

Reform of Australia's Payment System
Issues for the 2007-08 Review

Submission to the Reserve Bank of
Australia

September 2007



INTRODUCTION

Australia and New Zealand Banking Group Limited (ANZ) is pleased to provide a submission to the Reserve Bank of Australia’s (RBA’s) review of the reform of Australia’s payments system.

ANZ participated in the preparation of the Australian Bankers’ Association (ABA) submission to the RBA’s Review and broadly supports its recommendations. Nevertheless, ANZ would like to make the following additional comments from its own perspective.

1. IMPACT OF PAYMENTS SYSTEM REFORMS ON ANZ

Credit Cards

In 2003 the RBA issued a ‘standard’ which prescribed eligible costs for calculating credit card interchange fees; a revised standard was issued in November 2005 providing for a common benchmark for interchange fees, as between the Visa and MasterCard schemes (the open or four party schemes). The common benchmark – effectively a cap on the weighted average interchange fee in each scheme – to apply for three years from November 2006 is 0.50 per cent. That is lower than the average of 0.55 per cent that applied initially following the 2003 reforms, and much lower than the pre-reform average of 0.95 per cent.

As interchange fees are a mechanism for allocating costs between users of a system the reforms have shifted a substantial part of the costs of the credit card system away from merchants and acquirers to issuers and cardholders. The RBA has indicated that its reform approach of basing the interchange fee benchmark (or cap) on eligible costs was a pragmatic way of achieving a substantial reduction, with the goal of increasing the effective price to consumers for using credit cards relative to lower cost ways of paying.

The total sums involved were large – well over \$700 million per annum initially, rising to around \$900 million per annum on the most recent estimate.¹

As a result, banks issuing credit cards, including ANZ, had to make changes to their business, the benefits that their credit card customers received, and the fees they paid. One of the key changes ANZ introduced following the RBA interchange reform was to modify its rewards programs, balancing the need to cut back

¹ RBA, *Reform of Australia’s Payments System: Issues for the 2007/08 Review*, May 2007 (Issues Paper), p 22 (para 93). The total industry savings estimate of around \$900 million includes about \$80 million in respect of American Express and Diners Club charge cards. For Visa and MasterCard alone the estimate is \$870 million, with these savings slightly offset by the increase in the combined market share of American Express and Diners Club charge cards

rewards program benefits while maintaining an attractive value proposition to customers.

On its Qantas ANZ Visa Card, ANZ moved from an uncapped earn rate of one dollar for one reward point to a tiered reward point earn rate:

- Customers now earn 1 Qantas Frequent Flyer point per dollar spent up to a monthly limit of \$1,500 for Classic cardholders and \$2,500 for Gold cards; and
- After this customers earn 1 Qantas Frequent Flyer point per two dollars spent up to a monthly limit of \$5,000 for Classic cardholder and \$10,000 for Gold cards.

ANZ also changed the earn rate for its Telstra Visa Card and Sphere Rewards Program to one Reward Point per \$1.50 spent (both with annual caps on the amount of points able to be earned).

At the same time ANZ signed an agreement with Diners Club to launch two new Diners Club cards, one linked to its Qantas Frequent Flyer card and the other linked to its ANZ Rewards card. Both Diners Club cards provide one point per dollar spent with no cap on points. These cards were introduced to retain customers who might otherwise have moved to closed card (or three party) schemes, such as Diners Club, that were not affected by the interchange fee regulation.

ANZ also increased the annual fee for ANZ First Free Days Visa Card from \$26 to \$30.

In November 2006, ANZ introduced the ANZ Frequent Flyer Visa Platinum. This product was aimed at providing a stronger proposition for higher spending customers who were at risk of attrition to stronger competitor products, including the closed scheme cards.

The increased price for using credit cards faced by customers is the outcome sought by the RBA, on the view that prior to reform, price signals to consumers were biasing choices of payment methods away from lower cost means (such as PIN debit cards and Direct Debit) to higher cost credit cards. In addition to reduced rewards and increased fees, customers using credit cards are now increasingly facing surcharges, to which the reforms opened the way. The RBA Issues Paper for this review (cited above) quotes December quarter 2006 data indicating that 14 per cent of very large, 9 per cent of large and 5 per cent of small and very small merchants are now surcharging. As we discuss below, there are survey data indicating that many more merchants are considering doing so.

Visa Debit and Prepaid Visa

The RBA reforms also reduced the Visa Debit interchange fee which now must not exceed 12 cents per transaction on a weighted average basis. While the RBA decided not to designate Prepaid cards, interchange fees are set broadly in conformity with the Standard for those in the Visa Debit system. The reduced interchange fee was taken into account in the pricing structure for ANZ’s Visa Debit card and ANZ Prepaid card when each was launched, which again is the outcome sought by the RBA.

