

REFORM OF AUSTRALIA'S PAYMENTS SYSTEM
Conclusions of the 2007/08 Review

RESERVE BANK OF AUSTRALIA



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SEPTEMBER 2008

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Executive Summary

Following extensive consultation and analysis over the past year, the Payments System Board has finalised its review of the payments system reforms.

The Board has concluded that the reforms have delivered significant benefits, improving the overall efficiency of Australia's payments system. The Review has considered how best to build on those gains and, in particular, the improvement in the competitive environment that has taken place since the reforms were introduced.

The Board sees no case for allowing the schemes to reimpose restrictive rules on merchants, or for winding back access regimes or the improvements in transparency. The enhanced competitive environment does, however, provide an opportunity to consider stepping back from the regulation of interchange fees, although the Board remains concerned about the strength of the competitive forces acting on these fees. Given these concerns, the Board will only step back from regulation in this area if industry participants take further steps to reduce the risk that interchange fees in the credit card system increase from current levels in the absence of regulation. If such steps are not taken, interchange regulation will continue.

Two broad approaches to addressing the Board's concerns in this area have been identified. The first was suggested in the Preliminary Conclusions. It involves enhancing competition through: changes to the EFTPOS system to improve its ability to compete effectively with the international card schemes; further modifications to the honour-all-cards rules to allow merchants to make separate acceptance decisions for any card for which there is a separate interchange fee; and more transparent scheme fees. The consultation process has not fundamentally altered the Board's views on the benefits of these changes although this document sets out in more detail the Board's thinking in these areas.

The second approach was suggested during the consultation process. It directly addresses the Board's concern about the potential for interchange fees to increase through a commitment by the schemes to limit the weighted average of credit card interchange fees to the current level of 0.5 per cent. If this approach were adopted, the benefits from further modifications to the honour-all-cards rule suggested above would be reduced, and accordingly the Board would not see a need for these changes to be made.

Under both of these approaches, the Board will be seeking greater transparency of scheme fees. It recognises, however, that there are commercial sensitivities about these fees and will be working with the schemes to determine a way in which its requirement for transparency can best be balanced with commercial considerations.

The Board has also concluded that merchants should be permitted to make separate acceptance decisions on pre-paid cards and not be penalised by higher fees for any decision to do so. Further, it is not convinced that allowing schemes to place restrictions on merchants limiting surcharges would improve the efficiency of the system.

If insufficient progress has been made in meeting the Board's concerns by August 2009, interchange regulation would be retained with the Board proposing that the benchmark for credit card interchange fees be reduced to 0.3 per cent as proposed in the Preliminary Conclusions. In the EFTPOS and scheme debit systems, a common approach to setting interchange fees is being proposed, although the schemes would have more flexibility than was suggested in the Preliminary Conclusions. In particular, the Board is proposing that the weighted average of interchange fees be constrained to be between 5 cents paid to the issuer and 5 cents paid to the acquirer. If regulation of interchange fees were to continue, the Board would not require further modifications to the honour-all-cards rule to allow separate acceptance decisions for any card with a separate interchange fee, although it would still seek greater transparency of scheme fees.

Reform of Australia's Payments System: Conclusions of the 2007/08 Review

1. Introduction

This document sets out the Payments System Board's conclusions of its review of the regulation of Australia's card payment systems. The Review has been broad ranging and has benefited from extensive input by industry participants. The Board thanks the many institutions and individuals who have provided written submissions as part of the review process and who have taken the time to meet with the Bank's staff.

The document is intentionally forward looking. In particular, it sets out the Board's preferred approach to improving competition and efficiency in Australia's card-based payment systems over the years ahead. It discusses the industry's feedback on the Board's Preliminary Conclusions, released in April 2008, and the Bank's response to the main points raised through the consultation process. The document draws on the extensive analysis of the effects of the reforms to date presented in the Preliminary Conclusions, as well as the costs and benefits of various options, although it does not repeat this analysis.

2. The Payments System Board's Mandate and Objectives

The Payments System Board's responsibilities stem from the Financial System Inquiry, whose findings and recommendations were released in 1997.¹ The Inquiry found that, while earlier deregulation had improved competition and efficiency in Australia's payments system, further gains were possible. To that end, it recommended the establishment of the Payments System Board at the Reserve Bank with the responsibility and powers to promote greater competition, efficiency and stability in the payments system. The Government accepted those recommendations and established the Payments System Board in 1998. The Board's responsibilities are set out in the *Reserve Bank Act 1959*. The Act requires the Board to determine the Bank's payments system policy so as to best contribute to: controlling risk in the financial system; promoting the efficiency of the payments system; and promoting competition in the market for payment services, consistent with the overall stability of the financial system.

At the time the Board was established, the Government also provided the Bank with specific powers to regulate payment systems in order to implement the Board's policies. The most relevant powers in the context of the card payment reforms are those set out in the *Payment Systems (Regulation) Act 1998*. Under this Act, the Bank has the power to designate payment systems and to set standards and access regimes in designated systems. The Act also sets out the matters that the Bank must take into account when using these powers, including the desirability of payment systems: being financially safe for use by participants, efficient and competitive; and not materially causing or contributing to increased risk to the financial system.

1 *Financial System Inquiry (1997)*, Final Report, March.

3. The Board's Reforms and the Central Issues

The Board's various reforms are summarised in Table 1, with further details provided in the Preliminary Conclusions. Consistent with its responsibilities set out in the various Acts of Parliament, the Board has sought to improve the efficiency of the overall payments system and to promote competition in the system. It has done this by:

- increasing the transparency of the system;
- requiring the removal or modification of restrictions imposed on merchants that hinder competitive forces (in particular no-surcharge rules, honour-all-cards rules, and no-steering rules);
- liberalising access arrangements to both the debit and credit card systems; and
- promoting more appropriate price signals to consumers by reducing interchange fees in the debit and credit card systems and requiring the removal of restrictions on merchants.

The Board's assessment of the effectiveness of these various reforms is set out in its Preliminary Conclusions, with this assessment not changing materially as a result of the most recent round of consultation (see Section 6 below).

Looking forward, the Board has focused particular attention on two interrelated aspects of the current competitive environment that have the potential to impair efficiency and competition in the overall system. These are:

- the difficulty that merchants can have in exerting downward pressure on interchange fees; and
- the difficulties arising from the current structure and governance of the domestic debit card system (the EFTPOS system), which potentially limit its ability to compete with the international card schemes.

The Board's judgment has been that the competitive forces acting on interchange fees, particularly in the credit card system, are somewhat different to those in operation in most other parts of the economy. One reason for this is the structure of the incentives facing merchants. In the Board's view, in the absence of close oversight there is a significant risk that the aggregate cost that merchants pay for accepting some payment instruments (most notably credit cards) will be greater than the aggregate benefit that they receive. This distortion can arise despite the fact that each merchant that accepts credit cards judges the net benefit of doing so to be positive. The reconciliation between the aggregate and individual perspectives is found in the fact that part of the benefit that an individual merchant perceives is that of 'stealing' business from other merchants. But merchants cannot collectively steal business from themselves; one business's gain is another's loss. By acting individually, therefore, merchants can in aggregate end up paying more for credit card acceptance than the benefit they receive. These extra costs can then be used to subsidise cardholders' use of credit cards, which can lead to distortions in overall payment patterns in the economy.

