RESERVE BANK OF AUSTRALIA

Review of Card Payments Regulation

Regulation Impact Statement

May 2016

Contents

ISBN 978-0-9942093-8-2 (Online)

1. Executive Summary

This Regulation Impact Statement (RIS) is part of the Reserve Bank's review of card payments regulation. It presents the Bank's assessment of issues currently affecting the card payments market, options for reform and their costs and benefits. In March 2015 the Bank published the *Review of Cards Payments Regulation: Issues Paper* (the Issues Paper) (RBA 2015a). Following wide-ranging liaison with interested parties, in December 2015 the Bank published the *Review of Cards Payments Regulation: Consultation Paper* (the Consultation Paper) presenting preliminary options for reform (RBA 2015b). The submissions to the Issues and Consultation papers and follow-up discussions with industry and stakeholders have contributed to the analysis and options presented in this paper. The Bank will also be publishing a Conclusions Paper in May 2016 which, together with the two earlier papers, addresses the competition and efficiency mandate of the Bank under the *Reserve Bank Act 1959* and *Payment Systems (Regulation) Act 1998*.

This Review has focused on a number of different elements of the payments card market in Australia, including: interchange fee levels and regulatory compliance methodologies; the treatment of bank-issued companion cards; transparency of card acceptance costs to merchants; and allowable card surcharges. While different in nature, these areas relate in one way or another to the Bank's mandate for competition and efficiency in the payments system.

1.1 What is the policy problem?

There are five related policy issues that the Bank has identified:

Whether there is scope for interchange fees to fall further, consistent with falls in overall resource costs and as was contemplated in the conclusions to the 2007/08 Review (RBA 2008)**.** Interchange fees are wholesale fees set by four-party card schemes such as MasterCard, Visa and eftpos that involve payments from the merchant's bank to the cardholder's bank on every transaction. These fees affect the prices faced by cardholders and merchants in using and accepting payments. Most notably, interchange fees increase payment costs for merchants and are typically used to fund rewards programs for some cardholders. The rewards, funded by interchange fees, tend to distort price signals and skew consumer payment choices towards higher-resource-cost payment methods. While previous reforms have reduced interchange fees, there are signs they may still be inefficiently high. For instance, weighted-average interchange fees have tended to drift well above their benchmarks.

The decline in transparency for some end users of the card systems, in part due to the increased complexity and the wider range of interchange fee categories. The widening of interchange fee categories has created large differences in the average interchange rates paid on the transactions of strategic or qualifying merchants compared with other, generally smaller, merchants. Moreover, the increase in complexity hinders merchants' ability to control their payment costs, given that they are typically unable to see the cost of different cards and, in practice, are unable to differentially surcharge to reflect the difference in payment costs. As a result, cardholders may not face the correct price signals associated with their choices, which is likely to result in cross-subsidisation and less pressure to reduce the cost of payments.

Widespread perceptions that card surcharges remain excessive in some industries. The Bank's surcharging reforms removed the 'no-surcharge' rules that card schemes had in place, enabling merchants to surcharge card transactions and to provide price signals to cardholders. The ability to surcharge has been a valuable reform, but practices emerged in a limited number of industries where surcharges on some transactions appeared likely to be excessive. The Bank sought to address these cases with changes to its standards in 2013 that enabled schemes to limit surcharges to the reasonable cost of acceptance. However, scheme-led enforcement proved ineffective, with limited enforcement activities by certain schemes and by acquirers. Following the report of the Financial System Inquiry (FSI 2014), Parliament enacted legislation enabling the Australian Competition and Consumer Commission (ACCC) to take action against excessive surcharges, with provision for permitted surcharge levels to be defined by the Bank (Parliament of Australia 2016).

Perceptions that companion card arrangements may indicate that the current regulatory system is not fully competitively neutral. 'Companion card' models developed involving the four major banks and the three-party schemes in the mid 2000s. These featured the payment of an interchange-like fee as well as a range of other marketing and incentive fees, in many respects economically equivalent to the payment of interchange fees in four-party schemes that the Bank had regulated. Policy action may be needed to address concerns relating to competitive neutrality between unregulated companion card arrangements and regulated four-party schemes.

Some uncertainty in the regulatory treatment of prepaid cards. In many respects, prepaid cards are similar to debit cards. In 2006, the Payments System Board determined that it was not necessary to regulate prepaid cards at the time, but noted its expectations that interchange fees for transactions on these cards would be published and set broadly in conformity with the Standard on interchange fees in the Visa Debit system (RBA 2006). More recently, the Bank has become concerned that the Board's expectations may not be sufficiently clear, giving rise to concerns about the potential for interchange fees to be used in a way that is detrimental to payments system efficiency and also that ambiguity could contribute to an uneven playing field between card schemes.