The conclusion that ANZ draws is that the reforms have gone a considerable way towards achieving what the RBA set out to accomplish, and, for example as surcharging spreads and as banks generally have passed on more than half of the interchange fee reduction to cardholders,² this is becoming more so over time.

This makes it difficult to argue that further *radical* reform, such as reducing regulated interchange fees to zero, is required.

2. ZERO CREDIT CARD INTERCHANGE FEE

The Issues Paper suggests one option would be to set all interchange fees at zero.

However, surcharging has allowed merchants to attribute the cost of interchange fees directly to credit card users, meaning that, subject to merchants’ own choices, interchange fees no longer have to be cross-subsidised by other customers, who use payment mechanisms such as cash, EFTPOS or Direct Debit, through higher overall retail prices.

As well as directly allocating the cost of the credit card payment mechanism to users of that mechanism, surcharging also increases the transparency of the costs involved, empowering consumers themselves to choose the most appropriate form of payment. Because surcharging allocates costs on a *per usage* basis, this provides a prompt at the point of decision about choice of means of payment for potential credit card customers to consider altering their payment patterns. This choice would be based on their willingness to absorb these fees, as weighed against any actual or perceived benefit of using their credit card.

The regulated removal of interchange fees altogether would effectively eliminate the rationale for surcharging, and would mean that the choice as to how the costs of using the system are incurred by customers would revert to financial institutions. Financial institutions would need to make further changes to their credit card offerings.

² This is based on the estimates provided in paras 95 and 96 of the Issues Paper, together with the data published in Table C.3 of the RBA *Bulletin*.

Potential changes would most likely not be to introduce *per usage* fees, although they could include either reduced benefits for credit card consumers (such as a reduction or elimination of rewards programs and interest free periods) or an increase in interest rates or annual and other fees. These would, overall, not be as effective in presenting price signals to consumers as surcharging determined by merchants in the context of interchange fees that are positive, because surcharging presents to consumers a very visible *per usage* price.

Moreover, any changes made by a financial institution as a result of a regulated zero interchange fee would, as a practical matter, be made on the basis of overall and not individual circumstances. For example, a financial institution might choose to simply increase annual fees and this would mean that those low usage customers would pay more, while high usage customers pay less, averaged over their respective transactions; and, of course, annual fees do not present as effective a signal to consumers as per usage fees, as noted already.

Alternatively, a financial institution might eliminate rewards programs, meaning that even those customers who were willing to pay a premium for these privileges would be unable to participate. Again, relative to a regime with interchange fees and surcharging, price signals would be weaker. Financial institutions would also, we expect, migrate their customer bases to closed schemes, American Express and Diners Club, which are not subject to the RBA's reforms in order to offer the rewards programs that customers find attractive.

ANZ believes that interchange fees, combined with surcharging, provide an appropriate mechanism not only to remove or substantially reduce cross subsidization but also to ensure that price signals to consumers are strongest.

As the RBA has acknowledged, moreover, interchange fees can have an important role in making a payments system viable, or in helping achieve an optimum balance between benefits to merchants and benefits to consumers,³ in what is called a 'two-sided market'. Both credit card users and merchants benefit from the credit card payments system and costs should be borne by both. ANZ does not see how removing the current interchange fee would result in a balanced and 'two-sided market'. It may be well short of the optimum.

Similarly, there is no guarantee that arbitrarily setting the interchange fee at a lower level than it is at present would achieve the best or even a better outcome than where we are now.

The RBA has acknowledged that in addressing its concerns about price signals to consumers, its approach has been a practical one. The Assistant Governor of the Reserve Bank of Australia, Philip Lowe, in an address to the Payments System Conference in March 2006 said:

³ As canvassed, for example, in RBA, *Reform of the EFTPOS and Visa Debit Systems in Australia: A Consultation Document*, February 2005 (EFTPOS Consultation Document), pp 16-17.

“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.”

ANZ therefore believes that, given an appropriately competitive framework in which to function, market forces would achieve a better result than arbitrary fixing interchange fees at a lower level than is currently the case or removing them altogether.

3. THE WAY FORWARD

Accordingly ANZ’s first preference for further reform is for interchange fees to be set by the market under appropriate competitive conditions. The former Governor of the Reserve Bank of Australia, Mr Ian Macfarlane, characterized in a speech the key reform direction needed to achieve such conditions as ‘empowering the merchants’,⁴ although expressing disappointment that by early 2005, when he gave his address, the reforms intended to do this (notably the abolition of the ‘no surcharge’ rule) had shown only limited results in correcting the price signals faced by consumers in their choice of payment methods.

ANZ acknowledges the proposition that ‘empowering the merchants’ is a key path to establishing the conditions under which market competition will determine interchange fees that are not perversely driven above optimal levels in the (pre-reform) way that the former Governor was describing.

