st.george

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Ms Michele Bullock
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By email to: pysubmissions@rba.gov.au

Dear Ms Bullock,

RE: REVIEW OF THE REFORMS TO AUSTRALIA'S PAYMENTS SYSTEM

St.George Bank (St.George) welcomes the opportunity to contribute to the review being conducted by the Reserve Bank (the Bank) of its package of reforms of the payment system, and to be involved in future system and industry developments.

St.George firmly supports the review being forward looking, without re-engaging in past discussion and debate. At the same time, the review needs to be informed by:

- the history of the reform process;
- the consequences of changes that have been made – both intended and unintended. This should involve comparison of outcomes with anticipated consequences not only in directional terms, but also, where possible, with regard to the strength of causal relationships observed versus perceived;
- other changes that have taken place affecting the payment system and participants in it during the reform period; and
- the potential implications of maintaining or altering the current regulatory regime.

Fundamentally, the intent of the reforms has been, and the review of them and any future amendments is, to contribute to competition and efficiency in the Australian payments system. Ultimately, an assessment of the success or otherwise of the reforms on measures of competition and efficiency is difficult to isolate and/or to determine the degree of nexus of cause and effect in relationships. Indeed, the reform process did not set out specific performance benchmarks to judge the outcomes achieved. Further, some payment mechanisms, including cash, were excluded from the original Joint Study, with consequences for before and after economic comparison. With this setting, empirical judgement of "success" is difficult. The Bank accumulates much data, and has sought responses to a comprehensive cost and transactional volume survey as a data-point comparison to its previous Joint Study of Interchange and Access. However, the payments industry is complex and dynamic, and its forces and inter-relationships are not easily nor neatly defined.

Clearly, the Payments Systems Board (PSB) reforms have acted to:

- more closely align relative prices of different payment services with their costs;
- remove some scheme rule restrictions on merchant behaviour;
- remove or relax some barriers to entry; and
- increase the availability of information flows

in the payments industry.

The link between these actions and the changes that have resulted from them, and the overall outcome for overall market efficiency and competition now, and for the future, is the key question being posed by the review.

St.George is of the view that there have been myriad factors at play in the payments marketplace in the period that is the subject of the review including, but not limited to, the PSB's reforms. In combination, these factors have seen the outcomes for consumers, merchants, financial institutions and other interested parties in the payments system that can be witnessed in the volume and price data that is reported by the Bank (and which presumably will also be revealed with the updated cost study results). It is noteworthy that the degree of impact of each of the factors has also been subject to different timing influences. The complexity of the interactions between these influences and their flow-on consequences is such that it is difficult to determine to what extent particular outcomes are the effect of the reforms, if at all.

With the above caveats, St.George's observations of what has happened during the reform period in response to the PSB's questions, are contained in the Appendix.

Notwithstanding the uncertainty over degrees of correlation, St.George considers that the marketplace is now sufficiently evolved that the pre-conditions are in place for the PSB to step back from an interventionist approach to interchange regulation with confidence that no adverse competition or efficiency outcomes will result. In fact, it is St.George's contention that, in the context of the marketplace conditions now in place, an interchange setting mechanism based on market forces will derive superior results for system efficiency.

Previous restrictions on, or barriers to, participation in each of credit card, scheme debit, and eftpos markets have been relaxed or removed by the PSB reforms. With payments markets now fully contestable, "super-normal" or "sub-normal" returns in any element of the market can only be sustained over time if the reward or price-points involved are artificially set, and inflexible to pressures of competition. The continuation of interchange standards would present the requisite distortion to market forces for the relative returns of various payment mechanisms to misrepresent efficient outcomes. Credit card schemes with varied commercial structures as well as operating rules to those in evidence at the time of designation, along with a proposed centrally governed eftpos scheme, all display healthy competitive characteristics between themselves for market share of payment activity, as well as within themselves between acquiring and issuing interests.

