LWT Advisors

SUBMISSION TO PAYMENT SYSTEM BOARD

Re: REFORM OF AUSTRALIA'S PAYMENTS SYSTEM: PRELIMINARY CONCLUSIONS OF 2007/08 REVIEW

1. Introduction

Thankyou for the opportunity to comment on the Payment System Board's (PSB's) preliminary conclusions of the 2007/08 review of it's regulation of Australia's card payment systems. The PSB's document highlights the complexity of the issues that both led to and are the consequences of regulation. The document also highlights the challenge the PSB has in promoting both greater competition and efficiency in the payment systems.

The intent of this submission is to make a contribution to both clarifying the issues at stake, and designing a solution that will enable Australia's card industry to move forward.

This submission comes from a participant in the payment industry who has provided strategic advice to companies operating variously as merchants, issuers, acquirers, and card schemes across many markets including Australia, New Zealand, US and Europe. Prior to establishing LWT Advisors the author of this submission also managed a large international cards and payments business for a leading Australian bank. The author is also a director of TXN Pty Ltd, a company that focuses on R&D in payment systems.

While not without biases arising from past engagements and experience, having both managed businesses and provided services to all the key market stakeholders, this submission comes from a participant who has some insight into the each stakeholder's perspective.

This submission was not requested, discussed, funded or reviewed by any current, former or potential clients, and the views expressed solely represent those of the author.

2. Key messages

- After 10 years of regulatory review and intervention, there is still neither a clear end game nor an agreed path to an acceptable business model for card payment systems. It is time to end this uncertainty rather than embark on another decade of the PSB being forced to implement progressively greater intervention in the absence of an industry wide acceptable end game.
- Despite the PSB's confidence that their intervention has been in the public interest and delivered substantial net benefits in terms of resource allocation and welfare, there is no systematic and convincing evidence that supports this view. All evidence both for and against is either anecdotal, derived from assumptions, or based on focusing on only parts of the payment or broader financial and business systems.
- The PSB needs to put more weight on the transfers that have occurred as a result of its intervention. Transfers between participants within the same stakeholder group and between stakeholder groups have affected both competition and equity. In assessing the net welfare of its intervention, the distortions and unintended consequences of these transfers may outweigh any efficiency gain.
- The options presented in the current review signal further regulation to deal with what appear to be unintended consequences of the current intervention. In this respect, the option offering self-regulation of interchange represents the worst of both worlds for the industry, in that the offer appears subject to the industry delivering the result the PSB would have regulated for anyway, while exposing the industry to significant uncertainty from both PSB and ACCC review. In return for self-regulation the PSB also expects the industry to deliver a new switching infrastructure model for EFTPOS that may significantly affect the competitive dynamics within the industry. Overall, it is hard to see why the industry would pursue a self-regulation model on the terms currently offered by the PSB.
- Going forward the PSB and other stakeholders have a clear choice. Either the PSB prescribes a more regulatory driven model, or a more market driven solution to allowed to evolve. Either option is better than the current form of intervention which has created a tug of war between regulatory and market forces as each stakeholder "games" the system and the regulator acts to mitigate unintended consequences.
- A more prescriptive regulatory model requires the PSB to be definitive about what represents an acceptable end game for card payment systems in Australia. To adopt this option is to accept that the market cannot deliver an acceptable end game for key elements of the card payments business model. The PSB has already indicated it believes this to be the case through its regulation of aspects such as interchange.
- A more market driven competitive model would require all industry participants to allow market based mechanisms to resolve issues currently or proposed to me managed through regulation. This option would see the PSB operating a "lite" regulatory approach in terms of direct intervention. The key issue to be resolved is how interchange is determined in a market driven model. Assuming such a mechanism is possible (and one is proposed in this submission), the PSB should not set pre-conditions as to acceptable outcomes, such as interchange not increasing from current levels. Pre-conditions represent de-facto regulation.

3. Impacts of Regulatory Intervention on Stakeholders

The original intervention in the card payment systems was justified on the basis of three inter-linked issues:

- Competition between payment systems, especially between credit and debit card systems - regarded as close substitutes. Competition issues included how interchange was set, and the lack of incentives and/or ability of various stakeholders to influence or negotiate its setting.
- Efficiency of payment systems. Credit card interchange was seen as being set at levels that resulted in incentives to use credit cards that directed them away from lower cost networks whose expansion would result in higher net benefits
- Equity between end consumers. Credit card interchange fees resulted in merchants raising the prices charged to all consumers, so that the cost of interchange fees was ultimately borne by all consumers, not just those who used credit cards.

After 10 years of regulatory review and intervention it is still not evident that the policy goals of the original intervention have been achieved. The PSB's most significant action was the new interchange standards for credit cards, scheme debit, and EFTPOS, effectively reducing the levels of interchange on all card systems. The view of this submission is that there is still no clarity as to whether intervention has resulted in net benefits. There is no doubt that the competitive position of different payment systems has been altered, though the outcomes seem inconsistent with the original intent of the interventions. This submission is also highly sceptical that equity between consumers has been improved. The PSB's paper (section 5.2.2) also notes the challenges of measuring impacts on efficiency. There is no doubt that post intervention growth rates of debit card usage have done better than credit, and most likely this would not have occurred to the same extent without intervention. Hence there are likely to be some efficiency gains, but in the view of this submission at the lower end of PSB assumptions.