ANZ believes that the abolition of the ‘no surcharge’ rule is having increasing effects, as more and more merchants (although still a minority) choose to apply surcharges. This certainly helps achieve the goal of ensuring that the relative resource costs of using a credit card are presented to consumers in very visible higher effective prices for using a credit card. Data from East and Partners suggest that while 9 per cent of merchants, excluding the smallest ‘micro businesses’, are already surcharging, a further 57 per cent of these merchants are planning to, or are actively considering, surcharging.^{5, 6}

⁴ I J Macfarlane, “Gresham’s Law of Payments”, *RBA Bulletin*, April 2005, pp 8-13 at p 9.

⁵ East and Partners, *Australian Merchant Acquiring and Cards Markets*, Table 65, December 2006.

⁶ Approximately 32 per cent of micro businesses are already surcharging, are planning to or are actively considering surcharging.

ANZ believes that the reforms could be built upon by providing merchants even greater opportunity to surcharge. This could include initiatives to:

- Raise awareness among merchants of surcharging rights; and
- Allow merchants freedom to discriminate among cards by applying different surcharges to different types of cards, and perhaps to the cards of different issuers. Very large merchants already benefit from below average interchange rates offered by the Schemes due to their high transaction volumes and this would give negotiating leverage in respect of merchant fees with their acquirer or a potential acquirer to a much wider group of merchants.

There is a case for allowing the retention of the ‘honour all issuers’ component of the ‘honour all cards’ rules, since it means that smaller issuers’ cards of a given category will be accepted so long as the merchant accepts any cards of that category.⁷ From a credit card user’s perspective, a key part of the ‘value proposition’ of a credit card is the ability to use that card around the world and that includes visitors to Australia from overseas. This is compatible with giving merchants more leverage in the ways mentioned above.

ANZ believes that the ability of merchants to influence customers’ choice of payment instrument could also be improved by creating a more competitive environment for payments mechanisms themselves. This could be achieved through the further development of existing payment mechanisms, and by fostering new ones.

For example, to allow EFTPOS to compete more effectively against credit cards the network could establish a commercial scheme or governance structure⁸ which could focus on innovation, investment and, potentially, the more active promotion of EFTPOS. By strengthening the EFTPOS product through innovation and active promotion, it would be more attractive to consumers.

The Australian Payments Clearing Association is currently considering options for establishing a centralized commercial governance structure for EFTPOS.

In its review of payments system reforms, the RBA may consider the role interchange fees play in fostering the growth and development of new payment mechanisms. Allowing new mechanisms to develop in an environment free from surcharging, during their early stages of gaining acceptance by both merchants and consumers, could enable them to compete against existing mechanisms more effectively in less time.

⁷ The rationale for retaining ‘honour all issuers’ on grounds of promoting competition is discussed in the RBA’s EFTPOS Consultation Document, p40.

⁸ The EFTPOS system currently operates via bilateral agreements between participants. This has the potential to hinder innovation and investment due to the time needed to find industry agreement. A commercial governing scheme could potentially alleviate this issue by making scheme wide decisions binding on industry participants.

An example of how interchange fees facilitate the development of new payments mechanisms can be seen in the rollout of EMV chip cards which provide benefits to consumers and merchants alike by protecting against fraud. The higher interchange rate applicable to these cards has provided the basis of a business case for a full rollout of these cards. Without this incentive it is unlikely that ANZ would have invested as extensively in EMV.

ANZ believes that the ‘no surcharge’ and other reforms implemented to date, combined with the initiatives outlined above, will create a competitive environment where merchants can further influence their customers’ choice of payments mechanism and will remove the need for prescriptive regulation of credit card interchange fees. Continuing to regulate where there is no clear market failure will only hinder innovation and it also tends to create secondary effects that are not necessarily foreseen or desirable.

It has been well established that the socially optimum level of interchange fees may not be zero, and indeed may be significantly different from zero, depending on factors that are difficult to measure.⁹ It has also been shown that under realistic competitive conditions, card issuing networks may even set interchange fees on the *low* side of optimal.¹⁰

4. CONCLUDING COMMENTS

The market should set credit card interchange and interchange rates will be kept at reasonable levels by the ability of merchants to surcharge, perhaps differentially between cards according to the level of interchange that attaches (for example, standard versus premium) and to some extent, by the establishment of an EFTPOS scheme to ensure debit remains an attractive alternative for consumers.

This, in ANZ’s view, is more likely to achieve the objectives of reform than arbitrarily setting interchange fees anywhere from zero to the current 50 basis points. It is also the path to creating an environment of greater certainty for business, more conducive to innovation.

⁹ See for example Jean-Charles Rochet, “The Theory of Interchange Fees: A Synthesis of Recent Contributions”, *Review of Network Economics*, Vol. 2, Issue 2, June 2003.

¹⁰ *Ibid*, Section 5, Figure 9.

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