ABA's Submission
2007/08
Payments Systems Review

31 August 2007

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EXECUTIVE SUMMARY

The Australian Bankers' Association (ABA) welcomes the opportunity of making a submission to the Reserve Bank of Australia's (RBA's) 2007/08 Payments Systems Review.

The main purpose of the ABA's submission is to argue in favour of re-balancing the regulation of Australia's payment system away from more prescriptive approaches to that of a more pro-competitive approach and, by doing so, achieving a more stable and certain regulatory environment.

The main initiative to achieve this re-balancing is for a deregulation of interchange fees. ABA recommends that interchange fees should not be determined by Government regulation, but set commercially by payment instrument schemes. This would help restore regulatory certainty, and reduce the risk of sub-optimal levels of investment and innovation.

Key challenge for the 2007/08 review – configuration of interchange

The primary challenge posed for the 2007/08 review is to determine how best to regulate or configure interchange fees across the landscape of payment instruments. The Reserve Bank's stated policy concern is that interchange fees may result in consumer prices of various payment instruments that do not promote efficient price signals.

The ABA's submission argues that this policy benchmark provides a useful starting point to discuss issues of efficiency and competition, but that it poses significant difficulties with its implementation, particularly relating to interchange fee regulation.

The ABA's submission argues that a more effective alternative is to (a) deregulate interchange fees in preference to commercial setting of these fees and (b) promoting effective competitive tension between end-users of payment instruments – merchants and consumers.

Both consumers and merchants have incentives and tools available to reduce the costs each pays per payment transaction. Consumers can choose payment instruments that have lower consumer prices and greater benefits, and merchants can (a) refuse to accept instruments that have higher merchant prices or lower benefits, (b) provide incentives to alter or steer the consumer's choice, and/or (c) surcharge the transaction to reallocate costs.

Ultimately, the cost allocation burden of payment instruments will depend upon the relative bargaining strength between merchants and consumers. The role of policy should be to promote healthy competition between merchants and consumers.

Initiatives to strengthen merchant/consumer competition

To assist in encouraging competition between merchants and consumers, the ABA's submission recommends two initiatives:

1. Establishment of a commercial governance structure for EFTPOS; and

2. Allow the owners of new or emerging payment instruments to ensure they can secure network effects by allowing the use of no surcharge rules and, from inception of the new instrument, have the freedom to set optimal interchange fees.

Co-regulation

The ABA has had an opportunity to review a draft of submission by the Australian Payments Clearing Association (APCA) and we endorse its recommendations.

1 INTRODUCTION

The Australian Bankers' Association (ABA) welcomes the opportunity of making a submission to the Reserve Bank of Australia's (RBA) 2007/08 Payments Systems Review.

The main purpose of the ABA's submission is to argue in favour of re-balancing the regulation of Australia's payment system away from more prescriptive approaches to that of a more pro-competitive approach and, by doing so, achieving a more stable and certain regulatory environment. The main initiative to achieve this re-balancing is for a deregulation of interchange fees.

The pre-condition for this pro-competitive response is for there to exist healthy and balanced competitive tension between merchants and consumers over the type and final payment instrument price paid by consumers for undertaking a payment transaction. By ensuring this competitive tension, interchange fee regulation then becomes unnecessary and undesirable from a policy perspective.

1.1 Need for regulatory certainty

Without regulatory certainty, the risk of sub-optimal levels of investment and innovation are very real. While ABA applauds the openness of the Reserve Bank in stating that their cost-based credit card interchange standards were designed for the practical purpose of lowering interchange fees and that there is no clear theoretical basis[1], it should be recognised that such an arbitrary approach to economic regulation poses a challenge to investors and businesses looking for certainty in regulatory arrangements.

This risk is compounded by the lack of a merit appeal right for affected parties under the payments regulation legal structure. The Reserve Bank's powers under the *Payments Systems Regulation Act (PSRA) 1998* are strong, allowing intensive and prescriptive regulatory rules. The ABA is not aware of any other country that has such extensive powers.

Reserve Bank decisions taken under the PSRA are not subjected to review on the basis of merit (even decisions taken under the access regime powers[2]) nor are they disallowable instruments. This means RBA actions can have a marked effect on payments systems innovation as innovators are aware that the benefits of any innovation can be lost as a result of regulatory intervention.

Hence, the ABA recommends that for innovation to be adequately addressed, the RBA itself needs to ensure predictability and certainty in its regulatory responsibilities. Deregulation of interchange fees and a strong commitment to market-based outcomes is important for long-term investment and innovation.

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[1] *"Now it is undoubtedly true that the theory of two-sided markets and interchange fees is still evolving and realistic models are still being developed…I would like to repeat a point I have made elsewhere: and that is, the Bank's use of cost-based standards does not reflect a view that, conceptually, interchange fees should necessarily be set with an eye to costs on just one side of the market. We have adopted a cost-based approach for two very practical reasons. The first is that it is a transparent way of moving to a lower level of interchange fees, and was one that had been used by some card schemes to set these fees in at least some countries. The second is that under our legislation we cannot just set a particular interchange fee, but rather are required to impose a 'standard, and a cost-based approach meets the legal test of a standard."* Address to the Payments System Conference 2006, Philip Lowe, RBA Assistant Governor, Melbourne Business School, 14 March 2007.

[2] See ABA's 'Submission to the Taskforce on Reducing the Regulatory Burden', 16 December 2005.

1.2 Assumptions underlying the submission

The ABA's submission does not attempt to define specific payment instrument markets. It is an assumption that all payment instruments compete in one market, that for retail payment transactions.[3] Once the Reserve Bank completes its survey of customer payment usage, which is being undertaken as part of the 2007/08 Review, there will be additional information to assess the validity of this assumption.

Another issue not directly addressed in the paper is quantification of resource costs relating to various payment instruments. This is the subject of a major cost-study underway by the Reserve Bank, also as part of the 2007/08 Review. The ABA's submission, therefore, discusses payment system resource costs in an abstract way.

Finally, when the submission uses the term 'payment systems', the ABA is referring to all thirty payment instruments operating in Australia, but we recognise that the dominant payment systems are those with the largest market penetration. These are:

- Open scheme credit cards (Visa and MasterCard); Closed scheme charge cards (American Express and Diners Club); Scheme debit cards (Visa and MasterCard); EFTPOS; BPay; Cheques; Direct entry; Cash; PayPal and GE Store Cards.
- While not all of these payment instruments have interchange fees, they all (except cash) involve interconnection between issuers, acquirers and end users, so, in most cases, arrangements similar to explicit interchange fees exist.