While the PSB is focused on changes on net welfare rather than transfers between different participants in the payment system, the view of this submission is that in assessing the impacts of its intervention the PSB needs to put more weight on the transfers that have occurred as a result of its intervention. Transfers between participants within the same stakeholder group and between stakeholder groups have affected both competition and equity. In assessing the net welfare of its intervention, the distortions and unintended consequences of these transfers may outweigh any efficiency gain.

The rest of this section provides an assessment of the impacts of the regulatory intervention from the perspective of individual stakeholder groups.

3.1 Consumers

At the heart of the PSB's concerns around the credit card schemes has been the perceived cross-subsidisation of consumers paying by credit card from other consumers paying with lower cost payment instruments. In the PSB's view, credit card holders face "negative" price signals because of rewards they earn and the absence of transaction fees. Hence card interchange needs to be reduced to help send the right signals. The PSB points to reduced rewards and higher credit card fees as a consequence of reduced interchange.

The PSB's paper also suggests that the fact revolvers use their credit cards relatively less than transactors is because revolvers face a positive price for using a credit card whereas transactors face a negative price – providing justification for the PSB's intervention to correct the price signals. A more straightforward and plausible explanation is that revolvers use their credit card because they need access to credit. In this case, the consumer is influenced far more by the availability and cost of funding than payment price signals. The payment decision and the funding decision happen to be made simultaneously, but they need to be thought of as separate decisions. A debit card user may also be accessing a credit facility either directly or indirectly (eg an overdraft facility or a cheque account funded by drawing down on home loan facility). Once again, every payment decision has an implicit funding decision associated with it.

In order to understand the impact on consumers the experience of different segments needs to be understood. These segments need to be defined at least at a total consumer level, and if possible at a household/economic unit level. At this level, it is not clear that credit card holders were and continue to be subsidised by consumers paying with other instruments, especially when the distribution of credit card spend between credit card holders is accounted for.

As the PSB would be aware, in a "typical" credit card portfolio, around a third of credit card holders nearly always pay their balance off each month, another third nearly always don't. The remaining third switch back and forth. So overall around half the portfolio are "transactors" in any month. But it is the high spending "transactor" credit card holders that account for the overwhelming majority of spend. While they may account for less than half of cardholders they would generally account around 70% of spend each month. Of all segments this is the group the PSB must be most concerned about.

So are households that include this high spending transactor segment really cross-subsidised by all other consumers? And are these high spending transactor credit card holders worse off under the current regulatory regime? Have they borne the brunt of regulatory intervention? And are other card customers (credit and debit) and consumers in general better off?

Certainly there has been some devaluing of reward programs (driven as much by pressure on the cost of rewards as the pressure on the revenues that fund them), though there is no sign that the segment who were most benefiting from rewards have reduced their participation.

However, the issuer's response to reduced interchange has been to increase fees across the board on all credit cards products (including annual fees, over limit, late payment, currency conversion fees) while also managing account terms to increase the incidence of fees charged (eg reducing "grace" days before charging late payment fees). Overall, the bulk of the fee increases have not been paid by the cardholders who continue to benefit the most from reward programs. One can probably conclude that equity between credit card holders may have been worsened in that low spending and/or revolving credit card customers may be worse off relative to high spending transactors.

It is also not clear that households that include members of the high spending transactor segment credit card holders were and continue to be subsidised by households largely representing consumers paying with other instruments. The socio-economic reality is that high spending credit card transactors almost certainly account for a disproportionate share of all consumer spend across all instruments. ABS household expenditure data indicates that the top 40% of households account for around 60% of all goods and services expenditure. The levels of spending produced by the high spending transactor segment would put them in higher household income deciles. Hence the real question is whether high spending consumers are being cross-subsidised by low spending consumers.

On pure economic grounds I doubt this could be demonstrated. First, if we accept that reduced interchange has reduced consumer prices below that they would otherwise have been, then high decile socio-economic groups with the greatest spending power would benefit significantly from merchant cost savings being passed on in terms of lower prices. These groups are also the highest credit card transactors, so reductions in interchange are returned to them in terms of lower prices across all instruments they pay with. In simple terms, given average interchange has been reduced by around 50%, only "transactors" who use credit cards for more than 50% of their spend have suffered any net cost, and only on the proportion above 50%.

More importantly, it may have been that when viewed at the level of the overall cost per sale (payment costs being one element), the cross-subsidy operates in the other direction i.e. from high spending consumers to low spending consumers. Given the costs retailers face in providing the shopping experience are more driven by cost per sale, and not cost per $ sale, the higher average spend from high decile consumers must generate higher margins. Why else do so many merchants operate their own loyalty programs that provide incentives to increase sales per customer (among other objectives)?

