that the Visa Debit system would grow at the expense of the EFTPOS system, simply because of the structure of interchange fees.[48]

4.64 Consequently, the RBA has initiated changes to interchange fees for both EFTPOS and scheme debit cards. In determining these fees the RBA noted that it used similar methodology to that used in determining credit card benchmarks—nominating eligible costs. Once a benchmark has been determined, average interchange fees are required to be at or below that level.[49]

4.65 The eligible costs for the EFTPOS benchmark, which comes into force on 1 November 2006, are the acquirers' switching and processing costs. While the interchange fee will still flow in the opposite direction to credit and scheme debit cards—from issuer *to* acquirer—the average fee is expected to reduce from an average of 20 cents, to around 4 or 5 cents.[50]

4.66 The eligible costs for the scheme debit card benchmark are the issuer's authorisation and processing costs. This benchmark differs from the credit card benchmark (scheme debit cards having previously been set at the same level as a scheme's credit cards), by removing the costs of fraud and fraud prevention, and funding of the interest free period. Under these new standards, scheme debit card interchange fees are expected to be reduced from an average of 40 cents per transaction, to a flat fee expected to average around 15 cents per transaction.[51]

4.67 These reforms will apply to all EFTPOS transactions, except those involving the provision of cash by merchants to cardholders. With respect to this exclusion, the RBA asserted that:

> At this stage, the Bank is not convinced that the public interest would be served by regulating these fees, particularly when interchange fees for cash withdrawals through ATMs are not subject to regulation. As a result, issuers and acquirers will be able to negotiate a separate interchange fee for EFTPOS transactions involving the provision of cash.[52]

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48 RBA, *Payments system reforms,* media release, 27 April 2006.

49 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

50 RBA, *Payments system reforms,* media release, 27 April 2006.

51 RBA, *Payments system reforms,* media release, 27 April 2006.

52 RBA, *Payments system reforms,* media release, 27 April 2006.

4.68 The scheme debit card standards have not been gazetted as the RBA is allowing Visa and MasterCard an opportunity to voluntarily comply. The standards will be gazetted if, at 1 July 2006, Visa and MasterCard have not provided an undertaking to the RBA that they will voluntarily comply with the changes.[53]

4.69 Overall, the RBA argues that the reform of debit card interchange fees:

> Will promote competition between the schemes based on the benefits that they offer to cardholders and merchants, rather than on fees that are not subject to normal competitive pressures.[54]

Arguments against the RBA position

Lower interchange fees for scheme debit will push people to credit cards

4.70 The Credit Union Industry Association (CUIA) argued that the imminent reduction in scheme debit interchange fees will push people away from debit cards and toward credit cards:

> A cardholder buying a $1000 washing machine with a credit card will earn the card issuer an interchange fee of around $5.50 while a cardholder using a Visa Debit card will earn the card issuer 15 cents.
>
> …
>
> CUIA believes the price signals starkly shown in the above example will push Visa Debit issuers to steer cardholders towards credit cards.[55]
>
> …
>
> We do not necessarily see that as an efficient outcome for the payment system environment, and we certainly do not see it as being in the interests of the credit union membership in Australia overall.[56]

4.71 The ACA shared the concerns of CUIA, stating 'we think [scheme debit changes] have the potential, if things go the wrong way, of driving consumers back to more expensive credit card based transactions.'[57]

53 RBA, *Payments system reforms,* media release, 27 April 2006.

54 RBA, *Payments system reforms,* media release, 27 April 2006.

55 CUIA, *Submission no. 7,* p. 2.

56 Ms L Petschler, CUIA, *Transcript,* 15 May 2006, p. 55.

57 Mr P Kell, ACA, *Transcript,* 15 May 2006, p. 77.

4.72 In response to these claims, the RBA stated:

> One consequence of that narrowing is that, at the margin, building societies and credit unions find it less attractive to issue Visa Debit. At the margin, a few more customers may use credit cards rather than Visa debit as a result of these reforms. But I think the entirety of the package is a set of reforms that will encourage the use of debit relative to credit and it will make sure that the EFTPOS and the Visa Debit systems compete on their merits rather than through interchange fees, which are longstanding and not subject to competitive pressures.[58]

The costs included in the cost-based methodology are flawed

4.73 CUIA agreed that a four-party scheme's credit and debit transactions should have different interchange fees:

> We have agreed from the very beginning that Visa debit should have a distinct interchange fee that should be lower than the credit card interchange fees.[59]

4.74 However, CUIA had concerns as to the level at which the RBA has set scheme debit interchange fees:

> We are unhappy, because we think that, if the Reserve Bank has decided that certain costs—which underpin services to merchants which are of some value to merchants, which is what they have done in the credit card area—deserve to be compensated, why would you arbitrarily decide that Visa debit card issuers' costs do not deserve to be compensated? We think that does not make sense.[60]

4.75 MasterCard shared similar concerns, stating:

> By slashing interchange fees on scheme debit cards and not fully recognising the costs associated with issuing such programs, issuers will be forced to charge card holders higher fees for the privilege of accessing their funds while shopping over the internet, over the phone and with more than 24 million merchants. I think the denial of costs related to fraud reduction seem to be

58 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 48.

59 Ms L Petschler, CUIA, *Transcript,* 15 May 2006, p. 56.

60 Ms L Lawler, CUIA, *Transcript,* 15 May 2006, p. 58.

> counterproductive, particularly in the debit interchange formula that the bank is proposing.[61]

4.76 The RBA, in the debit card reforms' Regulation Impact Statement, defended the level at which scheme debit interchange fees will be set, stating:

> The Bank's approach to interchange fees is not one in which interchange fees are set to recover costs on one side of the system. Rather, the Bank is concerned with the overall effect on the efficiency of the payments system of the configuration of interchange fees across the various individual systems.[62]

Interchange fees should be set at zero

4.77 Both Peter Mair and the AMPF argued that interchange fees should be set at zero, instead of being reduced. This issue is discussed in detail below under *Zero interchange fees.*

Reduced interchange fees result in reduced incentive to invest

4.78 Several groups argued that the reduction in debit card interchange fees will in the future result in less incentive to invest in new technology. This issue is discussed in detail below under *Payments system techonology.*

Committee conclusions

4.79 The committee has found that there is little resistance to the lowered interchange fee for EFTPOS transactions. While merchants initially challenged the reform in the Federal Court, they came to the committee with a new perspective—zero interchange fees—which will be discussed below.