1.3 Structure of submission

The submission is structured around the following sections:

- Section 2 outlines the ABA's response to the key question posed for the review – how to optimally configure interchange fees across the payments landscape. This section starts with an attempt to clearly define the Reserve Bank's policy benchmark.
- Section 3 answers the Reserve Bank's specific questions outlined in its 2007/08 review issues paper.
- Section 4 summarises the submission and includes process steps for full deregulation of the Australian payments system in favour of a co-regulatory reform model.[4]

[3] In practice, payment markets are probably best understood by the payment instrument providers themselves, as these owners have the greatest incentive to achieve market share growth by appealing to the customer's of alternative payment instruments.

[4] ABA has had an opportunity to read a copy of the submission by the Australian Payments Clearing Association (APCA) and endorses the self-regulatory solution advocated.

2 THE KEY QUESTION POSED FOR THE 2007/08 REVIEW

The primary challenge posed for the 2007/08 review is to determine how best to regulate or configure interchange fees across the landscape of payment instruments. The stated policy concern is that interchange fees may result in consumer prices of various payment instruments that do not promote the efficient use of those payment instruments.[5]

2.1 Defining the policy goal

What does this mean specifically? The ABA interprets this as the Reserve Bank seeking, on efficiency grounds, to see payment instrument issuer prices effectively ranked in order according to the payment instrument's underlying resource cost.

Resource costs being composed of both issuer and acquirer production costs, but excluding or netting out any interchange fee costs from the calculation of total production costs[6]. The ABA's interpretation of the Reserve Bank's desired efficient pricing outcome is stylised in Table 1 below.

Table 1: ABA's interpretation of the Reserve Bank's desired (efficient) pricing outcome

Payment instrument[7]	Combined resource costs of issuers and acquirers (per $100[8] purchase)	Ranking of resource cost	Example of an efficient issuer pricing outcome* (per transaction, $100 purchase)
Payment instrument A	100 cents	5	50 cents
Payment instrument B	80 cents	3	40 cents
Payment instrument C	60 cents	2	30 cents
Payment instrument D	90 cents	4	45 cents
Payment instrument E	10 cents	1	5 cents

* Consistent with the Reserve Bank's policy benchmark as interpreted by ABA.

The first column lists five hypothetical payment instruments, A to E. The next column attributes per transaction[9] resource costs to each of the payment

[5] *"…the central issue has been whether the price signals facing consumers were encouraging the efficient use of the various payment instruments…the Payments System Board concluded they were not…the Board has sought a narrowing of the differences in interchange fees across the various systems in an effort to promote more appropriate price signals to consumers…Not surprisingly, a question that the Board has asked itself is whether it is a long-term solution for the issuer to receive 50 cents on a $100 credit card payment, 12 cents on a scheme debit payment, and have to pay 5 cents on an EFTPOS payment."* Philip Lowe, Assistant Governor (Financial System), Address to the 4th International Consumer Credit Card Summit, Sydney – 27 June 2007.

[6] Production costs would include, processing, authorising, instrument production, fraud, float costs, acquiring services, marketing costs.

[7] Please note that there is an implicit assumption of substitutability amongst these five payment instruments in the analysis.

[8] The ABA's use of a $100 transaction value is consistent with the example used by Assistant Governor, Philip Lowe, in his address to the International Consumer Credit Card Summit, Sydney, 27 June 2007, illustrating relative issuer interchange fee revenues for credit, debit and EFTPOS transactions. The $100 transaction value does not purport to be the average transaction size across all payment instruments.

[9] ABA confirmed with an informal discussion with an RBA representative (in August 2007) that the relevant metric is resource costs on a per transaction basis.

instruments. These are then ranked in the third column from 1 to 5, with 5 being the most resource costly.

The fourth column then provides an example of how the ABA interprets the Reserve Bank's view on efficient pricing, that being, each consumer payment price[10] ranked consistently in accordance with its resource cost ranking. For example, payment instrument 'A' uses the most resources (per transaction), so the Reserve Bank's efficient outcome is for the issuer price of payment instrument 'A' to be highest. The illustrative example given is a price of 50 cents per transaction (this, of course, incorporates any loyalty of other rebates that may apply).

It is not the purpose of this section to put words in the mouth of the Reserve Bank, but ABA believes there is some confusion as to the precise policy goal of payments regulation and, importantly, how this policy goal can be achieved in practice. The purpose of Table 1 is to make this policy goal tangible by defining what success would look like i.e. a set of consumer prices ranked in order of resource costs. In effect, the policy goal being sought by the Reserve Bank is a retail consumer price benchmark.

The next section details the relevance of interchange fees to this consumer price benchmark.

2.2 Role of interchange fees

Australian consumers have a range of payment options to transfer value from their accounts and purchase goods and services.[11] There are payment instruments that enable payments between consumers, such as cheques and cash. Other payment instruments specialise in consumer-to-business transactions such as debit, credit and bill payment systems.

The most widely used payment systems are those characterised as involving four parties. In consumer-to-business payment systems, these four parties are: (a) the consumer; (b) the consumer's payment instrument provider, known as the 'issuer'; (c) the merchant; and (d) the merchant's payment acceptance provider, known as the 'acquirer'.

To enable transactions, all four parties must have an incentive to facilitate the transaction. The consumer must choose the payment instrument. The consumer's issuer must have pre-issued the physical payment instruments (e.g. a card). The merchant must be willing to accept the payment instrument. The merchant's acquirer must have pre-provided acceptance facilities.

Interchange fees can help ensure the end-users (both the merchants and consumers) have a net-benefit incentive to undertake the transaction by influencing relative prices paid by these end-users. If one of the parties (e.g. the merchant) does not see the benefit of accepting a card as above the cost, then, an interchange fee can be used to reduce the cost until a net benefit incentive is created.

It is this role in influencing relative prices that has caused Reserve Bank policy concern because it is possible for the interchange fee to influence a consumer

[10] The consumer price is composed of following: (i) the issuer fees and charges, (ii) issuer loyalty or other rebates, (iii) merchant surcharge applied to the consumer's use of the instrument.

[11] This is the primary functionality of payments, but it should be kept in mind that payment instruments can provide additional functionality. A credit card, for example, can provide a means of payment where the customer has no current savings. An EFTPOS card can be used to obtain 'cash out' on top of purchases.

price such that it no longer aligns with its resource cost ranking. Hence, the Reserve Bank has identified the configuration of interchange fees across the payments instruments as important to configuring consumer prices in ranking of resource costs.

2.3 ABA's critique

The ABA's first observation of the Reserve Bank's consumer price policy benchmark is that it provides a good starting point from which to discuss issues of efficiency and competition in the payments system overall. The ABA can see a theoretical attractiveness to the idea that consumer prices should be aligned with underlying costs. In traditional markets (not two-sided markets) the existence of a product's price equalling marginal cost is one characteristic of a perfectly competitive market.

To the extent to which deriving a set of consumer payment prices consistent with a resource cost ranking is a worthwhile objective, then it follows that interchange fee regulation should be identified as a potential tool to assist in deriving this outcome because it is a reality that interchange fees influence retail prices, particularly when merchant surcharging is prohibited.