It may be possible to utilise the RBA's 2007 studies of household payment patterns and payment costs to estimate the likely size and direction of cross-subsidy between households segmented by household income. A reasonable expectation is that when viewed at an overall household level, there is no cross-subsidy between consumers responsible for the majority of credit card spend and other consumers (particularly low income consumers, or is the PSB concerned about cross-subsidies between two groups of high income consumers?). If anything the cross-subsidy (derived using the retailers net margin per consumer or household as a basis) is likely to be from credit card "transactors" to other consumers.

3.2 Merchants

One positive consequence of the PSB's intervention in the card industry has been the heightened recognition that merchants are a major stakeholder and participant in the card payment industry. Intervention has created a more level playing field in terms of the ability to influence the shaping of the industry, and for participating more directly in the operations of the industry.

As transaction originators, the RBA's monitoring of MSF clearly demonstrates that fee levels for acquiring Mastercard and Visa transactions have reduced more than reductions in interchange, while Amex and Diners have fallen much less.

Debate over whether these cost reductions have been passed onto consumers in terms of lower prices is challenging given the impossibility of tracking individual cost elements through the system. This would only be possible if consumer pricing was communicated with all input costs separately identified with an explicit margin revealed. Clearly this would be unreasonable on both practical and competitive grounds. In this regard, it is worth noting that even in a more transparent industry such as fuel retailing where oil is a far more significant input to petrol prices than interchange rates are to retail prices, there is still disagreement over the relative movements between costs and prices. Overall, its reasonable to assume that because interchange is a relatively small component in consumer prices, the pricing and competitive dynamics in each retail sector have not been affected by interchange regulation. Hence, retailers will have passed on or attempted to retain interchange reductions in accordance with how they have responded to changes in all other input costs.

Merchants have certainly taken the opportunity presented by MSF re-pricing due to reduced interchange to negotiate lower margins above interchange. The fact that margins above interchange have contracted to such a degree says a lot about the competitiveness of the acquiring market which is characterised by significant over capacity and a lack of significant differentiation for core acquiring services.

In terms of evaluating the outcomes of the regulatory intervention, two areas are worth more discussion: surcharging, and differentiated interchange by merchant.

Merchants who can have surcharged – mainly those in businesses driven primarily by price (eg discount computers), account based billers with virtual monopolies (eg local authorities, some utilities, schools), or where consumers have no other convenient way to pay (eg airline tickets bought online). The level of surcharging on Visa and Mastercard is almost always higher than interchange, and is probably set closer to MSF if the level of surcharging on Amex experience is any guide. Given interchange is regulated, the ability to surcharge is less justified to control interchange than it is to send "price signals" to consumers. As was argued earlier, the need for these price signals is unlikely to be justified on equity grounds given retailer margins on high spending consumers would be higher than those earned on low spending consumers.

While there may be justification for surcharging on efficiency grounds, the PSB's own data indicates that the incidence of surcharging is higher among large merchants than small merchants. The question then arises whether the differential ability to surcharge strengthens the competitive position of large merchants over small merchants, and whether this is a positive outcome. There are also questionable efficiency gains if surcharging is more prevalent where consumers have no other convenient way to pay.

If the PSB considers surcharging the best way to ensure consumers face appropriate price signals in order to maximise efficiency, then in order to deal with concerns over equity and competitiveness between merchants, the more effective regulatory response would be to require all merchants to surcharge. In order to protect consumers and recognising that in order to improve efficiency there is no requirement to impose surcharges equal to the entire MSF, the PSB could also cap surcharges at the level of interchange paid.

Differentiated interchange by merchant is also worthy of more consideration. This is an area where large merchants who can qualify for "strategic merchant" status (eg Visa's Merchant Alliance Program) and pay lower interchange have also done better than small merchants. The PSB has concerns that the "strategic merchant" category is against the "spirit" of the honour-all-cards Standard or Undertaking in that to obtain a lower interchange rate the merchant must apparently agree to honour-all-cards. This concern seems misplaced given the negotiations are between very large entities capable of making their own commercial decisions and trade-offs.

What is more surprising is that the PSB seems unconcerned by the whole concept of differentiated interchange by merchant which seems to fly in the face of the credit card interchange Standard itself. The cost based rationale for interchange existing in the first place is less driven by merchant size and more by transaction type. The size of the discount offered to strategic merchants looks far larger than any potential cost differences to an issuer arising from receiving their transactions from a "strategic" merchant. Exactly the same issue exists for the move to increasingly differentiate interchange by card product (eg standard versus premium), which appears to be in stark contrast to the rationale for interchange existing in the first place.

The point being made above is not suggesting the fact that large merchants have been able to negotiate lower interchange is a bad outcome. Large merchants have always been able to negotiate lower margins above interchange, reflecting the impact of their scale on pricing. Large merchants are as much if not more interested in preserving a cost advantage over their smaller competitors than they are in obtaining any absolute reduction in fees, so a flat rate of interchange works against the interests of large merchants.