1.2 Why is government action needed?

Regulation is needed to limit interchange fees because competitive forces in the payments card market do not have the usual effect of bringing costs down. Where merchants feel unable to decline particular cards (because consumers expect to be able to pay with that card and may take their business elsewhere if they cannot), card schemes tend to have strong incentives to raise interchange rates. Evidence from a range of countries suggests that competition between well-established payment card schemes can lead to the perverse result of increasing the price of payment services to merchants (and therefore to higher retail prices for consumers). The conclusion of the Reserve Bank in Australia, and by other regulators internationally, is that regulation is needed to contain the upward pressure on interchange fees. Previous attempts at self-regulatory responses to this issue have not proved feasible.

Prior to the Bank's surcharging standards, card schemes had 'no-surcharge' rules in place that prevented merchants from applying surcharges to reflect the cost of different payment methods and from providing price signals to cardholders. The surcharging standards have generally worked well but, in a limited number of industries, excessive surcharging practices have developed. A wide range of stakeholders have called for some public sector involvement to ensure that surcharging is not excessive. This was reflected in the Government's decision to amend the *Competition and Consumer*

Act 2010 to give the ACCC enforcement power over surcharges which are above the 'permitted surcharge' defined by the Reserve Bank. Accordingly, the Bank is amending its existing standard to make it simpler and more enforceable.

1.3 What are the policy options being considered?

In the Consultation Paper published in December 2015 the Bank proposed a number of options for regulatory reform across a series of issues. After wide consultation with stakeholders the Bank has refined and condensed these proposals into three main policy options:

Option 1: No change – business as usual.

Option 2: Mostly deregulatory – remove interchange fee regulation but introduce measures to increase the transparency of interchange fees to merchants, with real-time information, and strengthen their ability to surcharge and respond to higher interchange fee cards.

Option 3: **Regulatory** – modifying the regulatory regime, retaining the existing weighted-average interchange benchmark for credit cards but enforcing it more effectively with more frequently observed (quarterly) compliance, and supplementing it with maximum caps on interchange rates. Companion cards would be regulated in the same way as cards in the four-party schemes. The weighted-average benchmark for debit cards would be reduced, consistent with changes in average transaction values, and maximum caps would also apply to debit card rates. Prepaid cards would be brought formally into line with debit card interchange regulation. Permitted surcharge levels would be defined more narrowly to ensure more effective enforcement against excessive surcharging. Payments card acquirers would have to provide periodic statements with more detailed costs of acceptance to merchants.

1.4 What is the likely net benefit of each option?

Under **Option 1** – no change – the wide dispersion in interchange fees is likely to continue. Merchants that do not benefit from strategic rates, such as small merchants, are likely to continue facing much higher payment costs than merchants that benefit from strategic rates. Interchange fees may continue to exceed the benchmark between reset dates, putting upward pressure on payment costs and creating economic welfare deadweight losses. Interchange fees for premium cards would continue to be much higher than average and would continue to fund high rewards for holders of premium cards, at least partly subsidised by users of other cards and other payments methods. The four major banks would be likely to extend issuance of companion card products, taking advantage of the fact that the interchange-like fees for these products are not formally regulated. This may continue putting upward pressure on costs in general in the payments system. Instances of excessive surcharging, concentrated in certain industries, are likely to persist, distorting price signals. The status quo forms the baseline for analysis and so does not involve additional compliance costs.

Under **Option 2** interchange fees will be deregulated but merchants' ability to surcharge and, in general, resist higher-cost cards will be strengthened. Removal of the Bank's interchange fee benchmarks is likely to result in significant upward pressure on interchange fees, although there may be some balancing downward pressure from merchants' strengthened ability to surcharge (in particular in online channels). Overall, it is likely that interchange fees would increase from current levels, although the actual level is difficult to predict with any degree of precision. Higher interchange fees would likely increase rewards to holders of premium cards, which would be, at least partly, subsidised by users of other payment methods via higher prices for goods and services. Since higher-income individuals are more likely to hold premium cards, people on lower incomes would be effectively subsidising those on higher incomes. Removing interchange fee regulation from the four-party schemes would be a way to address competitive neutrality concerns regarding companion cards issued by the major banks in concert with three-party schemes. As a result financial institutions might find it less attractive to issue companion credit cards. While merchants would have greater ability to surcharge, and some may do so at higher rates, instances of excessive surcharging are likely to be reduced by a stricter definition of payment costs and stronger enforcement by the ACCC. The removal of interchange fee regulation would likely remove some existing compliance costs from schemes and financial institutions. However, the provision of real-time payment costs information to merchants is likely to more than offset these costs savings.