Indeed, the motivation for the Reserve Bank's credit and debit card interchange regulation was to influence respective consumer prices so these prices reflected relative ranking in terms of per transaction resource costs.

Having acknowledged usefulness of this consumer price benchmark as an analytical tool, the ABA believes there are significant theoretical shortcomings of the benchmark, and practical difficulties in using interchange regulation to implement it. These difficulties are discussed in the following sections.

<u>Resource cost rankings will change according to transaction value</u>

A significant difficulty with the consumer price ranking benchmark arises with respect to transaction value. Research shows[12] that the relative resource cost of payment instruments varies according to transaction size.

In practice, resource costs ranking can be derived from estimates of average transaction sizes, but this will suffer from imprecision. If payment instrument prices are forced to reflect these rankings based on averages, then transactions which are higher or lower than average size will potentially be priced inefficiently.

It would be possible to remedy this situation by developing a range of resource cost ranking schedules, each reflecting a nominal transaction value, but this would create significant complexity and compliance burden. Further, as average transaction sizes changed with growth in consumer spending, the per transaction resource cost rankings will also change, requiring constant adjustments to the interchange fees to ensure efficient prices are achieved.

<u>If consumer prices are to be ranked, what is the starting point?</u>

Assuming there is policy value in attempting to align consumer prices according to resource cost ranking, there is a question over the starting point. There are two components to this (a) what payment instrument should be considered the base or benchmark payment instrument, and (b) what proportion of system costs should be allocated between merchants and consumers?

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[12] _See 'The Move Towards a Cashless Society: A Closer Look at Payment Instrument Economics', Garcia-Swartz, Hahn, Layne-Farrer, Review of Network Economics, Vol.5, Issue 2 – June 2006.

In a two-sided market like a payment market, both consumers and merchants benefit from the produced service (i.e. a payment service). Each resource cost[13] spent on producing that payment service, therefore, benefits both consumer and merchant. So, any regulatory rule that dictates that just one end user should pay certain costs will be arbitrary.

The other issue is to determine what payment instrument constitutes the benchmark instrument. Cash is often considered the primary payment instrument, but it has been credit and debit cards in Australia that have motivated interchange fee regulations.

The problem with interchange fee regulation is that it requires the regulators to make arbitrary judgements on these issues.

<u>How can the ranking be made consistent when some instruments do not have interchange fees?</u>

Another complication with the Reserve Bank's consumer price benchmark is how to ensure the consistent ranking of consumer prices of payment instruments that do not have interchange fees.

American Express and Diners Club, for example, may have the highest per transaction resource costs, but they have no interchange fees to regulate and therefore provide no opportunity for regulators to influence consumer prices through mandating eligible costs to end users.

This means the schedule of resource cost rankings for all the payment instruments will be distorted by the payment instruments that do not have interchange fees and therefore fall outside regulatory control.

<u>Some consumer prices difficult to observe</u>

An obvious requirement of the Reserve Bank's consumer price policy benchmark is to accurately estimate the consumer prices of all the competing payment instruments. But, in recent years, it has become more difficult to observe the consumer prices for EFTPOS and direct entry (DE) transactions.

This is due to a change in transaction account offerings. There is now a greater use of what are called 'all you can eat' transaction accounts. These accounts require a monthly account payment of around $5-$7, but once the monthly fee is paid, typically EFTPOS, DE, own-ATM, telephone, Internet and over-the-counter transactions can be undertaken at no additional cost.

This raises the question of accuracy in attempting to configure retail prices according to resource ranking. Further, even if an analytical methodology[14] can be found to allocate common costs to the payment instruments that access funds in these 'all you can eat accounts', there is a further question over whether consumer's will see these prices consistently with this cost allocation methodology.

[13] Note that the ABA's submission is not addressing or discussing individual system costs for various payment instruments. The Reserve Bank's list of Review questions (see section 3) does not seek feedback on individual costs. This has been confirmed in informal discussions.

[14] ABA notes that an important component of the Reserve Bank's payment instrument cost study is to allocate common account costs to payment instruments, including with respect to 'all you can eat' accounts.

<u>Merchant surcharging can alter consumer price rankings</u>

As part of the Reserve Bank's payments system reforms, restrictions on merchant surcharging have been removed from Visa and MasterCard debit and credit products. American Express and Diners Club have given undertakings to remove merchant surcharging prohibitions from their merchant agreements.

This creates a problem for the Reserve Bank's consumer price ranking benchmark. A merchant can now use the surcharging freedom to impose an additional consumer cost to the transaction. This has the effect of increasing a consumer payment instrument price, potentially above the efficient price, as benchmarked by its resource cost ranking.

In effect, the ability for merchants to surcharge undermines the rationale for interchange regulation which aims to configure retail payment prices according to underlying resource cost.

<u>Issuing and acquiring scheme fees changes can dilute effect of interchange regulation</u>

By altering the configuration of issuing and acquiring scheme fees, a payment system scheme can influence the prices of merchant and consumer prices. For example, by increasing marketing incentives to issuers and increasing acquiring fees, the payment scheme can reduce the impact of interchange fee regulation.

In turn, this process may result in consumer prices inconsistent with the payment instrument's underlying resource cost ranking. The potential for this to happen strengthens the case against interchange fee regulation as a tool to influence consumer payment prices.

<u>Consumer price benchmark assumes uniform distribution of benefits</u>

Inherent in the Reserve Bank's consumer price benchmark is the assumption that underlying resource costs will reflect consumer and merchant benefits in the same proportion across all payment instruments.

Clearly an Internet business that has no retail shopfront will see a greater benefit from credit cards, BPay and DE more than it will from the cash payment instrument. Whereas a small retail food outlet would see more benefit in cash than it would in BPay.

So, the resources spent on producing payment instruments will be valued differently between merchants and consumers depending on the payment instrument.

We see this clearly in the newspaper market. Consumers are willing to pay part of the resource costs to receive a copy of the Australian Financial Review (about $2.70 per edition), whereas they pay none of the resource costs of the North Shore Times which is provided free to residents.

Reflecting relative benefits in pricing outcomes is one important reason why interchange fee setting should be deregulated (this issue is discussed further below).

<u>New entrants disadvantaged</u>

Another issue with the Reserve Bank's consumer price benchmark is that it potentially disadvantages new entrants compared with established payment instruments. The methodology for determining per transaction resource costs is to estimate total production costs and then divide by the number of transactions.

Newly emerging payment systems are likely to be characterised by (a) disproportionately large fixed costs and (b) low transaction volumes. This means that newly emerging payment instruments will be ranked as having a relatively high resource cost compared to payment instruments that have sufficient payment transaction to spread fixed costs – i.e. the large established players.

2.4 Alternative approach

In the ABA's view, a more effective alternative to the use of interchange regulation to achieve consumer payment prices more reflective of underlying resource costs and also to reflect benefit considerations into price outcomes is to (a) deregulate interchange fees in preference to commercial setting of these fees and (b) promote effective competitive tension between end-users of payment instruments – merchants and consumers.