4.80 There is more resistance to the reduction in interchange fees for scheme debit transactions. The major objections came from the Credit Unions, who issue most of the scheme debit cards in Australia, as well as Visa and MasterCard. They essentially argued that reducing interchange fees would push scheme debit cards out of the market and push people toward credit cards. Conversely, the RBA argues that its reforms are necessary to promote more appropriate price signals between the two debit products.

61 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 102.

62 RBA, *Reform of the EFTPOS and Visa Debit systems in Australia: Final Reforms and Regulation Impact Statement,* April 2006, p. 28.

4.81 The committee once again recognises that interchange fees have a strong influence on the fees cardholders are charged. Therefore, the committee considers that it appropriate for the RBA to regulate when interchange fees are causing distorted price signals. Indeed, the Credit Unions have agreed that scheme debit interchange fees should be lower than credit card interchange fees—they simply differ with the RBA on where it should be set.

4.82 At this point, the committee suggests there is no evidence as to the appropriateness of the level at which interchange fees have been set for the two debit products. Further, there is no evidence as to whether scheme debit customers will be drawn to use credit cards. Given that at the time of writing these reforms were not yet implemented, the committee feels that it would be premature to make any assessments. This issue should be closely scrutinised as part of any future review.

Are interchange fees unlawful?

4.83 Throughout the committee hearings and submissions there was debate over the legality of the four-party card schemes' multilateral interchange fees.

4.84 The submission of American Express contended:

> The multilateral interchange fees (MIF), which are a feature of the MasterCard and Visa card schemes in all countries, have been found by competition regulators in other countries to be unlawful anti-competitive agreements. [63]

4.85 In rebuttal of this claim, Visa stated:

> Regulators in the UK and Australia have expressed concern about the way interchange operates and the level of the interchange fee. They have subsequently either required or negotiated changes to the process of setting interchange fees. However, none of these regulators have found interchange fees to be illegal under any aspect of competition law.[64]

4.86 In similar terms, MasterCard maintained 'interchange fees have not been found to be illegal in any country in the world'.[65]

63 American Express, *Submission no. 6,* p. 14.

64 Visa, *Submission no. 23,* p. 5.

65 Mr A Naffah, MasterCard, *Transcript,* 15 May 2006, p. 103.

4.87 The Australian Competition and Consumer Commission (ACCC) confirmed to the committee that the setting of four-party schemes' interchange fees was thought to be in breach of the *Trade Practices Act*:

> The way the fees were set was the issue.[66]
>
> …
>
> There was a multilateral agreement between banks whereby they would set an interchange fee which had the effect or likely effect of controlling or maintaining the merchant service fee levels.[67]

4.88 However, the ACCC also stated:

> We did not have necessarily a problem with the interchange fee system as such and that there were potential public benefits that could result from a proper system being devised.[68]

4.89 Given this statement, the ACCC 'encouraged the banks to approach [them] for authorisation of an interchange fee system.'[69] However, in 2001 the ACCC concluded that an authorisation was not likely to occur:

> It was the Commission's view that effective and timely reform of the interchange fee system was not occurring. We therefore recommended that the Reserve Bank actually designate and use its powers to reform the system.[70]

4.90 The ACCC formed a view that 'the designation process of the Reserve Bank is a more direct and potentially more effective way of achieving [interchange fee reform].'[71]

4.91 Once the RBA designated under the *Payments System (Regulation) Act 1998,* the *Trade Practices Act 1974* ceased to apply to four-party schemes:

> Following the designation of those services by the Reserve Bank, the arrangements behind the interchange regime in relation to both credit and debit card systems fall outside the scope of the competitive provisions of the TPA and, accordingly, fall outside the scope of our enforcement and compliance activities.[72]

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66 Mr J Dimasi, ACCC, *Transcript,* 15 June 2006, p. 7.

67 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

68 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

69 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

70 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

71 Mr J Dimasi, ACCC, *Transcript,* 15 June 2006, p. 7.

72 Mr J Dimasi, ACCC, *Transcript,* 15 June 2006, p. 7. Under section 18A of the *Payments System (Regulation) Act 1998,* any actions involved in complying with Standards set under the Act are exempt from the provisions of the *Trade Practices Act 1974.*

Committee conclusions

4.92 The committee notes that four-party schemes' interchange fees, prior to designation, may have been in breach of the *Trade Practices Act.* However, now that the schemes have been designated under the *Payments System (Regulation) Act*, and interchange fee standards have been set, four-party schemes' interchange fees are regarded as lawful by both the RBA and the ACCC.

Zero interchange fees

4.93 At the committee's hearings both the AMPF and Mr Peter Mair proposed that Australia move to zero interchange fees for all payments systems.

Arguments for zero interchange fees

4.94 The AMPF stated that 'having zero interchange fees would remove any distortion in the payments system and may well avoid a swing to credit cards.'[73]

4.95 Mr Peter Mair argued that interchange fees are only necessary in infant systems:

> There may be a case for having an interchange fee in the early stages of setting up a payments network but, for a mature payments network like credit cards, BPay or EFTPOS, there is no longer any need for that.[74]

4.96 Some of the other proposed benefits of zero interchange fees are:

- Cardholders would be presented with true price signals for each product.
- Zero interchange fees would mean that cardholders are bearing costs, not consumers generally.