The point being made is that after 10 years of industry submissions, analysis and debate regarding the reasons for interchange, its calculation and justifiable level, the regulated interchange rate no longer represents the actual interchange rate operating in the market (except as an average). However, if the concept of differentiated and negotiated interchange by merchant is accepted then that may represent a pragmatic approach to managing interchange going forward. Clearly, in a regulated market differentiated interchange does disadvantage small merchants over large merchants, particularly when average interchange is regulated. The maths are simple: low interchange for some large merchants creates capacity in the regulated average rate for higher interchange to be paid by smaller merchants. Under a more market driven approach that difference is likely to be lower eg through smaller merchants consolidating volumes for "group" negotiations.

Of course, not all effects of regulation have been positive for large merchants. Merchants who have invested in switching are seeing their investment undermined as the domestic debit scheme (EFTPOS) interchange is reduced and likely ultimately reversed. The view of this submission is that the PSB needs to give greater consideration to the role merchants could play as direct participants in payments - eg as issuers, and as transaction processors and/or acquirers – in order to improve competition and efficiency. Most of the PSB's analysis and discussion of merchants is in relation to their role as transaction originators through accepting payment instruments. While the PSB clearly needs to remain neutral between stakeholder groups, the PSB should consider why after 10 years of regulatory intervention, no merchants have taken up the opportunity to operate as full issuers and/or acquirers.

3.3 Issuers and Acquirers

While there is some differentiation, the issuing and acquiring market in Australia is still dominated by banks who perform both activities. Only one significant primarily issuing-only player (GE) operates in the market. Likewise only one significant primarily acquiring-only player (FDI) exists.

For all the PSB's focus on access, since the PSB intervened in the market, there has been no significant new entrant in card issuing, and despite best efforts the only new acquiring player (Tyro) appears to have found the market challenging to build any meaningful scale. Woolworths has joined Coles as the only retailers with the ability to switch credit and debit transactions directly to all the major issuers. The two large retailers have taken a more aggressive position in acquiring as actual participants in EFTPOS and as "quasi" acquirers for credit cards, successfully shrinking the overall market by switching direct to issuers and lowering the retailers' transaction processing and acquiring costs.

Potential new entrants in credit card issuing (eg Coles, Woolworths, David Jones) have all chosen to co-brand rather than act as principals, so cards bearing their brand must be viewed as extensions of existing issuers.

The lack of new entrants should not been seen as highly surprising given the effect of regulatory intervention has been to reduce the interchange and overall MSF revenue pools available for issuers and acquirers. In what is a somewhat counter intuitive outcome, regulatory intervention primarily focused on issuing has impacted acquiring profitability relatively more significantly, evidenced by declining acquiring margins above interchange and a shift in card scheme cost recovery from issuing to acquiring.

Credit card issuing profitability has been more resilient, in that issuers have been able to reprice or restructure product offerings to more than recover any revenue reductions caused by interchange reductions. Pragmatic as it may be, banks can take comfort by the knowledge that consumers still have to transact, and will ensure they make money on whatever instrument consumers choose to pay with.

Certainly, competition on the credit card issuing side continues to flourish with a greater segmentation in product offerings targeting "transactors" and "revolvers" as different segments requiring differing offers and management (hence the focus on low rate cards and balance transfers targeting "revolvers"). As with many other credit card innovations, the shift to segmented products follows the evolution of the US and UK markets. Only the absence of positive credit bureaus, a different approach to consumer privacy, and possibly different consumer attitudes/responsiveness to direct marketing stops the Australian market also mirroring the US in terms of the volume of direct offers to consumers (this submission strongly disagrees with the PSB paper's suggestion that differential interchange rates between the US and Australia explain the different levels of direct solicitation). The change to the basis of competition in credit cards may have intensified during the period of regulatory intervention but started prior to intervention and have as their root cause risk-return cross subsidies with the card portfolio.

Overall, at least on the credit card issuing side, regulatory intervention itself is unlikely to have hurt the bank's profitability. But like the challenges in measuring the impact on retailers of reduced interchange, its challenging if not impossible to measure the impact on bank profitability given all the forces affecting profitability.

Regulatory intervention has definitely affected the dynamics of the debit card market significantly. Possibly the two greatest unintended consequences of intervention has been the "freezing" of the domestic debit EFTPOS bilateral model for acquiring, and for issuing the emergence of international debit schemes as serious competitors to the domestic debit EFTPOS scheme.

Looking at the issuing side first, the first question is why it took so long for international scheme debit to emerge as a competitor to domestic debit given in the pre-intervention period the relative economics were so overwhelmingly in its favour.

Post intervention the relative economics have increasingly narrowed yet the migration to international debit appears to be gathering pace. Pre-intervention the limited expansion of the international debit scheme probably can be put down to four factors:

- Migration from a PIN based product to a signature based product was seen as a retrograde step, a shift to an inferior product
- Institutional barriers – the debit accounts were managed by a different part of the bank to the area that had the relationship with the international schemes
- Migration costs - the infrastructure costs of connecting the bank debit account systems to the schemes were significant and not seen as a priority
- The belief inside some banks that the international scheme debit interchange model prior to regulatory intervention was "too good to be true" (it was), and while it was primarily the preserve of smaller institutions it might survive but not if large institutions adopted the product.