<u>Deregulation of interchange fees</u>

Currently, the Reserve Bank sets cost-based interchange methodologies in the Visa and MasterCard credit and debit products, and also the EFTPOS system. The Reserve Bank has also indicated comfort with the BPay interchange fee. The effect of interchange fee regulation has been to reduce credit card interchange fees from around 95 cents per $100 transaction (paid by the acquirer) down to around 50 cents.

Visa and MasterCard debit has declined to a flat rate of 12 cents per transaction from a level consistent with the pre-regulated credit card interchange fee. EFTPOS interchange fees have declined from an average of around 20 cents (paid by the issuer) to that of 4-5 cents.

The ABA advocates that the Reserve Bank deregulate these interchange fees and allow the scheme operators to set these fees commercially[15] in competition with other payment instrument providers. The basis of this recommendation is that through interchange deregulation, the policy objective of competition can be promoted with ultimate improvements in payment system efficiency and innovation.

At its core, the advantage of competition over direct interchange regulation is that it will allow consumer and merchant prices to reflect not only resource costs but also relative benefits between merchants and consumers. By allowing for the incorporation of benefit consideration into the consumer and merchant pricing outcome, the various payment instruments will be optimally used and, therefore, innovation and long-term efficiency will be enhanced.

<u>Promoting effective competitive tension between merchants and consumers</u>

Assuming the policy objective is to align consumer prices with relative underlying resource costs, there are two regulatory approaches available. The first is for the Reserve Bank to influence retail prices through cost-based regulation of interchange fees. This is the current approach in relation to credit and debit cards.

An alternative approach is to allow competition between merchants and consumers to ultimately determine the type and price of the payment

[15] See Table 4 in the conclusion section of this submission. ABA recommends a phased approach to deregulation, starting with (a) the establishment of conditions to foster competitive pressure between merchant and consumer, then (b) the removal of interchange fee standards, and (c) the final withdrawal of designations. This process could be accelerated through the introduction of self-regulatory controls.

instrument. This competitive tension will place both upward and downward pressures on interchange fees.

Both consumers and merchants have an incentive to reduce the costs each pays per transaction by transferring system costs to the other end-user. Both consumers and merchants have tools available to pursue this incentive.

Consumers can choose payment instruments that have lower costs and greater benefits, and merchants can engage a number of strategies, including: (a) refusing to accept an instrument, (b) providing incentives to guide the consumer's choice, such as 'cash out' option or 'discounts' for other instruments and/or, (c) placing a surcharge[16] on the transaction to reallocate costs, and (d) steering the customer's choice.

Ultimately, the cost allocation burden of payment instruments will depend upon the relative bargaining strength between merchants and consumers. In the interchange deregulation model, the policy goal is to ensure a healthy state of bargaining power between the end users. Table 3 details sources of competitive tension bearing upon credit card interchange fees.

<u>What is the current state of competitive tension between merchants and consumers?</u>

There is no accurate way of determining the current state of relative bargaining power between merchants and consumers.

It is not obvious to the ABA that the relative bargaining of merchants over the type and price of payment instruments is so weak that interchange regulation is justified. The rationale for continuing with direct interchange fee regulation is that without such regulation, consumers will transfer costs back onto merchants and prices may distort with respect to resource cost rankings.

Evidence from the United States

The Reserve Bank has used observations from the United States where, over the last decade, MasterCard and Visa undertook 'tit for tat'[17] credit card interchange fee increases to support the Reserve Bank's assessment that the pressure on interchange fees is upward and in favour of the consumers. The ABA questions the relevance of this evidence for Australia:

1. During these copy-cat interchange fee increases, unlike Australia, there was no capacity for merchants to offset these increases through surcharges;

2. Visa and MasterCard dominate the domestic debit card system in the United States, there is no effective debit card alternative for merchants to promote as an alternative, such as Australia's proprietary EFTPOS system;

3. The history of interchange fees in Australia is characterised as one of stability, indeed this stability has been a source of criticism. If anything, average interchange fees have fallen in favour of merchants through a re-weighting of credit card transactions attracting 'electronic' interchange fees from that of higher 'standard' rates.

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[16] Whether the option of surcharging is used or not, the fact this option exists provides increased bargaining power for merchants.

[17] 'The Evolution and Regulation of the Payments System', Philip Lowe, Assistant Governor, Address to the Payments System Conference 2006, Melbourne Business School, 14 March 2006, p.4.

4. In the 1980s, the domestic banks set EFTPOS interchange fees in favour of the merchants, not consumers.

5. Even before the Reserve Bank reduced the credit card interchange fee in 2002, Australia had one of, if not, the lowest credit card interchange fees in the world.[18]

Historical observations on merchants bargaining position

Merchants in Australia have demonstrated a capacity over the years to resist high cost payment instruments and influence the choice of consumers towards lower costs or payment instruments that yield them a higher benefit.

- Merchants have never in any significant numbers accepted personal cheques for payment of goods and services, even though for most of last Century personal cheques constituted one of two payment instruments. Further, the fact that a cheque insurance scheme was never properly established demonstrated that merchants could satisfactorily push consumers onto cash.

- There remain in Australia a large number of merchants that only accept cash for payment, particularly in fast-food venues in regional and city areas.

- AMEX and Diners Club have only 11.6% market share and have increased their market share by only 8% since the 2002 credit card reforms. This demonstrates merchant capacity to resist these higher costs card, particularly given:

    - American Express and Diners Club have been in existence for nearly twenty years longer than MasterCard and Visa;

    - Two major banks are now in agency arrangements to issue these cards; and

    - The loyalty point benefits of the closed cards exceed that of average benefits associated with Visa and MasterCard.

- Discounting for cash is also very common.[19] Some major retailers (e.g. the Good Guys[20]) actually advertise for cash discounts.

- Merchants have assisted in maintaining the growth rate of EFTPOS through offering inducements to use this card, such as 'cash out' on top of purchase.

- Around 8% of merchants currently surcharge credit cards.[21] More importantly, East and Partners[22] data shows that around 53% of surveyed

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[18] See 'Credit Card Networks in Australia: An Appropriate Regulatory Framework', Australian Bankers Association (ABA), July 2001, available on the Reserve Bank's website: www.rba.gov.au.

[19] The Queensland Office of Fair Trading advises consumers on its web-site that *"The advantages of paying with cash are: you can often negotiate a cash discount…"* Website: www.fairtrading.qld.gov.au.

[20] The Good Guys is an electrical appliance retailer. On the home page of its Internet site viewed on Saturday 25th August 2007 was the claim that *"pay cash and we'll slash the prices".* Internet site address is www.thegoodguys.com.au.

[21] While 8% of merchants may appear to be relatively small number, an explanation for this might be that interchange fee regulation has set interchange fees too low, resulting in a lower incidence of surcharging than would occur if credit card interchange fees were higher.