Option 3 would be expected to reduce the existing dispersion in interchange fees across products. In particular, interchange fees for premium cards would fall substantially. This narrower fee range would benefit small merchants and others that do not qualify for strategic rates. While the weighted-average benchmark for credit cards would remain at current levels, the proposed quarterly compliance regime is likely to keep overall interchange fees much closer to the benchmark and materially lower than they currently are between resets. This may lead to some reduction in rewards for some holders of high-cost cards. The regulation of fees paid by three-party schemes to issuers of companion cards would improve competitive neutrality of interchange regulation. Consistent with this, other interchange-like marketing and incentive payments to issuers would also be covered by provisions in the interchange fee standards. As a result, financial institutions may find it less attractive to issue companion cards and the three-party schemes may redirect their marketing efforts to proprietary cards. Instances of excessive surcharging are likely to be reduced by a stricter definition of payment costs and stronger enforcement by the ACCC. Under this option, there are likely to be some compliance costs for schemes in meeting the interchange benchmark and attesting compliance with the standards. Similarly, payment card acquirers may face some compliance costs from having to provide periodic statements with more detailed costs of acceptance to merchants.

1.5 What consultation has been done?

The Bank has consulted extensively about options for reform of payment cards regulation. In March 2015 the Bank published an Issues Paper and received more than 40 submissions from financial institutions, merchants, card schemes, consumer groups and individuals. Around 30 parties took up the invitation to have discussions with the Bank, with some major stakeholders having follow-up meetings. The Bank also convened a 'payments roundtable' on 23 June 2015, moderated by the Deputy Chair of the Payments System Board. Thirty-three organisations were represented at the Roundtable, including schemes, card issuers and acquirers, merchants, government and regulatory agencies, and ministerial staff. More recently, on 3 December 2015, the Bank published a Consultation Paper including draft standards for cards regulation. The Bank received substantive submissions to the Consultation Paper from over 40 stakeholders, with a number of parties providing both a public submission and additional confidential information. Following the Consultation Paper, Reserve Bank staff have held more than 50 meetings with interested parties to discuss their submissions.

1.6 What is the best option from those considered?

After wide-ranging consultation with industry and other stakeholders, and balancing the different costs and benefits, the Bank believes that **Option 3** (Regulatory) is the best approach to address the issues highlighted and to promote efficiency in the card payments market. This is consistent with the FSI's endorsement of the Bank's overall approach to interchange regulation, and the Bank's assessment that previous interchange reforms have contributed to a more efficient and competitive payments system.

1.7 How will you implement and evaluate your chosen option?

The Reserve Bank will publish final standards soon after the Board makes a decision. The new interchange standards would be effective from mid 2017 for compliance with the new interchange benchmarks and the rules on net payments to issuers.

The implementation of the surcharging standard would be in two stages, depending on the size of the merchants. The definition of 'permitted surcharge' for large merchants takes effect in the third quarter of 2016. For all other merchants, the definition of 'permitted surcharge' takes effect in the third quarter of 2017.

The Bank will continue monitoring developments in the card payments market through liaison with industry and collecting data on key indicators. Additionally, the Bank will analyse changes in surcharging practices and will liaise with the ACCC to stay aware of any developments concerning excessive surcharging and the enforcement of standards.

2. Background

2.1 The Review and RIS process

The Reserve Bank's review of card payments regulation formally started in February 2015 when the Payments System Board approved the publication of an Issues Paper (however, the Bank had identified in its March 2014 submission to the Financial System Inquiry (FSI) that there were a number of issues in the payments system that warranted review (RBA 2014)). Following the Board's approval, in March 2015 the Bank published the Issues Paper identifying the policy problems. To further examine these issues, and discuss views on the need and direction of regulation, the Bank convened a 'payments roundtable' on 23 June 2015 with industry and government representatives. Taking into account the many submissions to the Issues Paper and the discussions at the roundtable, the Board authorised a Consultation Paper, published in December 2015. That paper was prepared to be consistent with the requirements of an early-stage RIS and outlined numerous options for regulatory reform to address the policy problems. After this extensive policy development and consultation process the Bank has refined its views and condensed its regulatory proposals into this RIS.

2.2 The card payments market

Debit and credit cards are the most frequently used non-cash payment instruments in Australia. The four largest banks are the main **issuers** of these cards although there is also issuance by a number of other smaller financial institutions, both Australian and foreign-owned. Around 80 per cent of the value of transactions in the credit and charge card market are processed through the international 'four-party' (MasterCard and Visa) networks and around 20 per cent through the 'three-party' (American Express and Diners Club) networks.

Growth in debit card spending has been the strongest contributor to recent overall growth in card spending in Australia, in part reflecting broader macroeconomic developments and the strong adoption of contactless card technology. Most debit cards in Australia are 'dual-network' cards and can be used in both the international (MasterCard and Visa) and domestic proprietary (eftpos) card networks. Contactless technology and online functionality are widely available for debit cards issued under the MasterCard and Visa networks. Additionally, eftpos has recently introduced contactless functionality, although it is still being rolled out. The prepaid card market also has a growing presence in Australia, with these cards taking a variety of forms. Prepaid cards are currently issued by a number of Australian financial institutions via the main card networks and generally have similar functionality to debit cards.