The PSB's regulation of scheme debit, which confirmed a positive interchange, effectively gave the international debit scheme the regulator's endorsement, increasing issuer interest within the major banks (and the offline functionality at a time of growing e-commerce helped as well). Moreover, the reduction in the negative interchange on the domestic debit scheme eliminated the strongest internal champion for the EFTPOS system within the major acquiring banks – the banks' acquiring businesses. It is not clear that the PSB's latest proposal to align the international and domestic debit schemes' interchange model and level will deliver the PSB's implicit hopes for the domestic debit scheme to triumph over the international schemes:

- The PSB's offer for a "self-regulatory" model is conditional on a new infrastructure model for the domestic EFTPOS scheme. Its unclear what the industry gets under "self-regulation" given the PSB has made it clear it expects the results of self-regulation to be the same as continued PSB regulation.
- Now that the banks have invested in the capability to issue international scheme debit, together with the PIN on credit card functionality, the differentiation between international and domestic scheme debit has largely disappeared.
- Moreover, the international schemes already provide the multilateral switching model the PSB would like to see put in place for domestic debit – so why would the banks want to invest to duplicate the system?

- The business case for the large retailers who have invested in switching and other infrastructure required for the domestic debit scheme has evaporated with the proposed shift to positive interchange on domestic debit

While it is not inevitable that the domestic debit EFTPOS scheme will wither, its demise or reduced importance is the direct consequence of regulatory intervention.

Overall, the view of this submission is that intervention has done little to improve competition. If anything, intervention has both entrenched the position of incumbent players over new entrants, and improved the competitive position of large players over small players. Given the PSB's mandate to promote competition, these outcomes should be concerning, prompting questions including:

- Can a system really be more efficient in the long run if it is less competitive?
- Why haven't retailers/merchants taken on the issuer roles for credit and debit card products?
- Why have so few monoline issuers or acquirers chosen to compete in Australia?

3.4 Schemes

The "four party" schemes, Visa and Mastercard, have been the prime focus of regulatory intervention in Australia. While there has been some share shift from four-party to three-party schemes (Amex, Diners), it is unlikely that Visa and Mastercard have been harmed in any absolute manner (ignoring the opportunity cost of what might have happened otherwise):

- Card numbers and usage have continued to grow
- Debit products have been given a substantial boost
- Fees have been increased on both issuers and acquirers to grow revenues, and relativities adjusted to shift the incidence of fees between members and between acquirers and issuers.

Visa and Mastercard are not harmed directly by regulatory intervention that reduces interchange and encourages surcharging, they are only harmed if their member volumes decline, and this has not happened.

Amex and Diners appear unambiguous "winners" from the regulatory intervention. RBA data clearly indicates that while their acquiring margins have been squeezed, it is significantly less than the reduction that has occurred for Visa and Mastercard products. The ability of Amex and Diners to do better at maintaining acquiring margins demonstrates the power of a monopoly acquirer, and given the right to surcharge some merchants are clearly willing to accept a higher MSF in order to maintain the payment option. It also demonstrates that Amex and Diners have been prepared to sacrifice market share in order to maintain margins.

Amex and Diners have also had their competitive position relative to Visa and Mastercard improved in terms of competing for issuing partners and co-brands. Three out of the four largest banks have chosen to issue Amex or Diners, earning fees with interchange-like characteristics.

The PSB uses the relatively small absolute share shift as evidence that the three-party schemes do not have a competitive advantage. While its true that a 1 or 2 percent absolute increase in market share is relatively small, if your starting position was 13-14% the percentage growth is hardly trivial. The success of the three-party schemes is also evidenced by the increased margin above Visa and Mastercard MSF they maintain. Even if the incidence and level of surcharging on the three-party schemes is higher than the four-party schemes, the fact they have still grown market share indicates it has not affected their growth.

While it is not being suggested that regulating Amex and Diners MSF and the interchange-like arrangements they have with issuing partners is a desirable outcome, it is proposed that the extent of regulation of the four-party schemes is unambiguously biased in favour of the three-party schemes. Moreover, the bias is erroneously based around the institutional model chosen by the scheme rather than any fundamental difference in business model or strategy.

The issue can be illustrated another way. RBA data indicates that as of December 2007, Amex and Diners accounted for 15.6% of credit and charge card volumes by value, charging an average MSF of 2.17%. Mastercard and Visa accounted for 84.4% of the market at an average MSF of 0.85%. In other words, Amex and Diners now account for 32% of all MSF fees paid by merchants.

Visa and Mastercard could restructure themselves into a three-party scheme, and like Amex and Diners operate totally unregulated except for some undertakings around surcharging. As a three-party scheme, Visa and Mastercard could adopt a similar pricing strategy to Amex and Diners, charging similar MSF rates, even if this meant that sales volumes for each of them shrunk to the same size as Amex and Diners. Under this scenario, total industry sales volumes would be less than half the current level (15.6% times 3) but total MSF paid would be around the same level (32% times 3). All schemes would now be on the same level footing, with minimal regulation, and the ability to form partnerships with issuing partners. Given the experience of Amex and Diners, industry growth rates would continue at current levels, albeit from a lower starting point.