Table 1: Payments System Reforms

Standards	
<i>Interchange fees</i>	
Credit cards	Weighted-average interchange fees in the MasterCard and Visa schemes must not exceed 0.50 per cent of the value of transactions. MasterCard and Visa must publish their actual credit card interchange fees.
Visa Debit	The weighted-average interchange fee for Visa Debit transactions must not exceed 12 cents per transaction. Visa must publish its actual debit card interchange fees.
EFTPOS	EFTPOS interchange fees for transactions that do not involve a cash-out component must be between 4 and 5 cents per transaction.
<i>Merchant restrictions</i>	
Honour-all-cards	Visa is not permitted to require a merchant to accept Visa Debit cards as a condition of accepting Visa credit cards, or <i>vice versa</i>. Visa Debit cards must be visually and electronically identifiable as debit cards, and acquirers must provide merchants with information required to electronically distinguish Visa Debit and Visa credit card transactions.
Surcharges	The card schemes must not prohibit a merchant from imposing a surcharge for MasterCard or Visa credit card transactions, or for Visa Debit card transactions.
Access Regimes	
Credit cards and Visa Debit	Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit-taking institutions (ADIs). A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or <i>vice versa</i>. Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.
EFTPOS	The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently \$78 000 (ex GST). An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).

Voluntary Undertakings

American Express and Diners Club	American Express and Diners Club have provided the Bank with written undertakings to remove restrictions in their credit and charge card schemes preventing merchants from charging any fee or surcharge for the use of a card.
American Express	American Express has provided the Bank with a commitment to modify provisions in its merchant contracts that would otherwise prevent a merchant from 'steering' a customer's choice of payment instrument. Also, in the event that American Express introduces a debit card in Australia, the merchant agreements and pricing for that product will be separate to those for credit and charge cards.
MasterCard	MasterCard has provided the Bank with a written undertaking to voluntarily comply with the Visa Debit interchange Standard and the honour-all-cards Standard as they apply to credit and debit card transactions, as well as the Standard on surcharging as it applies to debit card transactions.

Other

EFTPOS Access Code	Under the EFTPOS Access Code developed by the Australian Payments Clearing Association, new and existing EFTPOS participants have specific rights to establish direct connections with other participants within a set time frame.
Scheme data	Since August 2005 the Bank has published aggregated data on the average merchant fee for each of the schemes as well as data on market shares.

As set out in the Preliminary Conclusions, the Board's assessment is that the various reforms have increased the competitive pressures on interchange fees, although these pressures are still not particularly strong. A central issue for the Review has therefore been whether additional steps could be taken to further enhance the competitive environment or develop safeguards that provide some assurance that, if the current regulations were removed, average interchange fees would not rise materially.

The second, and related, issue is the competitive dynamics in the debit card systems. For many years, Australia has benefited from having a widely used, low-cost debit card system (the EFTPOS system) which, to some extent, operates in competition with the payment systems operated by the international card schemes. Looking forward, there are likely to be benefits to both consumers and merchants from continuing to be able to choose amongst a variety of different payment systems, each of which competes on price and the range of services that it offers. In this regard, the Board has been concerned that the current governance arrangements in the EFTPOS system may limit its ability to act as an effective competitor to the international card schemes. The central issue here is whether changes to these governance arrangements would promote both competition and innovation in the Australian payments system over the years ahead.

4. The Process of the Review

The current review originated from a commitment made by the Payments System Board when it released its final reforms for the credit card systems in 2002. At that time, it said it would review the reforms in five years time. As things have transpired, the Review has been much more wide ranging than was originally envisaged, and has covered all the reforms in card payment systems introduced since 2002. This reflects the Board's view that the various reforms are interconnected and are, therefore, best assessed as part of a package, rather than on a stand-alone basis. Throughout the reform process, the Board's focus has very much been on the payments system as a whole, rather than on the operation of individual payment systems within the overall system.

The first step in the review process was taken in September 2006, with the Bank [seeking submissions](#) from interested parties on the scope and content of the Review. Most submissions called for the Review to be broad in nature and to cover all the Bank's reforms, not just those relating to the credit card system.

The second step was the publication of an issues paper in May 2007 ([Reform of Australia's Payments System: Issues for the 2007/08 Review](#)). This paper provided a summary of recent developments in card payment systems and sought industry feedback on three interrelated questions:

- (i) what have been the effects of the reforms to date?
- (ii) what is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach? and
- (iii) if the current regulatory approach is retained, what changes, if any, should be made to the standards and access regimes?

In total, 27 submissions were received, and 20 parties took up the invitation to discuss their submission with the Bank. The Bank also held a number of other related meetings with industry participants, including consumer groups. Appendix 1 lists the parties who made a submission on the Issues Paper.

The third step was the holding of an industry-wide conference in November 2007 to discuss the reforms. This conference was jointly organised by the Bank and the Centre for Business and Public Policy at the Melbourne Business School. Around 90 participants were invited, representing financial institutions, merchants, card schemes, industry associations, consultants and academia. All members of the Payments System Board attended. The first part of the conference involved a discussion of two commissioned papers and the results of the Reserve Bank's studies of the use and cost of payment instruments. The second part took the form of an open forum discussing the reforms to the card payment systems, particularly the issues of interchange fee regulation, innovation and access. The [conference proceedings](#) were published separately and are available on the Bank's website (www.rba.gov.au).

The fourth step was the release of the Board's Preliminary Conclusions in April 2008 ([Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review](#)). This

document set out the Board's views on the effects of the reforms to date and some possible ways forward for regulation of interchange fees.

On the reforms to date, the Board concluded that they have met their main objectives of: improving price signals in the Australian payments system; increasing transparency; improving access; and creating a more soundly based competitive environment. It was acknowledged, however, that the reforms have not affected all parties equally. In particular, those individuals who use EFTPOS and cash are more likely to have been made better off than those who use credit cards extensively and pay their balances off by the due date.

On the regulation of interchange fees going forward, the Board presented three broad options.

The *first option* was to retain the current credit and debit card interchange Standards, largely unchanged. This would mean that:

- the weighted-average interchange fee in the MasterCard and Visa credit card systems would continue to be capped at around 0.5 per cent;
- the weighted-average interchange fee in the MasterCard and Visa debit systems would continue to be capped at around 12 cents; and
- interchange fees in the EFTPOS system (paid to the acquirer) would continue to be between 4 and 5 cents.

The *second option* was to retain interchange regulation, but to reduce the benchmark applying to the credit card systems to around 0.3 per cent and to establish a common benchmark of, perhaps, 5 cents (paid to the issuer) for all debit card systems.

The *third option* was to step back from interchange regulation on the condition that industry took a number of steps to strengthen the competitive environment. These included: changes to the EFTPOS system; further modifications to honour-all-cards rules to allow merchants to make independent acceptance decisions for each type of card for which a separate interchange fee applies; and increased transparency of scheme fees and average interchange fees, as well as the fees and procedures that apply if an acquirer wishes to bypass scheme switches. In terms of the EFTPOS system, the Board identified a number of potential changes that might improve the competitive environment. These included:

- (i) the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make binding decisions about interchange fees;
- (ii) the creation of effective arrangements to promote the development of the system;
- (iii) reform of current access arrangements; and
- (iv) the development of alternative payment instruments for use in online payments (either by the EFTPOS scheme or through another channel).

The Board concluded that, while the costs and benefits of options 2 and 3 were finely balanced, its preferred approach was option 3. Despite its preference for this option, the Board noted that there was some probability that, even if it were implemented, the resulting competitive forces may still not be sufficient to constrain interchange fees. Reflecting this concern, the Board concluded that if average interchange fees in the credit card systems were to increase materially after the

implementation of this option, it would consider the reimposition of interchange regulation. The Board also indicated that if the necessary steps were not taken by industry participants to improve the competitive environment, then it would consider the implementation of option 2.

In addition to the Board's conclusions on interchange fees, its other key preliminary conclusions can be summarised as follows.