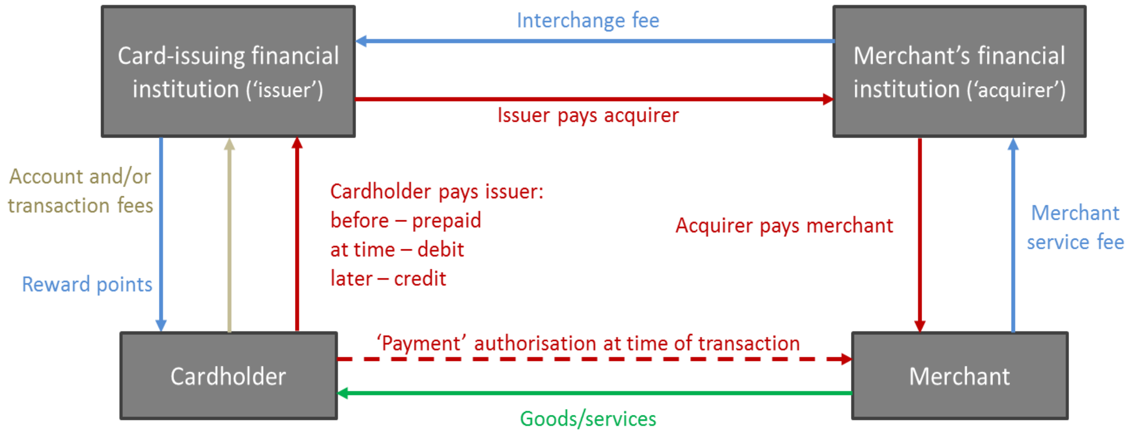
Domestic transactions on Australian-issued American Express, Diners Club, MasterCard and Visa chip cards now require a personal identification number (PIN) to authorise point-of-sale purchases. The main exception is contactless transactions, with no authorisation required for transactions under $100.

The four largest banks are also the main **acquirers** of card transactions in Australia. In addition, acquiring services are provided by larger regional banks and a number of specialist payment providers. Two major Australian retailers have payment switching arrangements which allow them to 'self-acquire' certain transactions. The three-party card schemes act as acquirers for cards issued under their respective networks.

2.3 Interchange fees

In four-party schemes, such as Master Card and Visa, interchange fees are wholesale fees paid by the merchant's financial institution (the acquirer) to the cardholder's financial institution (the issuer) when a cardholder undertakes a transaction (Figure 1). This has two effects. First, the merchant's financial institution will charge the merchant for the cost of providing it with the acceptance service plus the fee that it must pay to the card issuer (the interchange fee). The higher the interchange fee that the merchant's financial institution must pay, the more the merchant will have to pay to accept a card payment. Second, since the card issuer is receiving a fee from the merchant's financial institution every time its card is used, it does not need to charge its customer – the cardholder – as much. The higher the interchange fee, therefore, the less the cardholder has to pay. In effect, the merchant is meeting some of the card issuer's costs and some of these funds can then be used to subsidise the cardholder. Indeed, with rewards programs, the cardholders may actually be paid to use their card for transactions.

Figure 1: Stylised Flows in a Card Transaction



Interchange fees may be appropriate in some circumstances, particularly in the establishment of new systems where they may be necessary to rebalance costs between the sides of the market and ensure that both sides of a market have an incentive to participate. However, the major card schemes are mature systems in Australia, where both cardholding and merchant acceptance are extensive. In practice, with interchange fees being used to incentivise issuers to issue cards from a particular scheme and cardholders to use that card, the tendency has been for competition between mature card schemes to drive up interchange fees and costs to merchants, with adverse effects on the efficiency of the payments system.

2.4 Card payments regulation and Bank reforms

The Reserve Bank's reforms in the card payments sphere have used regulatory powers given to the Bank following the 1996–97 Financial System Inquiry. Following a study conducted jointly with the ACCC and a process of consultation, the Board's reform process for credit cards formally began in April 2001, when the Bank designated the Bankcard, MasterCard and Visa credit card schemes in

Australia. The Bank's reforms (announced in 2002 and coming into effect in 2003 and 2004) allowed merchants to apply surcharges to credit card transactions (whereas this was previously restricted by the international credit card schemes), introduced an interchange fee benchmark (currently set at a weighted average of 0.50 per cent) that brought down average interchange fees, and introduced an access regime to reduce barriers to entry into the credit card system for non-financial institutions. A modification of the access regime came into force in 2015, requiring the card systems to have transparent eligibility and assessment criteria and to report information about membership and applications to the Bank.