4.97 The RBA, while not necessarily supporting the concept, commented:

> It is an interesting idea and worth further exploration. Of course, we already have zero interchange fees in a number of our payment systems in Australia. In the cheque system there is no interchange fee, in the direct debiting system there is no interchange fee and in

73 Mr R Zimmerman, AMPF, *Transcript*, 15 May 2006, p. 63.

74 Mr P Mair, *Transcript,* 16 May 2006, p. 10.

> the direct crediting system there is no interchange fee. Zero interchange fees exist in some very successful debit card systems around the world.[75]

4.98 Interestingly, a recent report of the European Commission found that 'interchange fees are not intrinsic to the operation of card payment systems, as several national systems operate without an interchange fee mechanism.'[76]

Arguments against zero interchange fees

4.99 A number of groups were either opposed, or raised arguments against, zero interchange fees. The RBA, for example, stated:

> There are solid theoretical arguments as to why non-zero interchange fees might promote the efficiency of the system. There is a large and growing volume of academic literature exploring the rationale for non-zero interchange fees. Many of the points in that literature have merit.[77]

4.100 ANZ Bank commented on the implications of zero interchange fees for cardholders, stating:

> Zero interchange would mean credit card holders would likely face increased annual fees, increased interest rates, reduced or no interest-free period (which delivers benefits to card holders and merchants) and curtailed or no loyalty programs.[78]

4.101 CUIA criticised the proposal as an attempt from merchants to escape contributing to the cost of issuing credit cards, asserting:

> By seeking zero interchange fees, merchants are asking cardholders to pay for services provided by card issuers that benefit merchants. CUIA believes merchants should pay for services that benefit merchants.[79]

4.102 MasterCard considered that zero interchange would not respect past and future investment in networks, arguing:

> I do not believe it respects the investment that has gone into building the network both domestically and globally by

75 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 43.
76 European Commission, *Interim report I: Payments cards,* 12 April 2006, p. 32.
77 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 43.
78 ANK Bank, *Submission no. 17,* p. 2.
79 CUIA, *Submission no. 18,* p. 2.

> MasterCard and our customers. So I think it is highly inappropriate.[80]

4.103 Visa commented on the likely effect of zero interchange on innovation and technology:

> If card schemes such as Visa International were compelled to set the interchange fee at zero, they would be prevented from addressing the investment incentive problem on the issuer side. Cardholders would need to pay the full cost of card innovation even though it is clear that many of these innovations in cards provide substantial benefits to merchants, particularly innovations in the area of security and anti-fraud measures.[81]

4.104 Visa also commented on the likely effect on its business:

> If the current Visa International interchange fee were reduced to 0 while the implicit MIF embodied in the merchant service fee that American Express charges its merchants was unregulated, the potential pool of funds for investing in the cultivation of cardholder membership would be cut by millions of dollars each year. For these issuers the prospect of issuing American Express cards would become relatively more attractive than issuing VISA cards, leading them to promote issuing of American Express payment cards at the expense of Visa International. [82]

4.105 Another argument against zero interchange is that it would result in less incentive to invest in new technology. This issue is discussed below under *Payments system technology.*

Committee conclusions

4.106 The committee is of the view that while the concept of zero interchange fees is an interesting one, it would require intense examination before being considered in the context of the Australian payments system. Reducing interchange fees to zero would have the greatest impact on four-party scheme credit cards—debit cards interchange fees will be near to zero when the reforms come into effect. If credit card interchange fees were moved to zero, the committee believes that there would be two direct consequences:

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80 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 110.

81 Visa, *Submission no. 23,* p. 8.

82 Visa, *Submission no. 23,* p. 8.

- Issuers would need to recoup all of their costs from cardholders. Therefore, the prices paid by cardholders would increase; and
- Merchants' costs would be reduced because the merchant service fees, which are largely determined by interchange fees, would fall.

4.107 Those who are in favour of zero interchange fees support both of these outcomes. They argue that cardholders should bear the costs of issuing a credit card, not merchants.

4.108 It is true that any credit card interchange costs that are imposed on merchants result in higher prices for goods and services, and are therefore paid by all consumers, irrespective of whether they use credit cards. However, it is also true that all payment instruments incur a cost for merchants. There are costs for merchants in accepting cash, which, as with merchants' (who do not surcharge) interchange costs, are blended into the price of goods and services. The committee is not concerned that *some* of the costs of issuing credit cards are, in effect, paid by all consumers, just as the costs of merchants accepting cash, and any other payment product, are paid by all consumers. Under the old credit card interchange fee arrangements, merchants and consumers were effectively paying *all* of the costs. Under the current arrangements these costs are more evenly shared.

4.109 The committee notes that if surcharging were to be adopted by all businesses it would have the same effect as zero interchange fees—cardholders would be bearing all of the issuers' costs. While the committee supports the right of merchants to surcharge—a right they now have with all payment instruments—the committee doubts that surcharging will ever be common practice, as is explained below.