- There was no case for allowing schemes to reimpose their no-surcharge rules or their earlier honour-all-cards rules. Some consideration was given to allowing schemes to impose a restriction on merchants that limited the size of any surcharge, but it was concluded that such a restriction could limit the competitive pressure on interchange fees.
- Merchants should be able to make independent acceptance decisions about pre-paid cards. Furthermore, merchants should not be penalised with higher interchange fees if they do not accept all card types within a scheme.
- The various access regimes should be retained, although further improvements in access arrangements were necessary, particularly to those systems based on bilateral contracts. The industry was encouraged, as a matter of priority, to examine alternative approaches that would address this issue and possibly allow entry without the need to establish a multitude of bilateral connections.

5. Consultation on the Preliminary Conclusions

In releasing its Preliminary Conclusions, the Board sought submissions on both its analysis and policy conclusions. In all, 24 submissions were received, including from the card schemes, financial institutions, retailers, industry bodies, consultants and individuals. The majority of submissions are published on the Bank's website. Three submissions were provided on a confidential basis, while one other incorporated some confidential material which has been omitted from the published version. Appendix 1 lists the parties from whom a submission was received on the Preliminary Conclusions.

Most submissions focused on the three options for interchange regulation discussed in the Preliminary Conclusions, with relatively little comment on the Board's assessment of the effects of the reforms. Reflecting the complexity of the issues and the diversity of opinions, few, if any, parties were completely satisfied with any of the options presented. However, of those submissions that expressed a clear view on individual options, the majority (predominantly from financial institutions and card schemes) favoured option 3. Nonetheless, many had concerns with some of its elements, most notably the proposal to further modify honour-all-cards rules. Merchant submissions did not nominate a preferred option, arguing that a move to zero interchange fees across all card systems would be preferable.

The discussion below is separated into two parts. The first summarises the main issues raised in the consultation process regarding the Board's analysis, while the second summarises the various issues raised in response to the three specific options put forward by the Board. Section 6 provides the Board's response.

5.1 Interpretation and analysis

A number of submissions commented on the analytical reasoning behind the Board's Preliminary Conclusions. These comments were largely focused on two issues: the decision by merchants to accept various forms of payment and the benefits of the reforms.

5.1.1 *Merchant acceptance decisions*

As noted above, the Board has been of the view that the competitive forces on interchange fees in the credit card system are relatively weak, in part because merchants, as a group, are willing to pay more for credit card acceptance than the collective benefit they receive. A number of submissions disagreed with this conclusion, citing various arguments. In particular:

- Some argued that card acceptance is not a once-off decision for merchants and that it is therefore possible to achieve co-operative outcomes among merchants over time.
- Some questioned whether a distortion really exists in the system. Some submissions argued that the fact merchants may be willing to individually pay a high price to accept cards reflects competition between merchants, rather than a distortion in the system. Another submission suggested that if merchants have the ability to influence consumers to choose a particular payment instrument, merchant co-ordination is unnecessary. An increase in the prevalence of surcharging, declining acquiring margins and successful bargaining on interchange fees by large merchants were cited as evidence that merchants have the ability to influence consumers' choice of payment instrument.
- One submission argued that surcharging changes the pay-off for card acceptance and suggested that the combination of lower interchange fees, removal of no-surcharge rules and competition in merchant acquiring has resulted in merchants now receiving collective benefits from card acceptance that are greater than collective costs.

Other submissions acknowledged the complex incentives that merchants can face and argued that one solution to the 'co-ordination' problem might be a mechanism that allowed merchants to collectively negotiate interchange fees with issuers.

5.1.2 *Benefits of the reforms*

In the Preliminary Conclusions, the Board assessed that the reforms had been beneficial for the Australian economy, improving competition and efficiency in the payments system. A number of submissions supported this analysis. A major retailer, for example, argued that Australia's payments system had clearly benefited from the removal of anti-competitive restrictions, improved market access and transparency, and more appropriate price signals that promote more efficient decisions by consumers. Other merchants supported the view that the reforms had been beneficial. A number of financial institutions also highlighted the benefits from the reforms to date, observing in particular the benefits to competition from the removal of restrictions on merchants. A submission by the banking industry agreed with the finding that reforms to access and the removal of no-surcharge rules have been pro-competitive and would benefit the system in the long term.

Other submissions disputed the conclusion that there had been benefits and some questioned the analysis of the welfare gains from the reforms, including the Board's use of the principle

of revealed preference. This principle suggests that if consumers use a particular payment instrument at a given price, then they must receive a benefit at least equal to that price. By making assumptions about the number of credit card transactions that have migrated to the EFTPOS system as a result of the reforms, together with data on prices and costs, the Bank estimated that the welfare gains were likely to run into the hundreds of millions of dollars per year.

Submissions typically only addressed this analysis if they disagreed with its conclusions. One of the card schemes argued, for example, that any welfare gain from a shift to EFTPOS was more than outweighed by: the harm to consumers through increased fees; a reduction in rewards and other benefits; and reduced innovation. Two submissions also questioned the underlying resource cost analysis and suggested that there is no evidence that the reforms have had a significant effect on the use of credit cards relative to EFTPOS. On the other hand, another submission argued that recent stronger growth in debit card use than credit card use most likely would not have occurred to the same extent without the reforms, although it postulated that efficiency gains might be at the lower end of the Board's estimates.

A submission by the banking industry, while agreeing that there had been benefits to competition from the reforms, disagreed with the quantitative aspects of the welfare analysis. It suggested that the analysis should account for the loss of benefits to consumers from shifting to EFTPOS use, as well as policy reform costs such as economic and legal costs, interchange cost studies, and staff time. It was also argued that some merchants with market power have not lowered their prices in response to lower merchant service fees, but have instead increased their profits, and that this transfer should be excluded from the welfare analysis.

Another submission argued that those harmed by regulation will have a reduced incentive to innovate and that these costs were missing from the welfare analysis. This submission also questioned whether the principle of revealed preference was an appropriate tool for analysis since it relies upon something which is not possible to observe – behaviour in the absence of regulation.

5.2 The options

Of the three options for interchange fees discussed in the Preliminary Conclusions, the majority of submissions favoured option 3, although most expressed reservations about some aspects of the option. The Australian Payments Clearing Association (APCA), the Australian Bankers' Association (ABA), Abacus and individual bank submissions strongly supported the general approach of this option, but raised concerns about some specific elements. Of the card schemes, two indicated qualified support for option 3 (among the options presented) while a third argued that the best course of action for all parties would be the removal of all regulation. Merchant submissions supported a move to zero interchange fees for all card payment systems and did not express an opinion in their submissions in relation to the three options. One Specialist Credit Card Institution supported a further reduction in interchange fees via option 2. A small number of other submissions – particularly those focused on specific issues – did not express a preference among the Board's options.

Given the balance of opinion, the discussion below focuses predominantly on issues relevant to option 3.

5.2.1 The role of EFTPOS

A key element of option 3 was changes to the EFTPOS system to improve the competitive forces in the payments system. While parties had varying views on the potential impact of a more competitive EFTPOS system, a wide cross-section of submissions supported a change to existing governance arrangements, including the establishment of an EFTPOS scheme. APCA noted that it has for some time been co-ordinating efforts towards improving governance and business development in the EFTPOS system.

Submissions identified a number of benefits that an EFTPOS scheme might deliver. These include: an improved governance structure that would allow decisions to be made for the system as a whole; easier access for new entrants; an improved technological model; centralised setting of interchange fees; and greater ability to innovate. Many submissions argued that a scheme would be worthwhile if it could improve governance and the technological model, but some questioned the extent of benefits beyond that, and in particular whether it could realistically put significant downward pressure on scheme interchange fees.