Reform of the debit card systems began in 2004, when the Bank designated the Visa Debit and the eftpos systems. (At that time the Debit MasterCard system had not been formally designated; in 2006 MasterCard provided a voluntary undertaking to comply with the standards applying to Visa Debit.) In 2006, the Bank released a package of reforms to Australia's debit card system, including an interchange fee benchmark (currently set at a weighted average of 12 cents per transaction), standards to apply to Visa Debit interchange fees and Visa's 'honour-all-cards' and 'no-surcharge' rules. In addition, from January 2007, merchants were no longer obliged to accept a scheme's debit cards as a condition of accepting its credit cards and vice versa. Revised Standards came into effect in 2010 and again in 2013 that intended to place eftpos and the international debit schemes on a more consistent regulatory footing.

Finally, the Bank has modified its Standard with respect to surcharging. Reflecting concerns about excessive surcharging by some merchants and a tendency towards the 'blending' of surcharges for higher- and lower-cost schemes, the Board decided in May 2012 to vary the surcharging Standards to allow card scheme rules to limit surcharges to the reasonable cost of card acceptance. The Bank subsequently published a Guidance Note on the varied surcharging Standards (RBA 2012), to provide clarification about the costs that might be included in 'the reasonable cost of acceptance'.

3. Policy Issues and the Need for Government Action

3.1 The level of interchange fees

Interchange fees in card systems raise a number of interrelated policy issues. First, interchange fees tend to distort price signals and skew consumer payment choices, including towards higher-resource-cost payment methods. Second, interchange fees enable cross subsidies within the payments system, which are inefficient and likely to be regressive in practice.

In response to concerns associated with interchange fees, the Bank introduced regulation in the 2000s. These standards set caps of 0.50 per cent of transaction values for credit cards and 12 cents per transaction for debit cards, specified as a weighted average of interchange rates within a system. While these interchange caps have improved the efficiency of the payments system, there are signs that current interchange fees are still inefficiently high.

3.1.1 Distortion of price signals

Potential distortions from interchange fees arise because many merchants may feel that they have no choice but to accept the cards of a large scheme given the perceived or actual risk of losing sales. That is, these cards are regarded as a 'must-take' form of payment and merchants have little capacity to influence a significant component of their cost in the form of the interchange fee. With little capacity for many merchants to refuse acceptance, interchange fees can be focused largely on providing incentives to financial institutions to issue the cards of a particular scheme and to cardholders to use those cards (i.e. rewards programs). The higher the interchange fee paid to card issuers, the greater their incentive to issue the cards of a scheme and the larger the rewards that can be paid to cardholders to encourage the use of those cards (Graph 1).

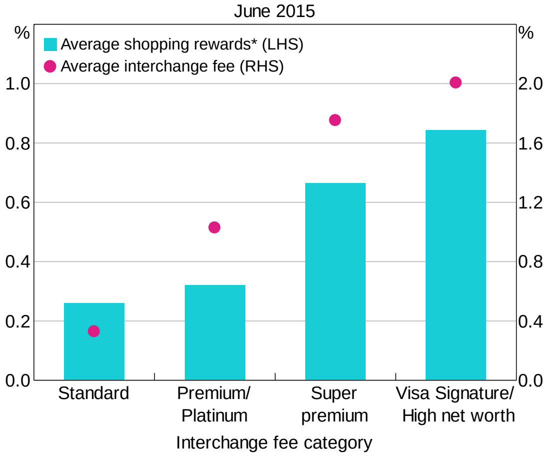
The incentives from rewards cards are independent of the resource costs of a particular card scheme and may distort payment decisions, leading to overuse of some payment instruments, including higher-cost payment methods.[1] For instance, the Bank's 2013 Payment Costs Study (Stewart *et al* 2014) shows that, for the average-size transaction for each payment method, the effective price paid by a cardholder to use a credit card is a little lower than that for a debit card, even though the resource costs associated with credit cards are substantially higher (Graph 2).

1 Resource costs are the economic resources expended by the various participants to 'produce' a payment. See Stewart *et al* (2014).

Graph 1

Credit Card Rewards and Interchange Fees

June 2015



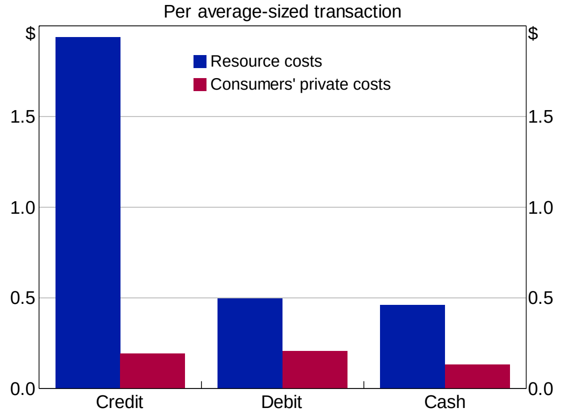
* Effective cash-back percentage from $100 shopping voucher; selected MasterCard and Visa cards only; excludes rewards not linked to spending