[22] Statistic derived from Table 65 in the 'Australian Merchant Acquiring and Cards Market – December 2006' report, page 114, East and Partners. This table was provided to ABA via an ABA member bank. Only Table 65 was provided, with no other information from the report. ABA was not charged by the member bank for this information.

merchants have either decided or are actively considering applying a credit card surcharge to purchases.

- Recently Visa and MasterCard cut their interchange fees applying to large merchants – more evidence of merchant resistance to high MSF cards.
- The use of cash in Australia is still high in comparison to many other countries.

Many Australian businesses already re-allocating costs back to consumers

Anecdotally, it is clear that many Australian businesses are allocating additional costs back to consumers on top of the costs already re-allocated as part of the Reserve Bank's credit card reforms in 2002.

Businesses have two primary means of re-allocating costs. The first is through imposing a surcharge. If the surcharge is greater than the merchant service fee (MSF), then the business has been successful in re-allocating all system costs to the consumer. Such an outcome would mean the consumer price is likely to be higher than would be normally justified by its relative resource cost ranking.

A second means of re-allocating is for the business to negotiate a lower interchange fee than the average paid. Recently, both Visa and MasterCard have effectively lowered interchange fees to merchants that have large transaction volumes[23]. Table 2 details a selection of industries where the businesses have successfully reallocated costs to consumers.

Table 2: Sample of industries where businesses have successfully reallocated credit card cost to consumers

Australian business paying lower than average fees	Mechanism
Retailing	Interchange fee
Air transport	Surcharging
Telecommunications	Surcharging
Petrol retailing	Interchange fee/surcharging
School education	Surcharging[24]
Gas	Surcharging
Local Government	Interchange fee
Taxis	Surcharging

2.5 Initiatives to strengthen competition

Having identified evidence that merchants have already demonstrated a capacity to influence the payment instrument choice of consumers and, therefore, put downward pressure on scheme interchange fees, the ABA believes further competitive tension can be derived through two initiatives. These are:

[23] See web-sites: Visa (www.visa.com.au) and MasterCard (www.mastercard.com.au).

[24] Optus will impose a 1% processing fee for debit, credit or charge cards used for paying bills starting on 1 October 2007. See Optus web-site: www.optus.com.au.

(a) Establish a commercial scheme or commercial governance structure for the EFTPOS network;

(b) Allow new entrant payment instruments to impose "no surcharge" rules until they have gained a level of maturity in the market and, importantly, allow the commercial setting of interchange fees from inception.

Establish commercial governance structure for EFTPOS

In recent years, the ABA and the Australian Payments Clearing Association (APCA) have been undertaking research into the payment system governance from the perspective of attempting to identify what payment system governance structure will promote innovation. One outcome from this research is a recommendation for the Australian banks and other stakeholders to develop a proposal to establish a commercial scheme to operate the EFTPOS system.[25]

Currently, the EFTPOS system is not governed by a central or commercial structure, it is based on bilateral agreements between banks and the only central body involved in its operation is that of APCA. But APCA does not have a commercial focus, it is the payments industry association that sets messaging and technical requirements for payments clearing.

With a commercial structure for EFTPOS, merchants will be more confident in promoting its usage because its long-term future will be more certain. Currently, the international schemes have debit products that not only have functional advantages but their promotion is centrally managed by professional marketing staff.

The existence of merchant surcharging along with a commercially focussed and enhanced EFTPOS system, will give merchants more confidence to apply surcharges to more costly payment instruments. If there are enhancements to EFTPOS, there might be an increase in the number of consumers that carry EFTPOS cards, reducing the probability of the merchant missing out on a sale. Already EFTPOS has a strong foundation.

Around 85% of total debit transactions and around 30% of total card transactions are undertaken on EFTPOS. It is estimated that there are around twenty seven million[26] bank accounts that can be accessed by a debit card. This provides an effective alternative to all other cards in existence and will encourage merchants to surcharge other cards if the costs of accepting these other cards are deemed to high.

Under a commercially-focussed EFTPOS governance structure, the probability of EFTPOS being revamped through features such as 'card not present' and EMV also increases, which will make the product an even stronger alternative to scheme debit and credit cards.

EFTPOS has an interchange fee regulated at 4-5 cents. Prior to regulation, the average interchange fee was around 20 cents per transaction flowing to the merchant acquirer from the issuer, unlike credit and scheme debit where the interchange fee flows towards the issuer.

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[25] 'EFTPOS Governance', ABA media release, 2 August 2007. Available on ABA website www.bankers.asn.au.

[26] Estimate of accounts taken from RBA Bulletin Table C4. This can be accessed via the RBA's web-site: www.rba.gov.au.

<u>Allow new entrant payment systems to impose "no surcharge" rules</u>

The ABA endorses the removal of "no surcharge" rules in established payment systems. However, greater competition may be focussed on interchange fees by allowing the imposition of no-surcharge rules with emerging payment instruments[27].

The Reserve Bank can only legally require the abolition of no-surcharge rules in 'designated' payment systems[28], but the Reserve Bank's public views on these rules sends a signal to the market that such rules are unacceptable.

From the perspective of a new payment instrument's owner, it seems competitively unfair that the established payment instruments were able to grow market share partly through imposition of no-surcharge rules[29], whereas new competitor instruments[30] are unlikely to have this option.

More importantly, it is well recognised that interchange fees can play a critical role in achieving network effects by allocating system costs to end users in a proportion that reflects relative benefit. The Reserve Bank has supported the interchange fee's role in achieving this outcome.[31]

But, the effect of merchant surcharging is to undermine this cost-allocation decision because merchant surcharging reallocates system costs back to the consumer. To the extent this then distorts the optimal cost allocation between merchant and consumer, will be paid in reduced network benefits.[32]

Of course, merchants can always refuse a payment instrument, but supplementing this power with the ability to surcharge gives the merchant, in ABA's view, too much power against payment instruments that are yet to derive a critical mass of consumers to push back against the merchant.

The ABA recognises this is not a perfect policy proposal as it does require judgements as to what market share is needed before a reasonable competitive tension between merchants and consumers can be assured.

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[27] A new payment instrument could come from a new scheme or a functionally different product from a scheme that already has established products. An example of the latter would be a pre-paid card from Visa or MasterCard.

[28] American Express and Diners Club gave voluntary undertaking to remove their no-surcharge rules.

[29] This include: Visa debit and credit products, MasterCard credit products, American Express and Diners Club. ABA understands that the merchant agreements for EFTPOS and BPay systems did not include no-surcharge rules.

[30] Emerging products could include (a) prepaid cards, (b) debit over the net products, (c) mobile phone payments, etc.