Some submissions argued that a critical decision for an EFTPOS scheme would be the level of interchange fees. Since scheme debit interchange fees currently flow in the opposite direction to those for EFTPOS, providing issuers with an incentive to promote the scheme products, an EFTPOS scheme may decide to set interchange fees centrally and reverse their direction. Abacus argued that the Board should regulate to achieve this reversal as soon as possible in order to ensure that issuers have the incentive to promote the scheme.

In contrast, merchants argued that there was little need to boost the competitive position of the EFTPOS system. They argued that the system is currently very strong and would remain so while ever it is being supported and promoted by the merchants. Furthermore, by permitting merchants to surcharge or refuse acceptance of scheme debit products, the reforms have provided merchants with the tools to effectively steer customers towards the EFTPOS system. A reversal of the EFTPOS interchange fee might therefore be detrimental to the system because it could undermine merchants' commitment to it.

The merchants also expressed concern that competition between the scheme debit systems and EFTPOS would result in rising interchange fees as the schemes compete for issuers. A submission on behalf of the Australian Merchant Payments Forum noted the 'dramatic increases' in PIN debit interchange fees in similar circumstances in the United States. Some merchants argued that bilaterally negotiated interchange fees produced better competitive outcomes than multilaterally determined fees.

While many submissions agreed that an EFTPOS scheme could deliver improved governance, a number – including those made by merchants and small financial institutions – expressed concern that it could also entrench the major banks' dominance of decision making and that the scheme would therefore not take sufficient account of the interests of other stakeholders. Some parties suggested that this issue might be addressed by the appointment of independent directors to the board of the EFTPOS scheme to ensure that decisions were made in the broader interest.

Several submissions took up the suggestion in the Preliminary Conclusions that the development of alternative payment instruments for use in online payments would be expected to

improve the competitive environment and, by extension, improve the prospects for deregulation of interchange fees. Some argued that online payments might not be an appropriate direction for EFTPOS and that in order to give the EFTPOS system the best prospects for long-term success, decisions on any developments should be made entirely on the basis of a sound business case. Others pointed out that alternative online payment options either existed or were in the process of being developed.

5.2.2 Further modifications to honour-all-cards rules

Strongly opposing views were expressed on the proposal that the honour-all-cards Standard be extended to give merchants the right to make independent acceptance decisions with respect to any card type that has a separate interchange fee.

A significant number of submissions, largely from financial institutions and the card schemes, opposed any extension of the Standard, arguing that it would: be detrimental to the scheme and issuer brands, which are built on an assurance to cardholders that if a scheme's logo is displayed, its card is accepted; lead to customer confusion and increased search costs; and be particularly disadvantageous for foreign travellers who might not be prepared for their card to be declined. Many submissions also argued that the ability to refuse specific types of credit card was unnecessary given merchants' ability to differentially surcharge.

The merchants, on the other hand, argued that the existing honour-all-cards Standard – which allows independent acceptance decisions for scheme credit and debit products – has been an extremely powerful tool, even though merchants have not actually chosen to refuse scheme debit products. Merchants argued that an extension of the Standard would also be valuable in providing bargaining power in respect of premium cards, although some submissions argued that this power is dulled somewhat by the prevalence of blended merchant pricing and, at least currently, technological constraints on the capacity of merchants to recognise card types.

Merchants argued that any potential customer confusion arising from an extension of the honour-all-cards Standard would be a transitional issue. Customers were not accustomed to merchants selectively refusing scheme cards, but would quickly become so were it to occur.

5.2.3 No-surcharge rules

Arguments for and against the removal of no-surcharge rules were covered extensively in earlier rounds of consultation. Given this, the most recent round of consultation has focused on: surcharges in excess of merchant fees; surcharging in cases where no alternative means of payment is available; the disclosure of surcharges; and the role of no-surcharge rules in 'new' payment systems.

The card schemes, smaller financial institutions and the Consumer Action Law Centre argued that surcharging has, at times, been used in an anti-competitive manner by merchants with market power, and that the size of the surcharge often does not reflect the costs of card acceptance. Some submissions argued that card schemes should be allowed to limit the level of surcharges. MasterCard pointed to arrangements in Europe where surcharging is permitted provided that: the merchant clearly indicates the amount of the surcharge and how it will be calculated prior to the sale; and that the amount of the surcharge is 'reasonably related' to the merchant's cost of accepting the card. It was also suggested that, if the price signals are

to deliver an efficient outcome, the surcharges imposed by merchants on different payment methods need to reflect their relative costs. American Express argued that an acquirer should simply be able to discontinue business with a merchant that is surcharging excessively or in a discriminatory fashion.

Concern was also expressed about surcharging in circumstances where other payment mechanisms are not available. The Consumer Action Law Centre, for example, cited the case of low-cost airfares, arguing that the imposition of surcharges is a hidden cost that ‘distorts competition because it hides the true cost of the good or service from the customer’. It argued that surcharging should not be allowed in these circumstances.

Other submissions expressed concerns about disclosure of surcharges. Abacus argued that some merchants claim surcharges reflect the cost of acceptance when in fact they are substantively above the payment costs. It suggested that the Bank ‘name and shame’ merchants imposing unreasonable surcharges. The Consumer Action Law Centre was concerned about surcharges in some cases not becoming clear to the customer until a point in the purchase process where they had already emotionally committed to the sale and had already provided personal details.

Finally, a small number of submissions argued that there is a case for allowing no-surcharge rules for start-up payment systems. For instance, ACIL Tasman argued that not allowing a no-surcharge rule in such circumstances effectively constitutes a barrier to entry given that the incumbents have already had the advantage of being allowed to build their businesses through the use of such rules.

5.2.4 Transparency

Several financial institutions and the merchants expressed support for increased transparency of average interchange fees and scheme fees. Woolworths, for instance, argued that while publication of *average* scheme fees would allow merchants to better understand the composition of their merchant service fees, complete transparency of scheme fees is preferable. Visa expressed concern that data on scheme fees are commercially sensitive and disclosure would be inappropriate. It argued that calculating meaningful averages would be difficult and methodologies would need to be specified in considerable detail by the Bank in order to produce data that are comparable and are not likely to distort fee structures over time. MasterCard indicated its willingness to discuss the issue further with the Bank.

APCA suggested that the following industry-wide principles should apply to any requirements for disclosure of average scheme and interchange fees:

- they should apply fairly across all schemes (including EFTPOS when relevant);
- commercial confidentiality should be protected; and
- calculation of any such averages should be consistently applied, to ensure ‘apples for apples’ comparisons.

5.2.5 Network choice

Few submissions commented on the Board’s observation that the competitive dynamics in the payments system could be fundamentally altered by allowing merchants to choose the scheme through which payments were processed. The merchants, however, expressed support for

the idea that they should be permitted to choose how payments were to be processed and urged the Board to reconsider its conclusion that such a fundamental change would require costly adjustments in existing systems and may well have significant unintended consequences. Woolworths argued that network choice should be considered a prerequisite for the Board to consider stepping back from interchange regulation.

5.2.6 *Practicalities of option 3*

A number of submissions raised questions relating to the conditions attached to option 3.

Some industry participants sought clarity on how to interpret the statement in the Preliminary Conclusions that if average interchange fees in the credit card systems *rose materially*, the Board would consider reimposition of interchange regulation. It was suggested that this statement introduces regulatory uncertainty that could have a detrimental impact on the card payment systems going forward.

Another issue raised was that the card schemes have no control over the implementation of some of the conditions set out under option 3, and could be significantly affected by decisions made by others. In a similar vein, some financial institutions noted that they have no control over the level of scheme interchange fees.