Removing the 'no surcharge' rule

4.110 According to the RBA the no surcharge rule:

> Prevents merchants from passing merchant service fees onto customers who choose to use credit cards. Merchants therefore face an 'all or nothing' choice—accept credit cards and absorb the merchant service fees into their overall cost structure, or refuse to accept credit cards at all.[83]

4.111 The RBA argues that:

83 RBA, *Standard on merchant pricing*, media release, December 2002.

> [Merchants'] ability to resist credit cards has been increasingly eroded as consumers respond to current price incentives by increasing the take-up of credit cards and demanding to make more and more use of them. Merchants have only limited negotiating power to put pressure on merchant service fees and indirectly, interchange fees.[84]

4.112 Therefore, the RBA, as of 1 January 2003, has required that four-party credit card schemes remove the no surcharge rule. Since this change, the RBA notes that:

- There has been charging in a wide range of industries, although the vast majority of merchants still do not charge.
- There have been some high-profile examples of large merchants surcharging, but surcharging has also become quite common amongst small firms operating in very competitive low-margin businesses—computer shops, removalists and carpet layers for example.
- In some cases the ability to levy a charge has actually led merchants to introduce credit cards as a payment option. Previously these cards were simply too expensive, so they were not offered.[85]

4.113 While not falling under the RBA's regulation, the three-party schemes—American Express and Diners Club—voluntarily agreed to comply with the removal of the no surcharge rule.[86] The removal of the no surcharge rule also already applies in practice to the Visa and MasterCard debit cards, although discussions are ongoing with these schemes as to whether its formal removal will be made voluntarily, or through the determination of standards by the RBA.

4.114 Overall, the RBA is highly supportive of merchants' right to surcharge. In fact, the RBA is so supportive of surcharging that the Governor of the RBA, Mr Ian McFarlane, stated 'we think [merchants] are acting in the national interest when they [surcharge].'[87]

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84 RBA, *Standard on merchant pricing*, media release, December 2002.

85 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

86 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* RBA, Sydney, August 2002, p. 33.

87 Mr I McFarlane, RBA, *Transcript,* 17 February 2006, p. 37.

Arguments against the RBA position

4.115 The committee did not hear a great deal of evidence which completely opposed the removal of the no surcharge rule. Visa, however, opposed the removal of the rule in part stating 'it is inappropriate to permit surcharging where interchange fees are strictly regulated.'[88]

4.116 Other groups were supportive of the rule's removal. Diners Club, for example, stated:

> We regard surcharging as an issue between the retailer and the customer, not between the retailer and us. If the retailer believes that it is positive for their relationship with their customer to negate and refuse their payment choice, then that is what the retailer should do.[89]

4.117 Similarly, CUIA stated:

> We have accepted the argument to remove the no-surcharge rule. If retailers want to directly recoup the costs of accepting a particular payment instrument they should be able to.[90]

4.118 However, there was evidence about concerns that the right to surcharge was being abused. For example, Visa asserted:

> Merchants are allowed to surcharge whatever amount they want, with no reference to what it costs them to accept the card. There is no cap on surcharging.[91]

4.119 A number of groups therefore commented that the surcharge should be capped at the merchants' costs. MasterCard, for example, stated:

> MasterCard believes that these protections should include amongst other things a requirement that any surcharge applied by a merchant should not exceed the actual merchant fee and associated costs incurred by that merchant for accepting a credit card payment.[92]

4.120 On the possibility of capping surcharges, the RBA stated:

> The credit card standard says that the acquirer may come to an agreement that the surcharge is to be no greater than the merchant service fee. The standard specifically allows that possibility. The

88 Mr B Mansfield, Visa, *Transcript,* 15 May 2006, p. 85.

89 Mr M McDonald, Diners Club, *Transcript,* 16 May 2006, pp. 15–16.

90 Ms L Lawler, CUIA, *Transcript,* 15 May 2006, p. 58.

91 Mr B Mansfield, Visa, *Transcript,* 15 May 2006, p. 85.

92 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 101.

> Reserve Bank, though, does not have the legislative power to say to the merchants of this country, 'You may not charge more than X for accepting a payment instrument.' That is beyond the scope of the power that the parliament has given the Reserve Bank. That is not something that the Payments System Board could do. It would have to be an initiative of government to pass relevant legislation.[93]

Committee conclusions

4.121 The committee believes that merchants should, in principle, have a right to surcharge, particularly when they are faced with significantly different prices for different payments products. The no surcharge restrictions only applied to credit and charge card transactions—merchants were always allowed to surcharge for all other payment products, including cash, debit cards, cheques and BPAY. These reforms bring all payments products into line.

4.122 However, the committee notes that surcharging has not yet become commonplace, particularly in highly competitive industries. Unsurprisingly, the committee heard that surcharging has only become common in industries where organisations have market dominance. While the committee is supportive of the rights of merchants to surcharge, the committee doubts whether surcharging will ever become widespread. Many merchants actually prefer being paid by card and therefore would not want to discourage its use by surcharging.

4.123 The committee was concerned by evidence which suggested that some merchants are profiteering from the ability to surcharge. While the committee notes proposals for surcharges to be capped at a merchant's costs, it does not believe a cap would be entirely effective. Surcharging—and in particular excessive surcharging—occurs in markets not subject to high levels of competition. If merchants in these markets want to charge excessively, they could simply do so through the prices of goods and services. If surcharges were to be capped, it is possible that other prices would rise to compensate for the lost revenue.

Removing the 'honour all cards rule'

4.124 The honour all cards rule imposed by Visa has meant 'merchants that accept Visa credit cards are also required, by Visa, to accept Visa Debit

93 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 47.

cards.'[94] The RBA argued that this rule meant that 'normal competitive pressures [could not] bear upon the price or acceptance of Visa Debit cards.'[95]

4.125 Therefore, the RBA developed the Honour All Cards standard, which:

> Requires that this tying of acceptance of Visa credit and debit cards be removed by Visa. It also requires that Visa Debit cards be identified both visually and electronically to allow merchants to decline acceptance if they so choose.