Sources: Card Issuers' Websites; RBA

Graph 2

Consumers' Private Costs and Resource Costs

Per average-sized transaction



Source: RBA

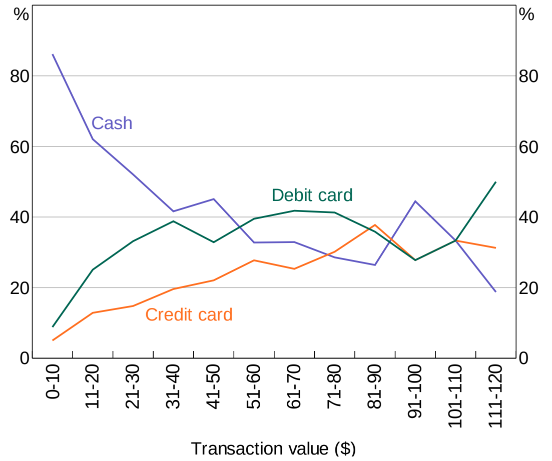
Data from the Bank's 2013 Survey of Consumers' Use of Payment Methods (the Consumer Payments Use Study) show that around 36 per cent of respondents hold a rewards credit card, making up around 60 per cent of credit card holders (Ossolinski, Lam and Emery 2014). Similarly, around 12 per cent of all transactions at the point of sale were made using a rewards credit card, accounting for about 70 per cent of credit card transactions made at the point of sale.

These data also show that participation in a credit card rewards program has a material and positive effect on the probability of paying with a credit card. Raw payment frequencies show a substitution from cash and debit cards to credit cards if the cardholder participates in a rewards program (Graph 3 and Graph 4). For non-rewards card holders, cash is the most frequently used payment method for transaction values up to around $50, whereas for rewards card holders cash is preferred only up to around $30. Moreover, for non-rewards card holders, debit cards are used more frequently than credit cards for values up to around $90, whereas for rewards card holders, credit cards are used more frequently than debit cards for all transaction values. Accordingly, these data strongly suggest that rewards programs encourage the use of credit cards, a higher-cost payment method, at the expense of lower-cost payment methods, potentially creating inefficiency in the payments system.

Graph 3

Payment Method Frequency

Non–rewards card holders

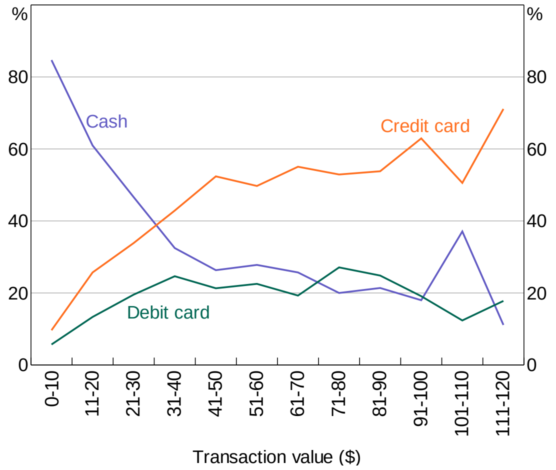


Source: Colmar Brunton

Graph 4

Payment Method Frequency

Rewards card holders



Source: Colmar Brunton

3.1.2 Cross subsidies in the payments system

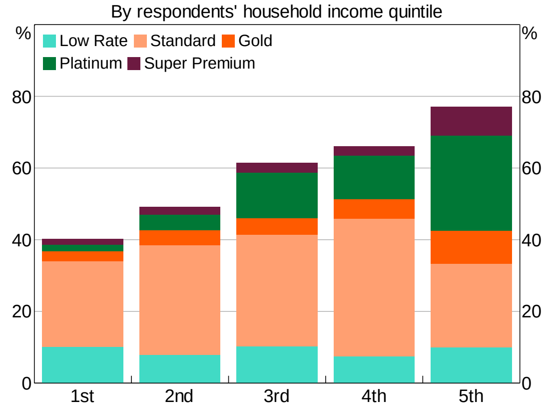
The incentives provided to cardholders also result in a significant degree of cross-subsidisation within the payments system. As mentioned, rewards programs provide incentives for customers to use higher-cost payment instruments. If merchants incorporate payment costs into the price of goods and services for *all* customers, users of these higher-cost payment methods are effectively receiving a subsidy from users of other payment instruments. To the extent that they encourage the use of higher-cost payment instruments, these subsidies detract from the efficiency of the payments system.

In practice, cross subsidies are likely to be regressive, with transfers flowing from lower-income households to higher-income households because of differences in the use of payment methods across households. Most noticeably, the share of payments made using a credit card tends to increase as household income rises. According to the Bank's 2013 Consumer Payments Use Study, households in the highest income quintile made around 30 per cent of their payments using a credit card, compared with 7 per cent for households in the lowest quintile. The survey also indicated that higher-income households are far more likely to hold premium credit cards (e.g. 'platinum' cards), which typically accrue rewards at a faster rate than standard cards (Graph 5). Over a third of households in the highest income quintile held a platinum or 'super premium' credit card, compared to around 3 per cent of households in lowest income quintile.