Even if the Bank still harboured concerns with relaxing its hold on interchange-setting, it should draw comfort from the fact that surcharging will, by the time of the review's conclusion, have been allowed in the Australian market for in excess of 5 years – a significant transition period to maturity. Surcharging has become far more prevalent amongst established credit card accepting merchants as well as a mechanism for merchants to commence acceptance of credit cards. While St.George does see merit in "no surcharge" as a means of fostering payment system innovation, we believe that the role of surcharging in fine-tuning price signals between merchants and cardholders is of greater importance and, therefore, the "no surcharge" abolitions ought to continue.

Any detriment to innovation from continued "no surcharge" abolition will, in St.George's view, be offset by the increased regulatory certainty experienced by market participants when the PSB returns interchange control powers to the market. This certainty will be enhanced by reductions in the compliance burden borne by participants during the reform period.

Innovation has been stifled by both the confidence of participants that the marketplace would develop predictably, but also the contention on resources for the participants when those finite expert resources have been diverted from pursuing innovation by the requirement to appropriately represent their organisation during the reform period – either through responding to the relevant surveys and studies, or in producing competitive reactions to the reforms implementations.

Alongside a continued capability to surcharge, St.George advocates no further adjustment to the "honour all cards" arrangements than is now the case (i.e. acceptance of a scheme's credit cards does not compel acceptance of that scheme's debit cards, but all variants of that scheme's credit card products must be accepted). St.George holds as true that Australia's previous leading position in development of payments markets and consumer adoption of the various means stemmed from the value consumers attached to the convenience and security of the networks – in terms of relative ubiquity of acceptance and interoperability of networks. Any diminution of consumer confidence in the breadth of acceptance would blur consumers' choice of payment instrument of preference and, in St.George's view, only prove harmful for market efficiency as a consequence.

The increase in the public availability of information regarding conduct of payments markets, including scheme rules and interchange rates has had the twofold effects of more informed markets and decreased perception of secrecy. Each is an important market outcome and transparency should continue to be pursued through publication of interchange rates and operating rules by the various central schemes and bodies governing payments systems.

St.George believes the prospects for even more vibrant competition and increased efficiency in payments markets is ahead. We would be happy to discuss the issues and St.George's perspective on them further in person at your convenience.

Yours sincerely

George Beatty
Acting Group Executive
Retail Bank

APPENDIX

St.George notes that the changes that can be observed in the payments market since the reform period commenced cannot be definitively explained as the effect of the PSB's reforms. Other factors were at play that may sometimes have accentuated the direct effect of the reform introduced, and at other times countered the reform's impact. Additionally, timing differences have been evident in the reforms deployment, which similarly cloud the ability to draw direct cause and effect conclusions.

Notwithstanding, the below summarises St.George's observations of the changes that have occurred during the reform period, in each of the key areas noted as questions by the Bank.

Q1: What have been the effects of the reforms to date?

The effect of the interchange fee reforms on cardholders and merchants

The commercial response to the reduction in interchange over the period has been that merchant service fees have decreased by at least the same amount as interchange was reduced. This was a clear demonstration of the price competition in the merchant acquiring sphere, and indicative that banks did not hold the balance of power over merchants in pricing negotiations.

The Bank estimates that reduction to merchants as a saving in the order of over $1bn p.a. While the Bank professes confidence in cost savings flowing through to consumers, it acknowledges it has no quantitative proof of changes to cardholders as a result. St.George has no additional data to support the contention of a general decrease in the cost of goods and services being passed on to consumers by merchants.

The exclusion of eftpos transactions with a "cash-out" component has been an inconsistency in treatment only and an illogical aberration. Merchants' decisions on whether to offer cash-out are driven by the nature of their business, the mix of payments they receive and their customers prefer to make, and their relative net cash receipt position as a result. The separate interchange treatment of itself is insufficient to influence the provision of cash-out.

Credit card holders enrolled in rewards programs saw the programs lose credibility as points values were diluted, and annual fees and interest rates were increased.