One suggestion that was raised to deal with at least some of these uncertainties is for MasterCard and Visa to provide a commitment to limit the weighted average of credit card interchange fees – say to the level of the current benchmark. While this possibility was not discussed in the Preliminary Conclusions, a small number of submissions indicated that this was a possibility that warranted further exploration.

APCA and a number of large financial institutions proposed a framework to establish greater co-ordination in a self-regulatory environment. It suggested bringing merchants, schemes and financial institutions together in a structured industry dialogue to: identify, monitor and publish indicators of competition in consumer payment instruments; identify and debate structural opportunities to enhance competition and increase efficiency; and provide a basis for industry discussions with the Bank and the Board on issues of regulatory oversight. In August, APCA provided more detail on this proposal, announcing the formation of the Card Payments Forum.²

Submissions also called for greater clarity on some other elements of option 3. In particular, APCA argued that there needs to be greater clarity between industry and the Bank as to what level of reporting, and what milestones, are required in relation to the EFTPOS scheme. Visa also sought clarification of a number of issues, including: what is meant by the continued need for ‘close oversight’ of retail payment systems under option 3; the Board’s intentions in respect of debit card interchange fees under option 3; and whether the Board would mandate the inclusion of separate product identifiers on all cards in order to assist merchants in making independent acceptance decisions about different card types. Visa also sought clarification of the regulatory and consultation processes that would be followed in implementing the policies flowing from the Review.

2 Australian Payments Clearing Association Media Release, ‘New Card Payments Forum’, 14 August 2008.

5.2.7 Other options

A number of aspects of option 2 – the position if the conditions for option 3 are not met – also drew comment.

A number of parties commented on the proposed realignment of interchange fees under this option, in particular the establishment of common benchmarks on EFTPOS and scheme debit interchange fees. As discussed above, merchants argued that changing the direction of EFTPOS interchange fees would remove their incentive to promote EFTPOS. From a different perspective, Visa also argued that alignment of the weighted-average benchmark for scheme debit and EFTPOS was inappropriate because a significant proportion of scheme debit use is in card-not-present environments where interchange fees are set at a higher level to cover costs associated with a higher fraud rate. Since EFTPOS cannot currently be used in card-not-present environments, setting the benchmarks at the same level would mean that the schemes would have to set card-present interchange fees at a lower rate than EFTPOS.

Abacus and Australian Settlements Limited agreed that if option 2 were adopted, the direction of EFTPOS interchange fees should be reversed, but argued that the scheme debit benchmark should not be reduced given that the cost structure and benefits of the scheme product differed from EFTPOS.

Merchants opposed the removal of the current exemption of EFTPOS cash-out transactions from the EFTPOS interchange Standard. A submission on behalf of the Australian Merchant Payments Forum argued that if the EFTPOS interchange benchmark is reversed as proposed in option 2, interchange fees on cash-out only transactions should be set to zero. Individual retailers argued that they should be free to separately negotiate fees on cash-out transactions and might be unwilling to provide the service otherwise, while other submissions suggested that a direct charging arrangement, equivalent to the new ATM regime, would be appropriate.

6. The Board's Response

Following this latest round of consultation, the Board remains of the view that the reforms have met their key objectives. They have: increased transparency; improved competition by removing restrictions on merchants and liberalising access; and promoted more appropriate price signals to consumers. Nevertheless, as discussed in Section 3, the Board remains of the view that the competitive forces acting on interchange fees are still relatively weak. The Board has therefore concluded that there are aspects of the payments system that will continue to require close oversight.

The Board acknowledges that precise quantitative measurement of the aggregate welfare gains from the reforms faces a number of challenges, particularly given the inevitable uncertainties about what would have happened in the absence of the reforms. Notwithstanding this, the Board remains of the view that based on reasonable assumptions, the welfare gains have been significant. In reaching this conclusion, the Board recognises that the effect of the reforms has not been evenly spread.

One argument that was raised through the consultation process to which the Board has paid particular attention is that the reforms have slowed the pace of innovation in the Australian

payments system. While it is clear that the reforms have been a primary focus of many industry participants over recent years, the Board is not persuaded that innovation has been harmed by the regulatory process. Instead its assessment is that the relatively slow pace of innovation over recent years largely reflects governance and co-ordination issues in some of Australia's payment systems, rather than the regulatory environment. Notwithstanding this, over the longer term, innovation is more likely to occur in a regime under which the regulatory arrangements are relatively stable and industry participants can make long-term plans.

Similarly, the Board is not persuaded that in the absence of some form of regulatory oversight the competitive forces would be strong enough to ensure that interchange fees will be set at levels that promote the overall efficiency of the system. This is particularly so if the schemes were to attempt to reimpose their various restrictions on merchants. While, in principle, the competitive dynamics could be changed by merchants co-ordinating their acceptance decisions or choosing which payment system is used to process credit card payments, neither of these changes appears to be practical at the current time.

Although the Board is of the view that oversight of card payment systems remains necessary, this does not necessarily imply a need for explicit regulation. Indeed, the Board would be prepared to remove the current regulations if the various payment systems took sufficient steps to address the various issues identified by the Board over recent years. However, in the absence of the schemes voluntarily changing their rules and procedures to remove restrictive rules and enhance transparency, some form of ongoing regulation is likely to be required. Notwithstanding this assessment, the consultation process has confirmed the Board's view that, given the changes that have taken place over recent years, there is now an opportunity for it to step back from regulation of interchange fees, provided that further steps are taken by industry participants.

6.1 The preferred approach

Given the improvement in the competitive environment over recent years, the Board is prepared to deregulate interchange fees. The Board remains concerned, however, that if it were to deregulate unconditionally, interchange fees (particularly in the credit card systems) would rise from their current levels, perhaps substantially. Given this concern, the Board has concluded that it will only step back from the regulation of interchange fees if industry participants take steps to reduce the risk of this outcome.

In the Preliminary Conclusions, the Board indicated that one way in which this could be achieved is for industry participants to further strengthen the competitive environment including through: changes to the EFTPOS system to improve its ability to compete effectively with the international card schemes; further modifications to honour-all-cards rules to allow merchants to make separate acceptance decisions for any card for which there is a separate interchange fee; and an improvement in the transparency of scheme fees and average interchange fees. The Board also indicated that if interchange fees in the credit card systems were to rise materially following deregulation, it would consider the reimposition of regulation on these fees.

Through the consultation process, a number of parties expressed concerns about some elements of this approach, particularly relating to honour-all-cards rules, and the uncertainty around the regulatory response if interchange fees were to rise after deregulation. The Board recognises

these concerns and is prepared to consider other ways of helping ensure that interchange fees do not increase from current levels. How this might be done is discussed below.

As part of its deliberation, the Board has also given further consideration to a number of issues raised in consultation. In particular, it has considered industry views on: proposals to further modify honour-all-cards rules; what might be required of an EFTPOS scheme; capping of surcharges; and transparency. It has also reconsidered the levels of the benchmarks on interchange fees if regulation were to continue.

6.1.1 Further modifications to honour-all-cards rules

As noted in Section 5, a number of submissions argued that further modifications to honour-all-cards rules would be detrimental to the payments system. The Board, however, remains unconvinced that such modifications would result in either substantial consumer confusion or brand damage. Indeed, if the competitive process is working well, merchants are unlikely to decline acceptance because the schemes will have an incentive to set interchange fees at a level that encourages acceptance. The experience with scheme debit, where there have been no cases of which the Board is aware of merchants accepting credit cards but refusing to accept scheme debit, provides a basis for this conclusion.