4.126 These standards only refer to Visa's debit product; however, MasterCard—who are new to the scheme debit business in Australia—has given an undertaking that they will comply. As with the changes to scheme debit interchange fees, Visa and MasterCard are being given an opportunity to voluntarily comply with the standard.[96]

Arguments against the RBA position

4.127 Several groups argued strongly against the removal of this rule. CUIA, for example, stated:

> In our view, the removal of 'honour all cards' at this stage was unnecessary because of the quite aggressive interchange fee reform that the Standard already proposes and because of the introduction of surcharging on the Visa debit product. Our argument is that those very strong reforms to the Visa debit product and the potential uncertainty around the acceptance of the card place our credit union and the 1.2 million credit union members who have Visa debit cards as their primary access point at risk of a potential threat that is unwarranted at this stage.[97]

4.128 Visa shared similar concerns, asserting:

> We believe that this is fundamentally bad policy. It is bad because it gives merchants the right to discriminate and limit consumer choices. It is bad because the people who will be hurt by this proposed new regulation are the four million Visa debit card holders, most of whom are the low- and middle-income earners of today or the children of parents who do not want their kids to have access to credit cards but who recognise there is an increasing need

94 RBA, *Payments system reforms,* media release, 27 April 2006.

95 RBA, *Payments system reforms,* media release, 27 April 2006.

96 RBA, *Payments system reforms,* media release, 27 April 2006.

97 Ms L Petschler, CUIA, *Transcript,* 15 May 2006, p. 54.

> for such cards to be part of their kids' daily lives. It's bad also because any harm suffered will fall disproportionately on the smaller financial institutions—the building societies and credit unions, which fundamentally issue the majority of those four million Visa debit cards that are in circulation today.

4.129 The AMPF, however, agreed with the RBA's perspective, stating:

> The issue about the honour-all-cards rule is that at least it now allows market forces and the merchants to decide. Until now our hands were tied behind our backs and we had no choice.[98]

Committee conclusions

4.130 The committee notes that there is differing opinion on this reform. The RBA argues that scheme debit cards and credit cards are fundamentally different products and therefore their acceptance should not be tied. Those who oppose the reform generally argue that it was unnecessary given the changes to scheme debit card interchange fees and the introduction of surcharging. They also argue that the reform will unnecessarily affect small institutions—credit unions and building societies—and scheme debit cardholders.

4.131 The committee does not believe that removing this rule will see widespread non-acceptance of scheme debit cards by merchants. Once the debit card interchange fee reforms are introduced, there will only be a small difference between the prices merchants pay for scheme debit and EFTPOS transactions. Therefore, the committee believes in competitive markets it would be unlikely that merchants would not accept scheme debit cards. The RBA should consider the impact of removing the honour all cards rule as part of its 2007 review.

Payments system technology

4.132 There was general consensus that Australia was once at the forefront of payments technology, but that it has subsequently fallen behind. Primarily, there was discussion about chip technology for all cards, and PIN technology for credit cards. There was also debate as to why EFTPOS cards do not offer the internet or over-the-phone functionality that credit cards do.

98 Ms D Karai, Woolworths, *Transcript,* 15 May 2006, p. 65.

Where has Australia fallen behind?

PIN-based credit cards

4.133 As outlined in chapter 3, credit card authorisation is signature-based, not PIN-based. It was noted during evidence that many countries around the world have moved to PIN-based authorisation. It was also noted that PIN-based systems are much more resistant to fraud.

4.134 Concerns were raised that Australians' signature-based cards may, at some point, become unusable in certain countries.

4.135 The AMPF told the committee that the capability to move to PIN-based credit cards has existed in Australia 'for 20 years'.[99]

Online EFTPOS

4.136 In Australia it is not possible to use EFTPOS cards over the internet or phone to make 'card not present' transactions. The RBA commented on this issue, stating:

> In some other countries you can essentially use your EFTPOS card to do that: you can go in on the website and it will take you back to your bank's website, where you type in your PIN number, and you can pay for that online transaction through a method other than credit cards.
>
> …
>
> There are many customers who do not like that and, as I said before, only 55 per cent of adult Australians have a credit card, so they are excluded from those sorts of transactions.[100]

4.137 The ACA commented on the desirability of having an online EFTPOS functionality.[101]

Chip technology

4.138 There was also some discussion of chip technology or 'EMV' (acronym for Europay, MasterCard and Visa) as it is also known. According to a report in *the Australian*, 'EMV compliant cards offer greater security against skimming, or copying the contents of a card's magnetic strip.' Further, the

99 Mr R Tweedle, Woolworths, *Transcript,* 15 May 2006, p. 76.

100 Dr P Lowe, RBA, *Transcript*, 15 May 2006, p. 18.

101 Mr P Kell, ACA, *Transcript*, 15 May 2006, p. 78.

article reports that 'Visa says this technology makes it almost impossible for a criminal to steal information to create counterfeit cards.'[102]

4.139 According to Visa's website, chip technology is already in widespread use:

> In Asia Pacific there are currently over 32 million Visa chip cards, which can be used in 750,000 chip terminals in 14 countries—Australia, Cambodia, HK, India, Japan, Korea, Malaysia, Maldives, NZ, Pakistan, Taiwan, Thailand, Vietnam, Singapore. Smart cards can be used at merchant locations worldwide and on the Internet.[103]

Why has Australia fallen behind?

The move to new technology is a cost-benefit proposition

4.140 During evidence the committee heard on numerous occasions that the move to new technology is a cost-benefit proposition—to justify any upgrade in technology the cost of fraud must be more than the cost of upgrading. Diners Club, for example, stated:

> Australia, as part of the wider global organisation, has obviously looked at chip and PIN based systems. The drivers of that are economic and a little bit political. The economics are the point at which your share of the cost to change the terminal fleet is roughly equal to the fraud that you are incurring or avoiding. That is the point at which you start to get interested in bearing, as I say, your share of replacing the terminal fleet.[104]

4.141 Similarly, the RBA stated:

> When we talked to the banks about why the upgrade to chip and PIN had not occurred in Australia, the answer has been that there is not a business case to do so. The argument has been that Australia already has very low levels of credit card fraud—we heard that again this morning—and there are few cost savings to be gained, at least at the moment, from the introduction of PIN on credit cards. As a result, in terms of fraud reduction, the investment simply did not pass the cost-benefit tests.[105]

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102 K Mills, 'Smartcard surge tipped', *The Australian*, 16 May 2006.