Would the PSB see a smaller credit card industry in terms of transaction volumes but at similar overall cost as a better outcome than today? Would they see it as more efficient or competitive?

What then if competition between the schemes led to greater issuance and volumes at the higher average MSF (and higher implicit interchange-type payments). How likely is it that the PSB would stand by and allow this business model to go unregulated? At what size or cost does the PSB regard designation of a payment system justifiable in the public interest?

If the PSB would regulate all three-party schemes if Mastercard and Visa restructured themselves (even if this is contingent on them achieving some critical mass), then it confirms that the current regulatory interventions are biased in terms of organisational form rather than market outcomes. This is an unambiguous distortion where three-party schemes are advantaged over four-party schemes.

3.5 Summary

Overall, it is unclear that the PSB's policy objectives for intervention have been met.

There is little evidence that competition has been improved. The view of this submission is more that the competitive environment has been distorted, particularly favouring large players over small players and new entrants. Three-party schemes have been advantaged over four-party schemes.

As the environment continues to evolve over time due to regulatory changes and the decisions of different stakeholders, the landscape of winners and losers keeps changing eg merchants may have benefited by lower interchange, but these benefits have eroded as issuers shift to three-party products and international debit schemes, and as domestic debit EFTPOS negative interchange levels are reduced and potentially reversed in the future.

The uncertainty around the business model and competitive environment works against all players, especially potential new entrants. Diversified and established players eg large banks who both issue and acquire, have probably performed relatively better, in that they have more capacity to absorb and respond to uncertainty.

Efficiency has probably improved if you assume that merchants have been unable to retain the cost savings. However, the efficiency gains are likely to have been eroded over time due to stakeholders gaming the system to their advantage eg the migration from EFTPOS to scheme debit.

The assumed cross-subsidy between credit card users and other consumers which is used as a fundamental rationale for regulatory intervention has never been proven. It is unclear that the group who should have been "the biggest loser", high spending credit card "transactors", have really been significantly impacted. Issuers have recovered revenues from all credit card account holders, and in any event high credit card spenders will be gaining the most from consumer prices being lower than they otherwise would have been. To the extent that high spending credit card consumers are also high spending consumers, then a significant element of the assumed equity problem may be illusory.

4. Alternative Ways Forward

4.1 PSB Options

The PSB's has considered three alternative models for the ongoing regulation of the card payment industry

I. Status quo: This option maintains the current interchange standards for the long term.

II. Reduce interchange fees further: This option reduces interchange fees further in the case of credit cards and international scheme debit, and reverses the interchange flow on the domestic debit scheme.

III. Removal of explicit interchange regulation, extending removal of the honour all cards rule to include each type of card for which separate interchange fees apply, greater transparency of scheme fees, and commitments to ensure a strong competitor remains to the international card schemes.

The PSB's options reflect a fundamental problem facing regulators, in that while they can regulate what is already in existence, it is far more challenging to use regulation to provide incentives to bring a new model into existence. Hence the PSB's attempt to offer "removal" of "explicit" interchange regulation so long as the outcomes of doing this are little different than if it directly regulated, plus the industry ensures the domestic debit EFTPOS system is an effective competitor to the international schemes.

The PSB also highlights the significant legal uncertainty that surrounds Option III. If Option III is a real option then the PSB needs to ensure the ACCC is involved in the development of any solution, rather than have the industry run the gauntlet after negotiating a framework with the PSB. Given the original review of the industry was a joint RBA/ACCC initiative it must be possible for the two regulatory bodies to again work together.

It is clear from the PSB's commentary that the real choice being offered is between options II and III. The view of this submission is that both options as presented are unlikely to deliver the PSB nor the industry an acceptable outcome in terms of certainty, competition, innovation, transparency, and efficiency.

Option II provides the greatest certainty in terms of interchange, but is likely to just exacerbate the current issues in terms of continued gaming the regulatory system and reduced competition. Option III delivers the worst of all worlds for industry players, apparent freedom from interchange regulation, but only so long as the PSB is satisfied with the outcome, and with all the associated legal uncertainty. And the card issuers and schemes will have more regulation of card types, and all players will be required to support a new domestic EFTPOS model.

4.2 Alternative Options

The view of this submission is that there is a need to implement an option that provides a decisive long-term outcome for all stakeholders. Two options are proposed:

A) Regulator driven prescriptive model

B) Market driven competitive model

It is assumed that the PSB's powers of designation and associated powers to define access and standards would enable it to pursue either model (with consultation to develop and refine the final design).

A) Regulator driven prescriptive model

This option takes the PSB's concerns and focus on efficiency and its preferred model for domestic debit EFTPOS to its logical conclusion. Underlying this option is the viewpoint that it is very hard to operate a conventional marketplace for key elements of the payment system. With each review of its intervention, the PSB has found it necessary to regulate more elements of the card system to mitigate unintended consequences. Hence, this option places more focus on efficiency over competition, and on limiting the ability of the market participates to "game" the system. Rather than trying to create the environment for, or coerce the market to produce an acceptable outcome, this option sees a more prescriptive outcome that may actually eliminate competition for some aspects of the payment system.