On the other hand, the Board accepts that visual identification of different cards is difficult and, therefore, potentially costly system changes would be required by acquirers to give effect to these modifications. It also accepts that differential surcharging by merchants could generate a similar result to modifying the honour-all-cards rules. In addition, evidence from acquirers suggests that most merchants are not charged a separate merchant service fee for different types of cards. This practice limits the potential benefits of further modifying the honour-all-cards rules.

The arguments here are finely balanced. However, the Board is of the view that if it proceeds with deregulation of interchange fees – and is relying on competitive forces to help ensure that interchange fees do not rise – it needs to provide merchants with all possible negotiating tools to ensure maximum competitive pressure on these fees. Further modifications to honour-all-cards rules would assist in this process. The Board does not, however, envisage mandating across-the-board changes to systems or to cards to achieve this. Rather, it expects that acquirers will respond to requests from merchants to facilitate non-acceptance. The Board would, however, monitor developments in this area and consider requiring such changes if there was a case to do so.

These considerations have not altered the Board's conclusion on the acceptance of pre-paid cards. It remains of the view that merchants should not be required to accept a scheme's pre-paid card or debit card as a condition of accepting the scheme's credit card. The Board encourages the schemes to allow separate acceptance decisions for pre-paid cards and, in the event that they do not do so, the Board would consider regulation. Furthermore, the Board considers that MasterCard's current practice of charging higher interchange fees to a merchant that does not accept all cards is not in the spirit of the reforms. Although not expressly prohibiting merchants from declining acceptance of pre-paid cards, it has the effect of discriminating against merchants

that choose to do so. The Board is of the view that this practice should be removed, and if it is not the Board would consider requiring changes through regulation.

6.1.2 *The EFTPOS scheme*

Through the consultation process a number of industry participants sought greater clarity regarding how the Board might assess whether developments in the EFTPOS system were adequate to meet the requirement of a viable competitor to the international schemes.

The Board is reluctant to be too prescriptive here. In its Preliminary Conclusions, it noted a number of developments that would provide it with some comfort that the competitive environment was being strengthened. These included:

- the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make decisions about multilateral interchange fees;
- the creation of effective arrangements to promote the development of the scheme;
- reform of current access arrangements; and
- the development of alternative payment instruments for use in online payments (either by the EFTPOS scheme or some other channel).

At a very general level, when making its assessment the Board will be looking at whether a scheme has been established, has an effective governance structure and is actively considering promotion and business development. The specific suggestions were not meant to imply that without these developments, the Board would be unable to step back. Rather, they were provided as examples of developments that would weigh in the Board's assessment of whether the EFTPOS system was likely to provide meaningful competition over the medium term.

One issue that was raised in submissions was whether the governance structure of the scheme will ensure the EFTPOS scheme can make decisions and take actions that are in *its own interests* rather than, for example, only those of the largest issuers of EFTPOS cards. A number of parties noted in consultation that the outcome from an EFTPOS scheme could be highly dependent on its governance structure and, in particular, whether decision making is dominated by the largest banks. An outcome where the interests of one or two large banks could prevent the scheme from taking action judged to be in the interests of the scheme as a whole would be unlikely to meet the Board's expectations. The Board will look closely at the governance structure to assess whether there are appropriate checks and balances in the decision-making processes.

A second aspect that the Board will consider in its assessment is the role of multi-function cards in facilitating competition between the debit card systems. The prevalence of these cards, combined with the modifications to honour-all-cards rules, facilitate network choice by merchants for debit card payments. In particular, a merchant is able to steer a customer towards its preferred payment option on a multi-function card – or even decline its non-preferred option – with limited risk of losing the sale. If financial institutions were to move away from issuing multi-function cards in any substantial way this could lessen competition between the schemes and the EFTPOS system.

A number of participants also sought guidance on the Board's expectations with regard to an online payment system. In the Preliminary Conclusions, the Board indicated that the

development of alternative payment instruments for use in online payments would strengthen the case for deregulation of interchange fees. It noted, however, that this need not be through EFTPOS – it could be developed through another channel. Indeed, a number of submissions suggested that alternatives from outside the EFTPOS system might soon be available.

In the time since the release of the Preliminary Conclusions, there has been less progress in the development of an alternative online payment system than the Board had previously expected. Apart from the concerns this raises about the ability of the industry to promote innovation in the Australian payments system, it introduces some doubt as to the speed of progress in this area. The Board continues to see it as important that consumers have a range of options available when making online payments.

Finally, a number of submissions suggested that a multilateral interchange fee may not be necessary for the EFTPOS system to be a viable competitor and that its interests may be best served by the maintenance of the current system of bilateral interchange fees. In the Preliminary Conclusions, the Board saw reasons why the ability to set a multilateral fee might be important for an EFTPOS scheme to promote its use. The consultation process has, however, suggested that this need not necessarily be the case. In particular, it has been suggested that the current system of bilateral interchange fees combined with the ability of merchants to decline acceptance of scheme debit cards makes it more likely that the EFTPOS system will be promoted and supported by merchants. Given these contrasting arguments, the Board has no particular view either way on which interchange fee regime might be best for the EFTPOS system; this matter is best left to the scheme to determine.

6.1.3 Capping of surcharges

The Board has not changed its view that there have been substantial benefits from the removal of no-surcharge rules. The share of merchants surcharging is continuing to increase and this is improving the competitive dynamics and price signals in the payments system. Evidence from card schemes and merchants indicates that the ability to surcharge is putting some downward pressure on interchange fees and merchant service fees in some areas.

In response to submissions, the Board has again considered the issue of caps on surcharges. On balance, it remains of the view that the case for such caps is relatively weak. The main arguments in favour of capping surcharging relate to improved consumer experience and limiting brand damage to the schemes from surcharges that are much higher than the relevant cost to the merchant. The Board, however, does not see the isolated cases of high surcharges as sufficient grounds to allow the schemes to reimpose restrictions on all merchants and hence limit their negotiating flexibility. Indeed, survey data suggest that, on average, surcharges are very similar to average merchant service fees, although there are some cases where surcharges appear considerably higher than these fees. This latter outcome is likely to reflect the market power of the merchants concerned which, if surcharging were capped, would likely find its way into higher prices in some other way. Finally, as noted above in its conclusion on honour-all-cards rules, the Board is of the view that in order to step back from interchange regulation, as much competitive pressure should be brought to bear on interchange fees as possible. Permitting a cap on surcharges would, at the margin, reduce such pressure.

Another issue considered in relation to surcharging was the role of no-surcharge rules in 'new' payment systems. The Board recognises that a no-surcharge rule might, in some limited circumstances, potentially be useful to a new payment system during its development phase when achieving critical mass of acceptance and use is important. It is, therefore, of the view that it would be inappropriate to rule out such a possibility categorically. Rather, the issue would need to be examined on a case-by-case basis.

Finally, the Board has considered the issue of disclosure of surcharges. Its strong view remains that any surcharge for the use of credit cards should be clearly disclosed to the customer *prior* to commencement of the payment process; in fact, in order for disclosure to be meaningful, this may require some merchants to disclose the surcharge even before the customer selects their purchase. Furthermore, a merchant should not mislead customers about the surcharge, for example, by claiming it is recovering the merchant fee when in fact the surcharge is substantially higher than the merchant fee. The Australian Securities and Investments Commission has produced a guide on *Merchant Pricing for Credit Card Payments* which sets out the disclosure requirements for merchants that choose to surcharge.³

6.1.4 Transparency of scheme fees

While the schemes have expressed some concerns about commercial confidentiality associated with the publication of scheme fees, most other submissions were in favour of increased disclosure. In the same way that interchange fees, which are now published, affect merchant service fees, so too do scheme fees. But, in contrast to interchange fees, the level of scheme fees is not disclosed. In addition to better informing merchant negotiations, improved transparency would assist in monitoring any changes in the structure of scheme fees which might be associated with new means of transferring revenue from acquirers to issuers. This improved transparency would be important regardless of whether or not the Bank were regulating interchange fees. The Board, therefore, remains of the view that information on the level of scheme fees should be available to merchants. The Bank will work with the schemes to address legitimate confidentiality concerns while ensuring that meaningful disclosure takes place.