During the same period, new card applicants have been exposed to an expansion in the range of "low rate" credit cards in the market, as well as the evolution of "premium" cards on offer to broader market segments.

Transaction account holders, who represent the vast majority of debit cardholders (scheme debit and proprietary) were increasingly likely during the review period to become subject to an "all you can eat" fee structure. Under such structures, the accountholder pays a flat monthly fee, and is entitled to perform unlimited volumes of specified types of transactions (typically including debit card related). As such, the cardholder in effect faces bundled or averaged pricing, and is not exposed to any direct pricing signals for the specified included transaction types. There is a corollary with the per transaction pricing signal in credit cards (without rewards programs) under such a structure. Whether any conclusion can be drawn that the relative price signal to consumers for debit card against credit card has changed as a result is debateable.

The effect of the interchange fee reforms on financial institutions

As mentioned above, St.George believes that in aggregate the reforms redistributed the net financial flows associated with interchange away from banks in favour of merchants, to the net cost of banks and consumers.

The impact for individual banks of the reforms varied by their relative net issuing/acquiring balance, including the mix of their transaction volumes of credit card, eftpos and scheme debit, their perspective of their competitive options, the nature of the tactical and strategic response they decided upon, and the quality of its execution.

Individual banks' resourcing loads dedicated to responding to the Bank's information requests and engaging in discussion and dialogue, then forming and implementing a competitive response will also have had varying degrees of impact on their "normal" business operations.

The effect of the removal of the no-surcharge rule

The Bank's data shows that the application of surcharging on credit card payments has been relatively more prevalent according to merchant size. It is not clear if there is variation by merchant size between those merchants which have begun accepting credit cards as a payment only when surcharging was open to them, or where they already accepted credit cards and have taken the opportunity to improve the economics of this payment method.

St.George believes that the rate of surcharging has had sufficient time in market to reach a maturity position, and that the current data is illustrative of the appeal to merchants and consumers alike of credit card payments.

In order for the market efficiency ideals attributed to merchant surcharging to have effect, including that consumers are able to make informed choices regarding payment instruments, it is critical that cardholders are alerted to the imposition of surcharges, and the quantum of them, in advance of the transaction being effected.

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

Anecdotally, the modification has had negligible impact on merchants' acceptance of any particular card types in the market when the modification took effect or card types launched subsequently. Consequently, the key consumer benefit of confidence in the breadth of acceptance points of their cards has not been impacted, which St.George considers as fundamental to vitality of future payment market development.

As a general statement, St.George notes that the life-cycle of product development follows identification of unmet consumer needs, or unfilled market gaps, and that regulatory issues, along with other internal and external considerations and constraints will then be factored into design solutions. We are not aware of any product development initiating from changes to rules like the honour-all-cards rule.

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

Market share data reported by the Bank indicates that the three-party or closed schemes achieved an uplift in share coinciding with the period of the interchange reforms for the four-party or open schemes taking effect. Arguably this can be attributed to a combination of the commencement of issuance of American Express cards by two of the major banks which were not previously issuers; the relatively heightened distraction for the schemes impacted by the reforms than those not; as well as the disquiet for merchants that attended the change process not being evident for the closed schemes. This has since partially reverted to previous levels, as the externalities affecting of all of the schemes returned to relative equilibrium.

From St.George's observations, competition between the two four-party schemes for cards on issue and cardholder spend remains keenly contested.

Scheme debit cards which were historically the purview of the smaller players in the market have gained increased appeal as part of the range of access mechanisms offered by previous non-issuers as evidenced by the launch of scheme debit by two of the four larger banks in the Australian market.

The effect of changes to access arrangements

The variations to access have seen new entrants in issuing and acquiring credit cards under the Specialist Credit Card Institution (SCCI) categorisation, not restricted by the previous ADI requirement, nor imbalance in issuing:acquiring ratios.