Some of the key design elements might include:

- An industry infrastructure model not just for domestic debit but for all domestic card payments eg implement a common multilateral switching model (in a virtual sense not necessarily one physical switch) for all domestic credit and debit card transactions, including all international schemes (three and four party)
- A model for allocating switching costs between merchants, acquirers and issuers (examples exist in other international markets)
- All domestic debit transactions processed through the switch are processed as domestic EFTPOS, with international marks where they exist only relevant for international transactions and e-commerce transactions (effectively eliminating international scheme debit in the domestic market as a product)
- No interchange on domestic debit transactions, replaced by the cost recovery model through a switching cost allocation model
- Maintaining an interchange standard for credit cards, but establishing a new standard to set caps on interchange like payments by the three-party schemes to their issuing partners. Potentially the interchange standard could be one flat rate for all products and schemes, removing the flexibility for differential rates by product.
- Review Specialist Credit Card Institutions and other opportunities to improve access eg could an acceptable framework for a Specialist Card Institution be created (incorporating ability to issue and /or acquire both credit and debit cards)
- Review of surcharging and honour-all-card standards. Potentially given other features of the system the need for these standards may be significantly reduced. It may be more reasonable to deny the right to surcharge and require

merchants to honour all cards. Alternatively, at least for surcharging, efficiency and competition may both be improved by requiring all merchants to surcharge.

Overall, this option would likely result in the most efficient and transparent business model. The option is competitively neutral between credit card schemes, though competition between schemes for issuing domestic debit would be eliminated.

Simplification of the business model may eliminate the requirement for some standards (Surcharging, Honour-all-cards), which are complex and difficult to implement and control.

The introduction of a multilateral switching model for all transactions may result in a more restricted role for acquirers, and in some respects may reduce acquiring competition. However, the model would also offer new entrants easier access to the market which may lead to more value added services targeting particular industry groups. Moreover, the new model would over time reduce the investment required to maintain the current over-capacity and complexity inherent in the current model. A multilateral model would likely result in a lesser role in acquiring for three party schemes, which may also exert downward pressure on their MSF rates.

On the issuing front a new regulatory framework focused on issuing in general rather than just credit cards could be considered in order to improve access and competition.

B) Market driven competitive model

This option attempts to find a business model that would allow industry participants to move to more market based mechanisms to resolve interchange and other issues currently mainly managed through regulation. The key issue to be resolved in any market driven model is how interchange is determined, and whether an acceptable market based mechanism can be found. Overall, this option places more focus on competition over efficiency.

Features of this model could include:

- Four-party schemes being authorised to negotiate interchange and some other commercial terms (eg scheme processing fees, the extent the "honour-all-cards" is applied) directly with merchants (or their authorised representatives to allow for groupings of small merchants to negotiate jointly)
- Review Specialist Credit Card Institutions and other opportunities to improve access eg could an acceptable framework for a Specialist Card Institution be created (incorporating ability to issue and /or acquire both credit and debit cards)
- Individual issuers only able to issue under a single scheme (whether three or four party) for credit cards, and one for debit cards.
- Maintenance of merchant rights to surcharge, though the need for regulatory standards around honour-all-cards may be reduced (could possibly have a default standard to cover the position of small merchants)
- Continue to leave three-party schemes largely unregulated (except their credit card issuing partners must now make a choice between schemes)
- Encouragement of the domestic debit EFTPOS scheme to "commercialise" itself as a scheme so it can compete as a commercial entity with other commercial

schemes. As a commercial entity the EFTPOS "scheme" is likely to want to shift to both a different infrastructure and commercial model

Overall, this option primarily uses market based mechanisms rather than regulation to resolve interchange levels through creating a framework that enables inter-scheme competition. This option attempts to be competitively neutral by not discriminating between schemes that organise as a three or four-party system. Maintenance of some minimum regulatory standards keeps some checks and balances on the relative bargaining positions of the different stakeholders.

This model increases the importance of the card schemes in ensuring a competitive environment, in that the schemes compete for merchants and negotiate interchange and other terms of acceptance, and compete for issuers and negotiate the terms of issuance.

A model requiring issuer exclusivity for schemes "turns back the clock" around 20 years when schemes did have anti-duality scheme membership rules, which were over-turned in some markets on competition grounds. This submission argues that the issue is worth reviewing.

The challenge is how to create a market based mechanism for negotiating interchange that creates a balanced set of incentives and negotiating power between issuers, schemes, and merchants. While the model is based on scheme-merchant negotiations, the indirect role and influence of issuers cannot be ignored.