The Preliminary Conclusions also noted that the fees and procedures that apply if an acquirer wishes to bypass scheme switches should also be transparent. The Board notes that there have recently been some improvements in transparency of scheme rules and the Bank will be discussing with industry participants whether further improvement is necessary.

6.1.5 An alternative way of meeting the Board's concerns

As noted above, some industry participants have expressed concerns regarding the ongoing regulatory uncertainty associated with the Board's preferred course of action. Concerns have also been expressed about the degree to which progress in establishing improved EFTPOS arrangements and alternative methods for online payments would affect the regulatory outcome for the credit card schemes. One possibility that was raised during consultation is that this uncertainty could be removed if the credit card schemes provided a public commitment that average interchange fees in the credit card systems would not be increased from current levels.

3 [http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/news_for_business.pdf/\\$file/news_for_business.pdf](http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/news_for_business.pdf/$file/news_for_business.pdf)

If the schemes were to provide such a commitment, the case for requiring further modifications to honour-all-cards rules to allow separate acceptance decisions for products that have different interchange fees is weakened. In particular, this type of commitment could provide the comfort that the Board is seeking that credit card interchange fees would not rise from current levels. As a result, the potential benefits of further changes to the honour-all-cards rules are somewhat reduced, making it less likely that these benefits exceed the costs associated with necessary system changes. As such, the Board is of the view that this particular change proposed to the honour-all-cards rules would not be required. The Board would still, however, require that acceptance of pre-paid cards not be bound by honour-all-cards requirements.

If a commitment on the level of credit card interchange fees were to eventuate, the Board would *not* see a need for similar caps on scheme debit and EFTPOS interchange fees. To impose such caps would, in effect, simply re-establish the *status quo* with voluntary commitments. Instead, the Board would rely on competitive pressure from the EFTPOS system and, in particular, the ability of merchants to steer transactions through the EFTPOS system if scheme debit interchange fees are too high, to help constrain the level of debit interchange fees.

One issue that has arisen in discussions with industry participants is how some form of commitment might be achieved. One possible approach would draw on the model used for scheme debit interchange in which the Bank published a draft standard and offered the schemes an opportunity to provide an undertaking that they would abide by the standard. In this case, rather than publish a draft standard the Bank would publish a 'Commitment' to which the schemes might bilaterally agree. Two examples of such a commitment are provided in Appendix 2. The Bank is prepared to consult with industry participants regarding the exact form of any commitment, although it would need to ensure that the average level of credit card interchange fees was no higher than the current level of around 0.5 per cent.

6.1.6 If the Board's concerns are not addressed

If in August 2009 the Board judges that insufficient progress has been made in addressing its concerns then regulation of interchange fees will continue. If this is the outcome, the Board sees a strong case to further reduce the difference between interchange fees in the various systems.

The Board has not changed its view that if interchange fee regulation is to continue, the benchmark for credit card interchange fees should be reduced to around 0.3 per cent. In response to views expressed in consultation, however, the Board has reconsidered the need to impose the same interchange benchmark on the scheme debit and EFTPOS systems. Under the current set of regulations, a transaction on a scheme debit card attracts, on average, around 17 cents more interchange revenue for an issuer than an equivalent transaction using the EFTPOS system. The Board had been concerned that, were this differential to persist, the EFTPOS system would be at a disadvantage to the scheme debit systems, not because of its merits but because issuers can earn more interchange revenue from a scheme debit transaction than for an EFTPOS transaction. Given this concern, the Board had proposed that the same benchmark – 5 cents paid to the issuer – apply to both debit card systems.

This proposal attracted criticism from merchants who argued that such an outcome would make it more difficult for the EFTPOS system to compete effectively with scheme debit.

Currently, with interchange flowing from issuers to acquirers, large merchants in particular have the incentive to promote the use of the EFTPOS system by their customers – in the extreme by refusing to accept payments using scheme debit cards. It was argued that eliminating the differential in interchange fees would result in the merchants having no such incentive and perhaps even result in merchants encouraging customers to use scheme debit. Furthermore, if the exemption for cash-out transactions were removed, as the Board concluded it should be, merchants would have a reduced incentive to offer cash out to customers, instead directing customers to more expensive cash withdrawals at ATMs in their stores. The outcome, according to the merchants, would be a decline in the EFTPOS system and more expensive cash withdrawals for customers.

The merchants' views highlight the issue of how payment systems balance promotion of merchant acceptance and consumer use. The Board has previously come to the conclusion that payment systems often have a tendency to focus more heavily on promoting consumer use. This reflects a number of observations including: the tendency of payment systems to compete by raising interchange fees to attract issuers; the fact that consumers (rather than merchants) make the choice of payment instrument at the time of payment; the prevalence of incentives to consumers to use credit cards; and the argument put to the Bank over many years by merchants that they have very little choice but to accept credit cards because of consumer pressure. In considering an appropriate differential between scheme debit and EFTPOS interchange fees if regulation were to continue, the Board therefore gave weight to the argument that systems with higher interchange fees would have an advantage because they would be promoted by issuers while continuing to be accepted by merchants.

The submissions from the merchants suggest that, rather than constraining interchange fees in the two systems to be the same, any regulatory option should provide some flexibility for the debit card systems to have different interchange fees. Thus, in the event that satisfactory voluntary reform does not eventuate, the Board proposes to change the existing interchange regulations such that:

- the weighted average of interchange fees in each of the scheme debit and EFTPOS systems would be constrained to be between 5 cents paid to the issuer and 5 cents paid to the acquirer; and
- credit card interchange fees would be capped at a weighted average of 0.3 per cent.

While the same regulatory framework would apply to both EFTPOS and scheme debit, there would be flexibility for EFTPOS to maintain fees that flowed to the acquirer and scheme debit to have fees that flowed to the issuer.

Requiring the *weighted average* for EFTPOS interchange fees to be within a band only makes sense, however, if these fees are set by the scheme as multilateral fees. If bilateral fees are maintained in the EFTPOS system, such an approach poses a number of practical problems – not least of which is how such a weighted average would be calculated. In this case, the Board is of the view that, in order to maintain the same general framework for setting interchange fees in the two systems, the *actual bilateral* EFTPOS interchange fees would be required to be between 5 cents paid to the issuer and 5 cents paid to the acquirer. The current non-discrimination

provisions, which prevent bilateral negotiation over interchange fees from hindering the ability of new entrants to compete in the EFTPOS system, would continue to apply.

Finally, there is the issue of cash-out transactions. When the Board regulated EFTPOS interchange fees in 2006, it exempted cash-out transactions on the basis that interchange fees for a substitute channel for cash, ATMs, were unregulated. Interchange fees in the ATM system are soon to be set at zero and, if scheme debit systems were to introduce cash out (which may be possible now that PINs can be used for scheme transactions), interchange fees on these transactions would not be exempted from regulation. The Board, therefore, does not see a strong case for maintaining this exemption for EFTPOS cash-out transactions if interchange fees continue to be regulated. The flexibility of the weighted-average calculation in this option, however, still allows for a payment to the merchant for a cash-out transaction if an EFTPOS scheme judges that such a model will best promote its interests. Such flexibility would, of course, be diminished if interchange fees remained bilateral.