31 *"I think the issue here is whether an interchange fee is in the public interest. There are respectable arguments for why such a fee is in the public interest and promotes efficiency in the system. It helps develop the network."* Philip Lowe, Assistant Governor, Reserve Bank, evidence before the Standing Committee on Economics, Finance and Public Administration: Review of the Reserve Bank and Payments System Board annual reports 2005: Discussion, 16 May, 2006.

[32] Inherent in this policy issue is the freedom for the owners of new or emerging payment instruments the commercial freedom to set interchange fees with the objective of competing effectively against established schemes.

2.6 Summary and recommendations

Table 3 sets down the evolution in factors influencing the relative bargaining position of merchants and consumers over interchange fees in the credit card system. While focused on credit cards, the general story applies to other instruments as well.

An arbitrary assessment based on Table 3 leads ABA to form the judgement that up until the Reserve Bank's 2002 reforms, the balance of bargaining power was on the side of the merchants, although merchants have always demonstrated at least some capacity to influence the payment choices of consumers.

In 2002, the Reserve Bank initiated two reforms to improve the merchant's bargaining position. This was the prohibition against surcharging and the prohibition against rules tying the acceptance of credit cards with that of scheme debit cards. The ABA's view is that the first of these initiatives is of real significance because it allows the merchant to directly reallocate system costs back to the consumer.

Going forward, the ABA believes the initiatives to establish a commercial governance structure for EFTPOS and allowing newly emerging instruments to apply no surcharge rules will improve the position of merchants in the competitive tension between consumers. This, in turn, should provide the Reserve Bank with further confidence that interchange fees can be deregulated.

Table 3: Evolution of factors influencing the competitive tension between merchants and consumers on credit card interchange fees

Source of competitive tension between merchants and consumers impacting on credit card interchange fees	Direction of pressure on interchange fees	ABA's qualitative assessment of the significance or weighting on the interchange fee setting decision
Pre payment system reforms (pre-2002)		
Merchant freedom <u>not</u> to accept credit cards.	Downward	Medium
Consumer freedom to apply for a credit card.	Upward	High
Consumer freedom to choose payment instrument at point-of-sale.	Upward	High
Merchant freedom to discount for cheaper instruments at point-of-sale.	Downward	Low
Merchant freedom to provide incentives to use lower cost payment instruments at point of sale.	Downward	Low
Post payment system reforms (2002 – currently)		
Merchant freedom to apply credit card surcharges.	Downward	High
Merchant freedom to refuse previously tied instruments[33]	Downward	Low/medium

[33] Referring to the 'honour all card rule' being abolished.

3 ANSWERING THE RESERVE BANK'S QUESTIONS

The current regulatory arrangements of the Reserve Bank to address policy concerns in the payments system are well documented in the Reserve Bank's issues paper for the 2007/08 Review[34]. Table 1 in the Reserve Bank's paper provides a useful summary. These arrangements fall into the following categories:

1. Rules requiring four-party credit card and debit card schemes to remove unnecessary restrictions on access to issuing and acquiring;
2. Rules removing restrictions on merchants from (a) surcharging customers and (b) refusing to honour all cards;
3. Mandated cost-based methodologies for setting interchange fees in four-party schemes; and
4. Rules requiring the disclosure of interchange fees on web-sites.

The sections below answers the specific question outlined in the Reserve Bank's issues paper.

3.1 What have been the effects of the reforms to date?

The effect of interchange fee reforms on cardholders and merchants

The effect of reducing the credit card interchange fee from 0.95 per cent on an average transaction down to about 0.50 per cent was to significantly transfer the credit card production cost burden from merchants to card holders.

The ABA estimates that credit card users are paying an additional $1 billion per year. This reflects: (a) increases in fees and charges, (b) dilution in the value of credit card loyalty points.

The ABA does not have a reliable estimate of the number of debit or credit card transactions that are currently surcharged, but assuming the number of surcharged credit card transactions equates to the proportion of merchants that the East & Partners survey shows that are surcharging, the ABA estimates that consumers are paying an additional $150 million per year.

To the extent credit card users are paying a higher proportion of system costs, will be reflected in the proportion of costs that merchants are now not paying.

The effect of the interchange fee reforms on financial institutions

The ABA does not have specific information of how interchange fee reforms impacted financial institutions.

In terms of impact on net issuer revenue, the ABA's estimate, based on media reports, is that reduction in issuer revenue was largely recovered from credit card holders in the form of higher fees, reduced loyalty benefits and changes to interest-free periods.

The ABA expects that smaller card issuers were impacted more than large issuers. As part of the ABA's input into the Reserve Bank's initial credit card reform process, the ABA lodged a confidential submission highlighting the relatively larger impact on smaller issuers from credit card interchange reductions.

[34] Reform of Australia's Payments System, Issues for the 2007/08 Review, May 2007.

The credit card interchange methodology which averages issuer costs, disadvantages higher cost issuers relative to lower cost issuers. Smaller institutions were also relatively impacted by the reduction in interchange fees for scheme debit cards as the major banks did not issue this card at that time.

In terms of credit card acquirers, there has been no obvious impact on margin. It is well documented that - on average - acquirers passed on the full savings from the interchange fee decline. The ABA doesn't know if any individual acquirers increased or decreased their margins.

The effect of the removal of the no-surcharge rule

The removal of the no-surcharge rules introduced merchant surcharging in Australia. Up until this reform, merchants had only three options to influence the consumer's choice of payment instrument or to offset costs. They could (a) refuse to accept the card, (b) provide a discount for cash, or (c) provide alternative inducement to use another instrument, e.g. cash out with EFTPOS. Surcharging freed up a fourth option: (d) charging an additional fee.

Graph 5 in the Reserve Bank's issues paper shows 15% of very large companies now surcharge credit card users; 9% of large merchants; 6% for small; and 5% for very small merchants.[35]

Surcharging has the effect of neutralising the interchange fees impact on relative retail prices for end users. It is an effective tool for merchants to re-allocate system costs back to the consumer. Of course, the consumer can refuse to pay the surcharge by choosing another instrument or looking for a non-surcharging merchant, but the existence of this merchant surcharging ability rebalances the relative bargaining position in the merchant's favour.

The ABA supports prohibitions of no-surcharge rules for established payment systems. We do, however, see an advantage for allowing newly emerging payment instruments to impose no surcharge rules. This potentially places downward pressure on interchange fees in existing payment systems and is competitively neutral in the sense that existing instruments were able to build critical mass using surcharging prohibitions.

The effect of the removal of the honour-all-cards rule

From discussions with payment schemes, the ABA understands there has been little evidence of merchants refusing to accept Visa or MasterCard debit while still accepting the respective scheme credit cards.

However, this newly acquired merchant freedom does rebalance bargaining power in the merchant's favour. In turn, this pressures the interchange fee setting decision as schemes will have an additional incentive to equalise merchant service fees for all their payment instrument offerings.

The ABA supports the abolition of honour-all-cards rules on pro-competition grounds,[36] but remains committed to the principle of honouring all issuers of essentially identical products.