103 Visa, *Chip Technology*, viewed 18 June 2006, <http://www.visa-asia.com/ap/au/cardholders/security/chip_technology.shtml?#What_are_smart_cards>.

104 Mr M McDonald, *Transcript*, 16 May 2006, p. 21.

105 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 42.

Less interchange revenue means less incentive to invest

4.142 A number of groups told the committee that because there is less money in the system from the reduction in interchange fees, there is less incentive to invest in new technology. Visa, for example, argued:

> That the regulation is also contrary to good policy principles because it dampens incentives to invest by not allowing flexibility or the ability to obtain an adequate return on investment.[106]

4.143 Dr Ric Simes agreed that there is a connection between interchange revenue and investment, asserting:

> I find it hard to accept that the revenue stream going into a particular activity does not affect the types of innovation or investment decision making on that side of the market.[107]

4.144 Conversely, the RBA dismissed the connection between lower interchange fees and the incentive to invest, stating:

> The example that is most commonly cited is the lack of PIN and chip functionality on credit cards. In our view this has nothing to do with interchange fees. I note here that this chip and PIN functionality does not exist in the United States, where interchange fees are over three times higher than they are in Australia. In some other countries chip and PIN exist on debit cards where there are no interchange fees at all. I think the relationship between interchange fees and the decision to invest in chip and PIN is very weak. Ultimately, innovation is financed through revenue earned from fees charged to card holders and merchants. The RBA has not regulated these fees at all.[108]

4.145 The RBA also asserted:

> The RBA over a long period have stated that around 80 per cent of the costs of upgrading to chip and PIN fall on the acquiring side of the market and not on the card-issuing side. This is because most of the main costs in moving to chip and PIN involve the updating of merchants' terminals rather than the reissue of cards. Given the costs fall mainly on the acquiring side, I find it puzzling that people have argued that reducing interchange fees paid by the

106 Visa, *Submission no. 4*, p. 3.

107 Dr R Simes, *Transcript,* 15 May 2006, p. 34.

108 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 42.

> acquirer to the issuer has in fact reduced the incentive for acquirers to upgrade their systems.[109]

4.146 ANZ Bank agreed that there is not necessarily a connection between investment and interchange fees, stating:

> In terms of why Australia has not rolled out chip technology when a number of countries around the world have, I would not say that that is directly related to interchange fees.[110]

Committee conclusions

4.147 The committee is concerned by the seemingly consensus view that Australia has fallen well behind in terms of payments system technology. In evidence, the committee heard that the reduction in issuers' interchange revenue was one of the reasons this has occurred. The committee does not accept this proposition. In the US, technology is even further behind but interchange revenues are three times as high. Conversely, technology is more advanced in some debit systems where interchange fees are zero.

4.148 The committee is particularly concerned that Australian credit cards still rely on signature-based, rather than PIN-based, authorisation. While credit card fraud is comparatively low in Australia, this does not mean steps should not be taken to prevent it. The committee considers that a move to PIN-based authorisation would be highly desirable in terms of fraud prevention. In addition, PIN-based authorisation would ensure that Australians' credit cards remain functional in overseas markets where PIN-based authorisation has been adopted.

4.149 The committee is also concerned that EFTPOS cards do not offer the same functionalities as credit cards or scheme debit cards—online and over-the-phone purchasing. The RBA noted in evidence that in other countries EFTPOS cards do offer these functionalities. Given that a significant proportion of Australians do not have a credit or scheme debit card, it seems they are excluded from the convenience of extra functionalities without good reason.

4.150 The committee notes the future importance of chip technology. The committee is of the view that its widespread introduction in the Australian payments system would be beneficial in terms of reducing fraud.

109 Dr P Lowe, RBA, *Transcript*, 16 May 2006, pp. 42–43.

110 Dr J Fagg, ANZ Bank, *Transcript*, 16 May 2006, p. 39.

Recommendation 1

4.151 **The committee recommends that card schemes, issuers, acquirers and merchants work together to improve Australia's payments system technology. In particular, the committee recommends that this partnership:**

- **Implements PIN-based authorisations for credit cards;**
- **Implements 'online' functionality for EFTPOS cards; and**
- **Considers the widespread adoption of chip technology.**

Other reforms

4.152 There are a number of areas of reform or areas where there is proposed reform, which are less controversial and which were less prevalent in the committee's evidence. These topics are outlined below.

Improving interchange fee transparency

4.153 The RBA has argued that 'prior to [our] investigation, the level of interchange fees and merchant service fees were sometimes seen as close to state secrets.'[111] As part of their reforms, the RBA required more transparency and disclosure of interchange fees, merchant service fees and market shares.[112]

4.154 These changes, according to the RBA, 'have helped improve understanding of the credit card market and given merchants better information when negotiating with their banks.'[113]

Introducing a standard benchmark for four-party scheme interchange fees

4.155 Following the introduction of the initial interchange fee reforms there was around 2 basis points difference between the two major credit card

111 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

112 RBA, *Payments System Board Annual Report 2005,* p. 9.

113 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

schemes' average interchange fee benchmarks. According to the RBA, this disparity partly resulted from:

> Differences in authorisation and processing costs across issuers as well as differences in the average cost of the interest-free period due to issuers having different portfolios of cardholders.[114]

4.156 The RBA determined that having a higher interchange fee provided one scheme with a competitive advantage over others. As the RBA noted:

> This difference, while small, may be encouraging credit card issuers to issue cards under the scheme with the higher interchange fee simply to receive more interchange revenue for each dollar spent by cardholders.[115]

4.157 Consequently, the RBA, instead of having a benchmark for each scheme based on their individual costs, has introduced a common benchmark to apply to all four-party card schemes. Under these changes, which are to apply from 1 November 2006, 'the weighted-average interchange fee in each of these … schemes must be no greater than a common benchmark.' The RBA will recalculate the benchmark every three years.[116]