6.2 Summary

In summary, the approach being adopted by the Board is the following.

- (i) The Board is prepared to step back from the regulation of interchange fees provided its concern that interchange fees in the credit card systems might rise in the absence of regulation is addressed.
- (ii) One way in which this could be done was suggested in the Preliminary Conclusions and involves a further strengthening of the competitive environment by industry participants: making changes to the EFTPOS system to improve its ability to compete effectively with the international card schemes; further modifying the honour-all-cards rules to allow merchants to make separate acceptance decisions for any card for which there is a separate interchange fee; and increasing the transparency of scheme fees and average interchange fees. This remains the Board's preferred approach, although it would be prepared to consider the reimposition of regulation if average credit card interchange fees were to rise again.
- (iii) An alternative way of meeting the Board's concerns would be for the schemes to commit to limiting the weighted average of their credit card interchange fees to the current level (0.5 per cent). If this approach were adopted, the benefits from further modifications to the honour-all-cards rules suggested above would be reduced, and accordingly the Board would not see a need for these changes to be made.
- (iv) The Board will assess the degree of progress in meeting its concerns in August 2009. If at that time it judges that insufficient progress has been made, regulation of interchange fees will be retained with the benchmark for credit card interchange fees reduced to 0.3 per cent as proposed in the Preliminary Conclusions. In the EFTPOS and scheme debit systems, a common approach to setting interchange fees is being proposed, although the schemes would have more flexibility than was suggested in the Preliminary Conclusions. In particular, average interchange fees would be constrained to be between 5 cents paid to the issuer and 5 cents paid to the acquirer.
- (v) In assessing whether the competitive environment has been adequately strengthened, the Board will consider: the governance structure of the EFTPOS system; whether

there is an alternative online payment system in prospect (not necessarily provided by the EFTPOS system); and whether multi-function cards continue to be maintained. It may also consider other issues, including whether the schemes have committed to limiting interchange fees.

- (vi) The schemes will not be permitted to reimpose no-surcharge rules. As currently, a merchant will be able to agree with an acquirer to limit its surcharge but neither schemes nor acquirers will be permitted to unilaterally impose a cap on a merchant.
- (vii) The current modification to honour-all-cards rules, allowing separate acceptance decisions for scheme debit and credit cards, will remain. In addition, the Board encourages the schemes to permit merchants to make separate acceptance decisions on pre-paid cards and to alter pricing arrangements that effectively penalise merchants who do not accept all cards. If these changes are not made the Board would consider regulation.
- (viii) Further transparency of scheme fees will be required. The Bank will be working with the schemes to find a mechanism of achieving this while balancing the schemes' concerns that scheme fees are commercially sensitive. Again, if an agreement cannot be reached, the Board would consider regulation.
- (ix) If regulation of interchange fees were to continue, the Board would not require further modifications to honour-all-cards rules to allow separate acceptance decisions for any card with a separate interchange fee, although it would still seek greater transparency of scheme fees.

7. Process and Implementation

The Board's final decision on interchange fees will be made by August 2009. At that time, it will assess the extent of progress by industry in addressing the various issues raised above. If the Board's concerns are met, interchange regulation would be removed, probably in November 2009. However, in the event that the Board's concerns are not adequately addressed, regulation of interchange fees would continue. In this case, it is anticipated that draft standards would be released for comment late in 2009, with the aim of finalising the new regulatory arrangements in the first quarter of 2010. Further, the resetting of interchange fees with respect to the current benchmarks, which is due to occur in November 2009, would not be required and the Board would make a technical amendment to the Standard in August 2009 to give effect to this.

In the meantime, the Board plans to introduce a technical modification to the interchange fee Standards in November 2008 to remove the requirement for future cost studies. Cost studies were due to commence over the next few months to fulfil the requirement in the credit card and EFTPOS interchange fee Standards for such a study to be completed at least every three years.

Appendix 1: Submissions

During the process of conducting the Review, the Bank has received a substantial number of submissions from interested parties. A first set of submissions was in response to the Issues Paper released in May 2007 and a second set was in response to the Preliminary Conclusions released in April 2008. All non-confidential submissions are available on the Bank's website (www.rba.gov.au).

The Issues Paper

The Reserve Bank received a total of 27 submissions from the following organisations or individuals in response to the Issues Paper.

Abacus Australian Mutuals Pty Ltd
ACIL Tasman (on behalf of American Express Australia Limited)
American Express Australia Limited
Australia and New Zealand Banking Group Limited
Australian Bankers' Association
Australian Merchant Payments Forum
Australian Payments Clearing Association
Australian Settlements Limited
Bank of Queensland Limited
BPAY Pty Ltd
Commonwealth Bank of Australia
Cuscal Limited
Diners Club (prepared by the Allen Consulting Group)
Dr Alan Frankel (on behalf of the Australian Merchant Payments Forum)
Professor Joshua Gans
GE Money
Indue Limited
Mr Peter Mair
MasterCard Worldwide (prepared with the assistance of Frontier Economics)
National Australia Bank Limited
PayPal Australia Pty Ltd
St George Bank Limited
Tyro Payments
Village Mall Pty Ltd

Visa International
Westpac Banking Corporation
Woolworths Limited

The Preliminary Conclusions

The Reserve Bank received a total of 24 submissions from the following organisations or individuals in response to the Preliminary Conclusions.

Abacus Australian Mutuals Pty Ltd
ACIL Tasman (on behalf of American Express Australia Limited)
American Express Australia Limited
Australia and New Zealand Banking Group Limited
Australian Bankers' Association
Australian Merchant Payments Forum
Australian Payments Clearing Association
Australian Settlements Limited
Coles Group Limited
Commonwealth Bank of Australia
Consumer Action Law Centre
CRA International
GE Money
Indue Limited
LWT Advisors
Mr Joe Lenzo
Mr Peter Mair
MasterCard Worldwide
National Australia Bank Limited
PayPal Australia Pty Ltd
Tyro Payments
Visa International
Westpac Banking Corporation
Woolworths Limited

Appendix 2: Examples of Commitments on Interchange Fees

Section 6.1.5 raised the possibility of the schemes making a public commitment on the level of credit card interchange fees. The Board has no particular view at this stage on the form of this commitment, other than it should be competitively neutral and provide comfort that average interchange fees would not rise from current levels.

One possibility would be to effectively reproduce the current credit card interchange fee Standard in a less legalistic manner. Such a commitment might read as follows:

[] agrees that on 1 November 2009 and every [third] year thereafter, the weighted average of credit card interchange fees in Australia will not exceed 50 basis points. If interchange fees on credit cards are introduced, varied or removed between these periods, [] agrees that the new weighted average will not exceed 50 basis points. The weighted average is calculated by dividing the total interchange revenue that would have been payable on credit card transactions in Australia had the interchange fees implemented on that date been applicable in the previous financial year, by the total value of Australian domestic credit card transactions in that financial year. [] agrees to publish its Australian interchange fees on its website. In addition [] agrees to publish its actual weighted-average interchange fee on credit card transactions quarterly, no later than 30 days after the end of the quarter.

This drafting is quite complex, reflecting the fact that it is based on a legal standard and the current arrangements for calculating the weighted-average interchange fee for compliance purposes. Another simpler possibility might be to base a commitment around the actual weighted-average interchange fee which is directly observable by the schemes. For example, it might read:

[] agrees that each quarter, no later than 30 days after the end of the quarter, it will publish data on the average credit card interchange fee for that quarter. [] further agrees that the average credit card interchange fee calculated across the most recent four quarters will not exceed 50 basis points.

The Board is prepared to discuss the precise form of such a commitment bilaterally with the schemes.