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[35] This is based on data from and East and Partners report. ABA has not seen a full copy of this report.

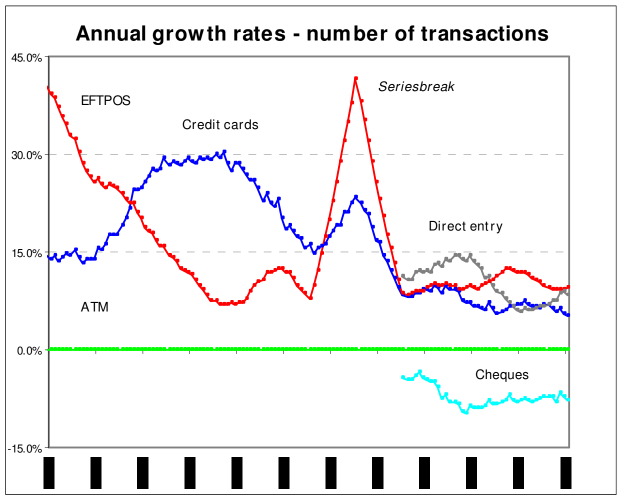
[36] Notwithstanding this position, ABA does not believe this policy is costless in terms of efficiency and competition within the system. Removing the honour-all-cards rules may, in some circumstances, provide a competitive advantage to higher cost competitor products. For example, merchants with strong market share in their particular product range could refuse a payment instrument in order to advantage its own competitor product. If this competitor product uses greater resource costs, there might be an efficiency implication.

The effect of the reforms on the competitive position of different payment systems

The ABA's reading of the market share data and payment transaction data is that interchange fee reforms have not significantly altered competitive positions between payment systems.

The main effect was to slow credit card growth through higher fees and charges, lower loyalty benefits, reduced interest free periods and merchant surcharging. Credit card usage is, however, still growing at a rate of around 5% which is consistent with growth in consumer spending. This is somewhat surprising, and is evidence that the credit card provides strong consumer as well as merchant benefits.

Graph 1: Growth rates of various payment instruments



Visa and MasterCard's collective credit card market share fell 2 percentage points in the initial years following the halving of the interchange fee, with American Express and Diners Club the beneficiaries.

However, the most recent data shows Visa and MasterCard are starting to recover lost ground. Currently, the closed schemes have a market share of 11.9% - down from 12.8% in April 2006.

After discussions with member banks and schemes, the ABA concludes the recent decline in closed scheme market share reflects higher merchant surcharging of these cards.

In respect to EFTPOS transactions, the data shows little change to growth. BPay has probably been a beneficiary in the share of card-not-present transactions.

The effect of changes to access arrangements

The effect of the access regimes in scheme credit, scheme debit and EFTPOS has been to increase the contestability of issuing and acquiring markets. The ABA supports access liberalisation, consistent with system integrity.

New entrants in credit cards include MoneySwitch and GE Capital. Over the next few years, merchant self-acquirers are likely to emerge in credit and EFTPOS markets. This will put more pressure on acquiring margins, although the evidence is that already acquiring markets are competitive. When credit card interchange fees were reduced in 2002, all acquirer savings (in aggregate) were passed on in lower MSFs.

MSF's have declined systematically since the early 1990s, reflecting cost reductions and margin declines.

APCA has broadened access eligibility for the DE system and BPay has liberalised access arrangements.

3.2 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?

What are the characteristics of payments system that have given rise to public policy concerns, particularly over interchange fees?

Interchange fees are paid between issuers and acquirers. Interchange fees are sources of revenues and, at the same time, sources of cost.

By influencing these costs and revenues, interchange fees affect relative consumer and merchant prices. The policy concern is that these fees can drive consumer price signals unreflective of underlying resource costs. In turn, the concern is that retail prices can configure in a way that does not promote efficient price signals.

The ABA acknowledges the role of interchange fees in allocating system costs to end-users and, therefore, the influence of interchange fees in relative prices. Of course, with merchant surcharging, the influence of interchange fees in allocating costs can be neutralised.

While the ABA acknowledged that interchange fees can be set in such a way to influence retail prices, we would also argue this can play a critical role in developing payment systems. Two examples are given below:

- In building the EFTPOS network in the 1980s, the essential business problem was not to convince cardholders to use EFTPOS – customers were familiar with cards for ATM access. The main business problem was to convince merchants to accept EFTPOS. To solve this problem, an interchange fee flowing to merchant acquirer was used to allocate a higher proportion of system costs to cardholders. This was a successful strategy and EFTPOS grew in Australia faster than all other countries.

- In contrast, the main business problem facing the international credit card scheme developers in the 1950s and 1960s was to convince consumers to substitute cheque and cash usage for credit cards – a formidable task given the entrenched nature of these two universal payment instruments.

  Unlike with EFTPOS, the task of securing merchant acceptance was not as great. Merchants were already familiar with 'store credit', so the opportunity to outsource this service was considered to be potentially very beneficial to merchants.

  Hence, the real business problem was to get consumers on board. An interchange fee flowing from merchant acquirer to card issuer was used. The strategy was successful with credit cards now recognised as an alternative to cash, cheque and debit.

The conditions under which current regulations could be removed or relaxed

The ABA believes the main condition for deregulating interchange fees is for the competitive market to be allowed to work effectively. In practice, this means a healthy competitive tension between merchants and consumers over what payment instrument is used for a transaction and at what price.

ABA believes this healthy competition currently exists, as a result, in part, of past Reserve Bank reforms aimed at removing restrictions on merchants.

In section 2 of this submission, ABA argued that already merchants showed a strong bargaining position but, nonetheless, ABA advocates initiatives to assist this competitive tension, the most important of which is the establishment of a commercial governance structure for EFTPOS.

With a long-term competitive EFTPOS system, merchants will have greater confidence that they will not lose a sale by surcharging a more expensive card such as American Express or Diners Club.

The extent to which the Bank's public policy concerns could be addressed through self-regulation

Currently, the regulatory environment for payment is characterised as co-regulatory. The Reserve Bank is commissioned by the *Payment Systems Regulation Act (PSRA) 1998* to supervise safety, competition and efficiency of the system. The Australian Payments Clearing Association (APCA) has responsibility for setting technical standards for clearing transactions.

The ABA has no formal powers but does have an ad-hoc role in coordinating policy positions to address concerns over aspects of the payments system. Two recent examples are (a) a reform position on ATM reform and (b) a reform position on EFTPOS governance. In both cases, the ABA requested that APCA undertake the technical work to implement these policy decisions.

The ABA does believe there is scope for APCA to undertake additional responsibility in relation to the supervision of efficiency and competition objectives as part of a co-regulatory approach.

The ABA has had an opportunity to review a draft of submission by the Australian Payments Clearing Association (APCA) and we endorse its recommendations.