St.George also understands that potential entrants to eftpos networks experience greater certainty in the process and price of entering the market.

The effect of these changes on competition is in the perception of contestability as well as from the new entrants' actions themselves. The way has been paved to ensure that distortions to market efficiency can only be sustained where imposed by powers outside market dynamics.

Q2: What is the case for ongoing regulation to interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach?
What are the characteristics of payment systems that have given rise to public policy concerns, particularly over interchange fees?

The Bank's concerns regarding interchange fees in the payment systems has consistently been that the fees were not subject to normal market forces, and were set so as to send a pricing signal to cardholders favouring credit card payment to an extent that was mis-aligned with market efficiency.

Interchange fees that had had a genesis in the encouragement of the adoption of particular payment instruments (variously, by instrument, to merchants/acquirers or card issuers/cardholders), and in some ways compensated for the sunk cost of innovation and system development, were seen as non-responsive to market forces. It is arguable that the comparative pricing signal relationship to customer behaviour is relatively tenuous between credit card and transaction account, and for the range of payment mechanisms available on the transaction account. Cardholder behaviour is not (always) a simple association with the relative price of substitute payment instruments. Furthermore, variations that have occurred in product pricing of both transaction and credit card accounts in response to the reforms, and other market developments, have further blurred the direct pricing signal comparison.

The conditions under which current regulations could be removed or relaxed

In addition to the product pricing witnessed to date, the price-setting mechanisms and structures of the payments bodies have and are changing. The open card schemes have altered or are in the process of altering their corporate structures. The consequences of the structural changes, along with the actions during the reform period will be that pricing decisions become more rigorous, and the outcomes of them publicly apparent. In addition, a central governance scheme for domestic eftpos has been proposed which, when it is established, will reduce individual institution's influence in eftpos interchange setting, and heighten competitive tension between eftpos and credit cards.

St.George contends that for the PSB to remove the standards and return interchange-setting powers in total to commercial forces should be conditional on the "no-surcharge" and "honour-all-cards" being maintained in the current status.

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

St.George considers that the marketplace has evolved sufficiently for a self-regulatory approach to succeed. The previous inertia related to interchange setting has been lifted, and the relative pricing signals previously concerning to the Bank are no longer apparent.

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

The Bank previously considered, but rejected, the removal of the no-surcharge rule alone as a means to alleviate its concerns in relation to interchange. That rejection was primarily because of doubts as to the speed and extent to which surcharging could impact and produce the outcomes the Bank was seeking.

By the time of the review's conclusion, surcharging will have been allowed in this market for in excess of 5 years. St.George considers that this a more than adequate period to have reached a maturity level of use and effect.

St.George advocates that with continued removal of the no-surcharge rule, the Bank can comfortably return interchange control to market forces. In forming this view, St.George has been cognisant of the role that "no-surcharge" can play in encouraging innovation and investment, but on balance the role of surcharging in fine-tuning price signals between merchants and cardholders is of greater importance and, therefore, the "no surcharge" abolitions ought to continue.

A fundamental pre-condition for surcharging to drive efficient market outcomes is for merchants to disclose, in advance, the existence and magnitude of the surcharge applicable to any particular payment method.

In conjunction with this ongoing surcharging arrangement, St.George advocates maintaining the status quo in respect of the "honour all cards" arrangements. St.George believes consumer confidence in the broad acceptance of their card is a fundamental feature of successful and efficient payments markets. Surcharging, as appropriate, can be used by merchants who are concerned regarding the outcomes of acceptance all of a card type. It should be noted that the incidence of merchants receiving specific Merchant Service Fees for various credit cards attracting different interchange rates are low. Rather most merchants are priced on averages based on historic or assessed acceptance behaviour i.e. the merchant is not subject to a variable pricing signal per different type of credit card presented by its customers.

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

St.George considers that with the combination of the modifications to the surcharging and honour-all-cards rules that the PSB has already deployed, merchants have adequate ability to influence the payment method used. Any limitations on the ability to influence the method used result from consumer preference, depending on the purchase item, rather than scheme rules.