Graph 5

Type of Credit Card Held

By respondents' household income quintile



* Card products not identified by survey respondents are proportionately included across each remaining product category

Sources: Colmar Brunton; RBA

3.1.3 Benchmark compliance

The existing Standards on interchange fees for the MasterCard and Visa systems set benchmarks for the average interchange fee that can be paid in those systems. The Standards require that every three years, or at the time of any other reset of interchange fees, the weighted-average of the new schedule of interchange rates does not exceed the benchmark set by the Bank, with weights based on the transactions of the most recent financial year. In practice, compliance resets have occurred every three years on 1 November, with MasterCard and Visa voluntarily resetting their interchange schedules on 30 June of the following year and on a few other occasions.

Under the current three-yearly backward-looking approach, schemes are not required to reset their schedules in the event that their average interchange rates rise above the benchmark due to deliberate strategic decisions. In particular, the downside of infrequent and backward-looking compliance has been that it has allowed the international schemes' actual weighted-average interchange fees to drift well above the benchmarks over time.

When the schemes reset their interchange schedules they have tended to introduce new, higher interchange fee categories. These new categories initially have a zero transaction weight for benchmark compliance purposes. Issuers have an incentive to increase their interchange revenue by issuing and promoting new high-interchange premium cards, which in turn pushes average interchange fees higher.[2] After three years of upwards drift in average interchange fees in a compliance period, the schemes must then lower some interchange rates to ensure compliance with the benchmark, at which time they have tended to reset their schedules in ways that will again cause their average interchange fees to rise during the next three-year period.

As a result, schemes' weighted-average interchange fees – especially for credit cards – have almost always been above the benchmarks. This is likely to continue under the status quo.

2 The broad pattern has been gold → platinum → premium → super premium →signature/elite/high net worth.

3.1.4 Need for government action

Regulation is needed to limit interchange fees because they distort price signals and payment patterns, reducing the efficiency of the payments system. Further, in contrast to normal markets for goods and services, competition in payment card networks can actually drive fees higher. Where the market structure is such that there are two payment networks whose cards are accepted very widely (i.e. merchants accept cards from both networks) and where consumers may hold one network's card but not necessarily both, competition tends to involve offering incentives for a consumer to hold and use a particular network's cards (typically loyalty or rewards programs). A network that increases the interchange fee paid by the merchant's bank to the cardholder's bank enables the cardholder's bank to pay more generous incentives and can increase use of its cards. The competitive response from the other network is to increase the interchange rates applicable to its cards.

That is, competition in well-established payment card networks can lead to the perverse result of *increasing* the price of payment services to merchants (and thereby leading to higher retail prices for consumers). This phenomenon has been most clearly observed in the US credit card market, which has not been subject to regulation, with a 2009 report documenting a significant increase in interchange fees over the previous two decades (United States Government Accountability Office 2009). It has also occurred to an extent in the Australian credit card market over the past decade, with average interchange rates in the MasterCard and Visa systems tending to rise in between the three-year compliance resets under the current interchange Standard.

In contrast to the fees charged in the international card schemes, in the eftpos system the cardholder's financial institution used to pay the merchant's financial institution a fee for each eftpos transaction. This had two effects. First, it increased the cost to the cardholder's bank and, potentially, the fee paid by the cardholder to use eftpos. Second, since the merchant's financial institution received a fee from the card issuer, it did not need to charge the merchant as much – if the fee was high enough, the merchant could even receive a fee from its financial institution. In this case, the cardholder was in effect meeting some of the costs of the merchant's financial institution.

When one compares the incentives for cardholders and merchants and for their financial institutions the implications of the different direction of interchange flows are clear. Other things equal – in particular assuming no regulatory intervention and no surcharging by merchants to offset the differences in their costs – cardholders will have a preference to use a card from a network where interchange payments flow to the card-issuing financial institution, while merchants will prefer to receive cards from a network where interchange fees flow in the opposite direction. In circumstances where multiple card networks are widely accepted by merchants (as in Australia and many other developed countries), the consumer typically decides which means of payment is tendered and used in a transaction. Given this, financial institutions will have an incentive to issue cards from networks where interchange fees flow from the merchant's financial institution to the cardholder's institution, and competition may lead networks to increase the size of such fees. The generosity of cardholder rewards programs will rise, as will the cost of payments to merchants.

The Bank's reforms starting in 2003 have served to bring the average interchange fees of the different card systems closer together (and closer to zero). This means that decisions about the choice of payment method are more likely to be based on the relative attributes of the different systems themselves, rather than being driven by skewed price signals underpinned by centrally set interchange fees. The Bank's assessment is that the caps on card interchange fees have limited the potential for those fees to disrupt efficient payment choices and have contributed in a significant way to the fall in the overall resource cost of payments that is apparent in the Bank's most recent Payment Costs Study (Stewart *et al* 2014). However, as suggested in the Issues Paper and the FSI Final Report, it is likely that existing caps are still inefficiently high. Previous attempts at self-regulatory responses to issues involving interchange payments have not proved feasible.