The extent to which the no-surcharge rule alone could address the Bank's concerns over interchange fees

ABA does believe surcharging can provide the means by which merchants can resist higher cost payment instruments and, therefore, address the Reserve Bank's concerns over price signals reflecting underlying resource costs. Merchants are now more aware of the ability to surcharge and have indicated in surveys a willingness to begin surcharging.

The Reserve Bank's main concern is that interchange fees result in consumer prices unreflective of underlying resource costs. The ABA acknowledges interchange fees can result in this outcome.

With merchant surcharging, full scheme control over cost allocation between merchants and consumers is removed because the merchant is free to impose an additional levy on the transaction, increasing the consumer cost. The consumer can resist this by walking away from the transaction or choosing another payment instrument, so there is also a competitive pressure on the merchant to surcharge in-line with the MSF.

This competitive dynamic will tend to drive consumer payments prices toward underlying resource costs. Of course, the more resource costly the payment instrument, the higher will be the consumer price.

The extent to which the structure and rules of payment schemes affect competition by limiting of merchants to influence which payment method is used

With removal of no-surcharging rules and honour-all-cards rules, there appears little constraint on merchant's ability to offset high MSFs.

With respect to the proposal to widen the honour-all-cards prohibition to include varieties of payment instruments (e.g. premium credit cards), ABA notes that differential surcharging is an effective alternative imposing lower compliance costs and, potentially, less disruptive to consumers.

The regulation of other payment systems, including American Express, Diners Club and BPAY

Already American Express and Diners Club voluntarily agree to removal of no surcharge and no steering rules. The ABA does not believe it is feasible to regulate the implicit interchange fee that operates in these systems.

The best means of ensuring competitive neutrality is to deregulate all interchange fees. Similarly with BPay, we do not see a case to regulate the merchant capture fee and note there are around 13,000 biller codes[37] accepting payment via BPay – indicating strong merchant acceptance.

The effectiveness of existing access arrangements

There have been few new entrants into EFTPOS, scheme debit or scheme credit, but the issuing and acquiring markets are now more contestable. The ABA understands merchant self-acquiring is likely to provide the strongest new competitive force.

Merchant service fees for credit cards have declined consistently since the early 1990s, reflecting both cost reductions and margin decline. Credit card acquirers passed on the full savings from interchange fee reductions initiated in 2002.

3.3 If the current regulatory approach is retained, what changes, if any, should be made to standards and access regimes?

A further reduction in credit card interchange fees and/or the adoption of a uniform approach to the setting of all regulated interchange fees

If the Reserve Bank mandates further interchange fee reductions by removing an eligible cost in the methodology, credit card users will, on average, face increased fees or reduced loyalty points.

When interchange fees were cut in 2002, credit card users paid roughly $1 billion per year extra for using their credit cards (this excludes additional costs paid through the levying of merchant surcharging.)

The ABA supports the deregulation of interchange fees. This is the only uniform regulatory treatment of interchange fees that we believe will promote competition, innovation and long-term efficiency.

Setting all interchange fees to zero

This policy would result in credit card holders paying around $700 million[38] extra in fees and charges per year (including reduced loyalty and other benefits.

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[37] BPay website: www.bpay.com.au.

[38] This is derived by multiplying the number of credit card transactions (taken from Table C1 of the Reserve Bank statistics located on their website at www.rba.gov.au) undertaken over the year to June

Merchants would benefit through lower MSFs and increased attractiveness of their own proprietary charge card[39] systems, such as those supported by GE Capital.

If this policy was applied to all payment instruments, including emerging payment instruments, the established payment instruments would be given protection against new entrants.

If the zero-interchange fee rule had been in place in the 1980s, the EFTPOS system growth would have been slower. Debit growth in countries without interchange fees was slower than Australia.

Payment system innovation would also be impacted. Innovators would be influenced to design payment instruments that could not optimally allocate costs to end users to drive acceptance and usage.

ABA does not oppose payment instrument schemes deciding the best commercial strategy is to set interchange fees to zero, but the ABA opposes such a rule being mandated by Government.

Modification of the compliance aspects of the interchange fee standards

The main compliance burdens with interchange fee standards are that (a) expensive cost studies required under the standards and (b) the ongoing uncertainty over the future of interchange levels.

Modifications to the honour-all-cards rule to include premium and/or pre-paid cards

The ABA notes that an alternative approach to widening the honour-all-cards to include premium and/or pre-paid cards is via differential surcharging. The advantage of this approach is that compliance costs would be lower and probably less disruptive to consumers.

The regulation of interchange fees on EFTPOS cash-out transactions

The ABA's position is that all interchange fees should be deregulated, so the cash-out transactions would receive the same regulatory treatment as all other EFTPOS transactions.

Once again, the interchange fee regulatory exemption given to cash out transactions highlights that once an interventionist regulatory approach is embarked upon, an unintended consequence is increasingly prescriptive band aids.

2007, and multiplying by the average interchange fee revenue of $0.54 per transaction. This assumes all reduction in issuer revenue will be passed on in higher fees and reduced benefits.

[39] The origin of the credit card is the old 'store credit' system operated by merchants where customers could conveniently buy goods on merchant's credit, then repay the accumulated debt at then end of the month. This function of 'buy now, pay later' was a merchant invention and the costs of the free credit were always paid by the merchant.

The credit card is simply an outsourced version of the old 'store credit' system. Instead of merchants having to pay for a store credit service in-house, including costs such as the interest-free period, open credit card schemes like Visa and MasterCard allow for this service to be outsourced by using an interchange fee to ensure merchants still pay for the services provided by the credit card, as they always have.

Possible changes to legislation to allow the RBA to set interchange fees directly

The key issue is how to set interchange fees in the optimal manner. As argued throughout this submission, the ABA advocates a deregulation of interchange fees, so the ability of the RBA to set interchange fees directly is immaterial to ABA's model.

The availability of information on Australian payment system

The ABA believes the current amount of information collected and published by the Reserve Bank and APCA, including the Reserve Bank's annual bank fees survey is best-practice when compared to information disclosed in other countries.

Detailed information is always valued highly by academics and policy analysts, but the compliance burden on institutions needs to be weighed as well.

4 SUMMARY & CO-REGULATORY APPROACH

In summary, the ABA is arguing for a deregulation of interchange fees across the payment industry. We think this is the optimal model for Australia, with the only pre-condition that a reasonable balance is achieved in the competitive tension between merchants and consumers.

Already we believe that balance is achieved, but the submission recommends some initiatives to further increase the bargaining position of merchants. The ABA believes interchange fees can be deregulated without policy concerns arising.

ABA has had an opportunity to review a draft of the Australian Payments Clearing Association's (APCA's) submission and we endorse its recommendations. As to next steps, we see the logical order as involving:

Step 1: Finalise 2007/08 Payment Review (mid-2008);

Step 2: Remove interchange fee regulations, but leave designations in place (mid-late 2008);

Step 3: Move to co-regulatory model, remove designations (end-2008).