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

Assuming the PSB returns interchange setting power to market forces then arrangements for interchange will be competitively neutral between payment systems. The existing commitments of the three-party schemes have similar effect with the continuation of the no-surcharge abolition advocated.

The effectiveness of existing access arrangements

St.George believes that despite little activity in new entrants to the eftpos market, the alterations to access have both acted to, and enhanced the perception of, improved contestability of these markets.

The lack of new entrants may be indicative that there is insufficient opportunity to prosper in an already efficient market.

New credit card (especially acquiring) entrants have been witnessed under the new SCCI provisions, but again the relative muted response is considered to be the result of the fact that competition is already strong in these markets.

Accordingly, St.George holds the view that current access arrangements require no change.

Q3: 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 fees

St.George does not support the retention of the current regulatory approach to interchange standards. It does, however, support the retention of the current arrangements regarding access; "no-surcharge" and "honour-all-cards" rules as the fine-tuning aspects of competitive tension in the market place.

Insofar as it represents "uniformity" with regard to the Bank's question, the consistent approach that St.George believes ought to be deployed in respect of interchange is a return to marketplace setting mechanisms.

Setting all interchange fees to zero

St.George does not believe that the rationale exists for uniformity of price of interchange across all payment systems at any level. The different payment systems have different dynamics at play, are at different levels of maturity, and have, and do, require different levels of investment and allocation of the resource costs and consequent participant encouragement in order that the configuration of the aggregate payments market is most efficient.

Whilst there may be an argument for interchange to be set at zero for a particular payment system that, and the consequences for all participants in that payment system, is far removed from a zero setting for all payments systems and the impacts for the overall payments market.

Modification of the compliance aspects of the interchange standards

The costs associated with current compliance are already significant and result in the diversion of resources away from other pro-competitive and innovative activities.

However, meritorious the impost on industry participants to date, St.George believes that current compliance can distort efficient resource allocation and, accordingly, cannot support any increased compliance burden.

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

St.George strongly supports the maintenance of the current "honour all cards" arrangements, along with the capacity for merchants to surcharge. Breadth of acceptance has been, and is, one of the fundamental consumer proposition of card-based payment instruments (debit and credit), and is crucial to successful and efficient payments markets.

Surcharging, as appropriate, can be used by merchants if they choose to accept credit card payments, but are concerned with the financial consequences of acceptance of all of a card type.

St.George reiterates its belief that the incidence of merchants receiving specific Merchant Service Fees for premium credit cards is low, and that most Merchant Service Fees are based on historic or assessed averages of transactions processed. If a merchant is not subject to a variable pricing signal per different type of credit card presented by its customers then it has no cause to not honour that card type. If it is, then surcharging is an available action to it.

The regulation of interchange fees on EFTPOS cash-out transactions

St.George believes that cash-out transactions should be treated in the same way as any other eftpos transaction i.e. that the interchange should be set in the market rather than regulated.

St.George considers the current "cash-out" arrangements as aberrant rather than based on any different payment theory. The current arrangements serve only to increase the likelihood of distortion when the provision of cash-out is, and should be primarily driven by the nature of the merchant's business. This includes, in the normal course, whether the mechant is a net payer or receiver of cash as a consequence of the types of goods, ticket price and customer base it holds, and its relative costs of receiving and disbursing cash. Separate interchange treatment is not warranted.

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

St.George supports returning interchange setting powers to the marketplace. In these circumstances, no legislative changes are required to affect the ease with which the Bank can set interchange standards.

The availability of information on Australian payment systems

Market efficiency theory always values a well-informed market. St.George considers the current availability of information to be more than sufficient for market participants, analysts, theorists, and other interested parties.

Regardless of who is imposing any charge, the direct cost to the consumer of any particular transaction they are considering undertaking should be disclosed to them in advance.