Removing restrictions on access to four-party schemes

4.158 The RBA believed that credit card schemes were imposing unnecessary restrictions, which limited new entrants into the schemes. The RBA stated:

> Each scheme in Australia imposes minimum entry standards that are intended to ensure the safety of the scheme, but have the effect of unduly limiting competition.[117]

4.159 In particular, the RBA was concerned that:

- Only authorised deposit-taking institutions supervised by the Australian Prudential Regulation Authority (APRA) were eligible for participation.
- Two of the schemes prohibited their members from acting only as acquirers and two schemes have penalties for members whose business is weighted heavily towards acquiring rather than issuing.[118]

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114 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

115 RBA, *Payments system reform,* media release, 20 July 2005.

116 RBA, *Payments System Board – November 2005,* media release, 25 November 2005.

117 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* p. 6.

118 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* p. 7.

4.160 The RBA argued that these penalties and restrictions:

> Discourage the participation of specialist credit card acquirers which could promote competition in the acquiring market and strengthen the representation of acquiring interests in the process of setting interchange fees.[119]

4.161 The RBA therefore introduced a new access regime that:

> Requires that specialist credit card institutions supervised by the Australian Prudential Regulation Authority (APRA) be eligible to apply for membership in the designated credit card schemes on the same basis as other authorised deposit-taking institutions. It also requires the removal of certain restrictions and penalties on the credit card acquiring activity of members. [120]

4.162 The access regime applies to Visa's and MasterCard's credit cards (and also applied to Bankcard, until the recent revocation of its designation—see below). Visa's debit products are subject to a separate formal access regime although it 'is largely the same as that imposed on the … credit card system.'[121]

Removing restrictions on access to the EFTPOS network

4.163 In 2000 the joint study of the RBA and ACCC determined:

> Access to the debit card network through a series of bilateral agreements can put both new issuers and acquirers at a competitive disadvantage, because they may need to use more expensive gateway arrangements.[122]

4.164 The RBA has also noted Australia's unique EFTPOS access arrangements:

> Typically, in other countries, there is a single point of entry to the system for new participants, who must meet a single set of technical criteria and business requirements. Where there are entry fees, these fees are usually known in advance and, where there are interchange fees, they generally apply uniformly to all participants. In contrast, in Australia, the system is built around a series of

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119 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement*, p. 7.

120 RBA, *Reform of credit card schemes in Australia – access regime*, media release, 23 February 2004.

121 RBA, *Payments System Board decisions*, media release, 22 August 2005.

122 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 71.

> bilateral connections and there is much less standardisation of the terms of access.[123]

4.165 The RBA raised three specific concerns about access to the Australian EFTPOS network:

- A new participant wanting to establish direct connections must separately approach each of the existing eight participants with direct connections to negotiate the technical and business arrangements for exchanging EFTPOS transactions;
- Existing direct connectors have little incentive to facilitate the entry of a new participant, particularly when the entrant is likely to be a direct competitor in at least some business lines; and
- An existing participant might be unwilling to agree to an interchange fee that is similar to the fee paid to, or received from, existing participants. [124]

4.166 As a result of these concerns, the RBA and Australian Payments Clearing Association (APCA) have undertaken a co-regulatory approach to reforming EFTPOS access, through the APCA's 'access code' and the RBA's 'access regime'. According to the RBA, the APCA code will:

> For the first time, provide new and existing participants the right to establish direct connections with participants in the EFTPOS system, and require that existing participants establish such connections within a specified time frame.[125]

4.167 Further, the RBA states that its own access regime will:

> Place a cap on the price that can be charged by existing participants to establish these connections, and it also contains provisions that ensure that negotiations over interchange fees cannot be used to frustrate entry.[126]

123 RBA, *Reforms of debit card systems in Australia: A consultation document,* RBA, Sydney, December 2005, p. 3

124 RBA, *Reforms of debit card systems in Australia: A consultation document,* RBA, Sydney, December 2005, p. 3

125 RBA, *Reform of debit card systems in Australia,* media release, 20 December 2005.

126 RBA, *Reform of debit card systems in Australia,* media release, 20 December 2005.

Revoking Bankcard's designation

4.168 The RBA has:

> Decided to revoke the designation of the Bankcard scheme, given that the scheme has announced that no new Bankcard cards will be issued and that the scheme will be wound up in first half of 2007.[127]

4.169 The RBA argues that this change will prevent Bankcard from having to incur the expense of collecting the cost data that will facilitate the changes to the benchmarking of interchange fees at the end of this year.[128]

4.170 The RBA also noted:

> While the Bankcard scheme will no longer be subject to regulation under the *Payment Systems (Regulation) Act 1998*, the Bank expects that the scheme's current interchange fees will be maintained until the scheme is closed.[129]

Possible reform of ATM transactions

4.171 Currently, interchange fees are paid by a cardholder's bank (issuer) to the ATM owner, which are negotiated bilaterally between participants. These interchange fees are not subject to RBA regulation as debit and credit card transactions are. Interchange fees in the ATM network are, on average, around $1.00.[130]

4.172 Issuers pass the cost of interchange fees onto customers by way of a so-called 'foreign fee'. This fee is, on average, around $1.50.[131] Where a cardholder uses an ATM owned by their bank, there is no interchange fee and transactions are often free.

4.173 In 2000 the joint study of the RBA and ACCC asserted that 'interchange fees for ATM services are around double the average cost of providing these services.'[132]

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127 RBA, *Payments system reforms,* media release, 27 April 2006.

128 RBA, *Payments system reforms,* media release, 27 April 2006.

129 RBA, *Payments system reforms,* media release, 27 April 2006.

130 RBA, *Payments System Board Annual Report 2005,* p. 29.

131 RBA, *Payments System Board Annual Report 2005,* p. 29. Recently, a number of institutions have increased their foreign ATM fee to $2.00.