Because schemes are highly substitutable within an issuer portfolio, maintaining the issuer's right to multiple scheme issuance may create one sided incentives for the scheme in their negotiation with merchants. The primary incentive for the scheme is then to keep interchange as high as possible in order to compete for issuers. Likewise, any merchant threat to a scheme regarding acceptance is weakened if an issuer can easily substitute between schemes. Hence, while the scheme is effectively negotiating on behalf of its issuers, incentives between issuers and schemes are not aligned, and this may undermine the authenticity of the negotiations between merchants and schemes.

Under a new model, schemes would have more balanced incentives in their negotiations with merchants – they may want a high interchange to attract issuers, but they also have to ensure high acceptance, exerting downward pressure on what they might be willing to accept. Merchant negotiating power would also be enhanced if a refusal to accept a scheme actually made a significant difference to an issuer. Requiring issuers to have exclusive relationships with a scheme significantly aligns the issuer and scheme incentives, and may make the scheme-merchant negotiations more authentic.

This model would also likely be more balanced in terms of competition between three and four party schemes, both in terms of competition for issuers and in negotiations with merchants.

The biggest potential problem with the model relates to issuer costs in switching between schemes. There are numerous pragmatic ways of managing this to ensure an issuer is not faced with unreasonable costs, timeframes or processes if a decision to change preferred scheme was made.

Alternative mechanisms to balance incentives and negotiating power could also be created. In the US a recent bill introduced to the senate suggests that if scheme-merchant negotiations become deadlocked then an arbitrator would select either the merchant's or scheme's final offer.

Acquiring competition may be enhanced in this model. With the schemes negotiating interchange and scheme fees direct with merchants, the decisions schemes make around pricing of their services no longer discriminates between acquirers, improving the ability of new entrants to compete. Schemes also have less ability to shift cost recovery between issuers and acquirers.

Competition between issuers should be maintained despite the requirement for the issuer to be exclusive in terms of a preferred scheme for credit and debit cards. Scheme choice is only one of a myriad of decisions an issuer makes in designing its product offer. If interchange levels and scheme incentives are the prime reason for scheme issuance decisions rather than any inherent value of the scheme services, then it also suggests that issuer decisions to issue multiple schemes are made to game between schemes and optimise interchange (like) revenues. This goes to the heart of why the PSB has regulated interchange and won't allow a market mechanism to determine it. Under the new model, creating a more market mechanism for interchange may come at the price of one degree of issuer flexibility.

Whether the domestic debit EFTPOS scheme survives in this environment depends on it being reformed as a commercial entity rather than more a standards entity.

If efficiency improvements must require lower interchange then it is harder to predict whether this model will be more or less efficient. But short of some extreme unintended consequences, the PSB should not set pre-conditions as to acceptable outcomes. Interchange may go up but that cannot be viewed as failure and a reason for re-regulation so long as genuine inter-scheme competition and genuine scheme-merchant negotiations are occurring.

4.3 Choosing Between Alternatives

The view of this submission is that the PSB's objectives for regulatory intervention will be better met by either choosing a more regulatory driven or more market driven solution compared to the current form of regulatory intervention, which appears "stuck in the middle".

This submission has outlined two alternative models to those proposed by the PSB. The view of this submission is that the alternatives provide more clear-cut options in that they use either efficiency or competition as the primary design criteria. Both alternatives see an ongoing role for regulatory intervention, though to significantly different degrees and form.

The decision as to the preferred form of regulatory intervention depends on both philosophical and pragmatic considerations. The more regulatory driven model reflects more prescriptive approaches to intervention taken in many European markets including the EU. The more market driven model is more reflective of the US, illustrated by the recent introduction of legislation to enable direct negotiation between merchants and schemes over interchange. In Australia the choice between models also needs to be pragmatic and take account of the fact that both the financial services and retailing industries are both highly national and concentrated markets compared to most other international markets.

It may be that a more regulated model would best serve Australia due to the inability to create real markets for key elements of the business model for payments, especially interchange. But then regulators must also recognise and be concerned that regulation is far more neutral between market participants than is currently the case. Transfers between participants caused by regulatory driven distortions in the marketplace need to be addressed. Potential trade-offs between the aims of competition and efficiency need to recognised.

A more market driven solution should not be discarded quickly. Regulated solutions are unlikely to anticipate or respond to changes in the environment as rapidly as market driven solutions. A market driven model could be designed to resolve concerns over interchange setting. The challenge for the PSB is to allow market solutions to evolve without imposing pre-conditions around particular pricing outcomes.

5. Next Steps

The PSB should engage the industry in designing and determining which of the more clear-cut model options is preferred. Possibly through this engagement the industry will come up with another more favoured alternative.

The preferred process for designing the solution is a collaborative and focussed working session with participation from all stakeholder groups. While the PSB has consulted widely and held an industry conference in the past, a different style of working session, and a different mindset by stakeholder groups is required. The key differences include: less presentation of set positions and more engaged and flexible collaboration, less academic input and more pragmatic input, and less debate on the problems and more focus on design of solutions.

If the industry fails to design a model with sufficient consensus, then the PSB can always regulate to impose what it views as the preferred option. At least then the industry can move forward operating within clear boundaries, not having to endure another decade of regulatory driven uncertainty.

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