132 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 42.

4.174 The RBA has stated that it has not yet become involved in regulating ATM transactions because:

> Many participants in the ATM industry [want] to pursue voluntary reform, with a view to increasing competition in the charges cardholders pay when using so-called 'foreign' ATMs.[133]

4.175 One of the most commonly proposed options for reform is to remove interchange fees and have ATM owners directly charge cardholders at the time of transaction.

4.176 The potential advantages of direct charging are:

- Cardholders would know at the time of transaction the fee they are being charged, rather then subsequently being charged a 'foreign fee' by their banks;
- ATM owners would be forced to compete for business with their transaction fees, which should reduce prices for cardholders; and
- ATM owners would be encouraged to put machines in remote locations where they could charge higher fees. Currently, interchange fees are the same regardless of the location of an ATM.[134]

4.177 There are also a number of potential concerns:

- It may be difficult for small financial institutions with a limited ATM network of their own to offer their cardholders a widespread network that is free to use; and
- Direct charging meet with consumer opposition, as has been evident in the UK and the US.[135]

4.178 While the direct charging model has come under consideration by the banks and the RBA, there is little prospect of it being implemented in the near future. The RBA has stated:

> Despite considerable effort, the various parties have been unable to agree on an alternative set of arrangements to those currently in place and, as a result, the industry reform process has stalled.
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> …

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133 RBA, *Reform of card payments in Australia,* media release, 9 September 2004.

134 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 41.

135 RBA, *Payments System Board Annual Report 2005,* pp. 30-31.

> It [has become] clear that support in the banking industry for a broad-based move to direct charging by ATM owners ha[s] declined.[136]

4.179 At this point, the RBA has not indicated any intention to intervene in the ATM system to introduce direct charging through regulation. Concerns remain over whether direct charging would be in the public interest.

4.180 Instead, the RBA has focussed on other issues surrounding ATM transactions. The RBA has recently written to the Australian Bankers' Association asking them to consider two issues:

> - The first relates to access to the system. In the [RBA's} view, current arrangements for access to the ATM system are unnecessarily restrictive. As part of the development of more appropriate arrangements, the [RBA] has also indicated to the Australian Bankers' Association that it sees merit in ensuring that bilateral negotiations over interchange fees cannot be used in a way that adversely affects access or competition. One way of doing this would be the establishment of a common interchange fee in the ATM system, as exists in many other countries.
> - The second relates to the ability of ATM owners to levy a direct charge if they wish to do so. While the [RBA] is not proposing to make such charges mandatory, it is of the view that ATM owners should be able to levy such charges if they see a case for doing so. At present, there are some technical impediments to ATM owners levying such charges, and there is a concern amongst some ATM owners that should they do so, their access to the system may be curtailed. In the [RBA's] view, there is a strong case for the removal of any technical or business restrictions that limit the ability of ATM owners to impose a direct charge.[137]

Possible reform of BPAY

4.181 As discussed previously, BPAY, like Visa and MasterCard, sets interchange fees centrally and has interchange fees that flow *from* the biller's institution *to* the payer's institution. Discussing BPAY's interchange fees, the Reserve Bank stated that:

136 RBA, *Payments System Board – November 2005*, media release, 25 November 2005.

137 RBA, *Payments System Board – November 2005*, media release, 25 November 2005.

> BPAY is the only system in Australia that currently has an interchange fee that has not been subject to actual or proposed regulation.[138]

4.182 The RBA has noted that BPAY's interchange fee consists of two parts—a flat fee that applies to all transactions and an *ad valorem* fee that only applies where payment is made from a credit card account.

4.183 The flat fee differs depending on whether the payment is from a deposit account or a credit card account. The fee for a transaction from a debit account has fallen from $0.75 in 2002 to $0.44 in 2005 (excluding GST). For a transaction from a credit card account the fee has fallen from $0.67 in 2002 to $0.38 in 2005.[139]

4.184 The additional *ad valorem* fee for credit card transactions 'has fallen from 0.8 per cent in 2002 to 0.27 per cent in 2005.'[140]

4.185 With regard to possible regulation of these fees, the RBA has stated:

> A decline in interchange fees, through regulation, would be likely to lead to a reduction in the price charged to billers for accepting payments through BPAY, but that it would also be likely to lead to an increase in the price charged to consumers for using the BPAY system.
>
> …
>
> One likely effect of such a change in pricing would have been a shift away from BPAY towards other methods of bill payment, including credit card payments directly to billers, cheques and over-the-counter cash payments. Given the current relative prices and resource costs of these alternative payment methods, the Bank's view is that such a shift could not have been said to be in the public interest. [141]

4.186 The RBA therefore decided against regulating BPAY's interchange fees. They did, however, request that BPAY publish their interchange fees. The RBA stated:

> If BPAY was unable to agree, then the Bank would consider designating BPAY as a first step to possibly setting a 'transparency'

138 RBA, *Payments System Board Annual Report 2005,* p. 27.

139 RBA, *Payments System Board Annual Report 2005,* p. 28.

140 RBA, *Payments System Board Annual Report 2005,* p. 28.

141 RBA, *Payments System Board Annual Report 2005,* pp. 28–29.

standard that would require publication of interchange fees. In response BPAY agreed to publish its interchange fees.[142]

4.187 With regard to possible future regulation, the RBA stated:

> In announcing its decision not to regulate BPAY, the Bank noted that it will again review BPAY's interchange fee arrangements in 2007 as part of its review of all systems with interchange fees.[143]

The Hon Bruce Baird MP
Chair
22 June 2006

142 RBA, *Payments System Board Annual Report 2005*, p. 29.
143 RBA, *Payments System Board Annual Report 2005*, p. 29.