3.2 Transparency of card payments

In some areas there has been a decline in the visibility many merchants have about the cost of cards, in part due to the increased complexity and the wider range of interchange fee categories. Merchants are hindered in their ability to control their payment costs, given that they are typically unable to see the cost of different cards, are restricted by card scheme rules from choosing to accept only some types of debit or credit cards, and in practice are unable to differentially surcharge to reflect the difference in payment costs. As a result, cardholders may not face the correct price signals associated with their choices, which is likely to result in cross-subsidisation and less pressure to reduce the cost of payments.

3.2.1 Visibility of debit and credit cards

One example of the lack of transparency in the card systems concerns the inability of merchants to distinguish between debit and credit cards in some contexts. In the card-present/point-of-sale environment, a merchant should have full visibility over whether a physical card is a debit card or a credit card, given that the relevant Standard requires that all debit cards must be *visually* identifiable as such. In principle, cards should also be *electronically* identifiable as debit rather than credit in the card-not-present environment, given that the Standard requires that debit cards are issued on identifiable Bank Identifier Numbers (BINs) and that acquirers are required to provide these to merchants on request. In practice, however, some merchants in the card-not-present environment report that they are unable to distinguish between debit and credit. One reason that has been reported is that acquirers are unable to obtain reliable and timely lists of debit and credit BINs from the international schemes.

Based on follow-up on some of the consumer complaints about surcharging that the Bank receives, the inability of merchants to distinguish between debit and credit cards appears to be a fairly common phenomenon. It may not, however, be that surprising, given that until now many merchants have been presented with a single merchant service fee applying to both credit and debit transactions, and may not have perceived an incentive to distinguish debit from credit cards.

3.2.2 Widening range of interchange fees

There has been a significant increase in the range of credit card interchange fees since the introduction of merchant-based interchange categories in 2006 (by Visa) and 2007 (by MasterCard) (Graph 6).[3]

Interchange rates for 'strategic' and some other specific types of merchants have been lowered over this period, while the interchange fee rates that apply to the various types of premium cards have

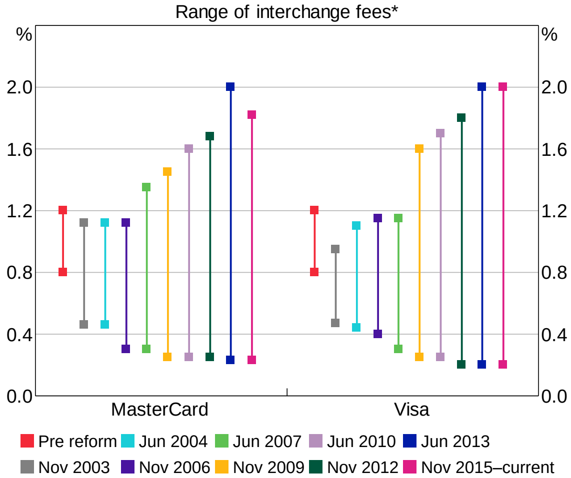
3 The tendency towards a larger number of interchange categories is not, however, a purely Australian phenomenon nor a product of our regulatory system. In the United States, where there is no regulation of credit card interchange, the average number of credit card interchange fee categories for MasterCard and Visa increased from 4 in 1991 to 151 in 2009 (United States Government Accountability Office 2009).

risen. Based on the hierarchy of interchange rates, the cost of the high interchange rates for consumer premium and commercial cards falls on small merchants and other merchants that do not benefit from special rates. The same credit card when presented to a merchant with a low strategic rate will carry an interchange fee of around 0.2 to 0.3 per cent, but could have a fee of around 1.8 to 2.0 per cent for a merchant that does not benefit from preferential arrangements.

Broadly similar developments have also occurred with respect to the debit interchange rates of MasterCard and Visa. The schemes have introduced low strategic or special rates for particular types of merchants as well as high rates for commercial cards. They have also introduced high rates for premium cards, though there has been relatively little issuance of such cards, with rewards programs being much less prevalent and less generous than for credit cards.

For both schemes, the hierarchy of interchange rates is such that strategic or preferred merchants receive low rates on all their transactions, so that only non-qualifying merchants are subject to the high commercial and premium rates.

Graph 6
Credit Card Interchange Fees
Range of interchange fees*



* Excludes the charity categories (which have an interchange fee of zero) and interchange fee categories with a flat-fee component; excludes GST

Sources: Mastercard; Visa

There are two significant consequences of these developments in interchange schedules. First, there are now large differences in the average interchange rates paid on the transactions of strategic or qualifying merchants compared with other merchants. The Bank estimates that the average credit card interchange rate for non-preferred merchants (i.e. those not benefiting from strategic or other preferential rates) was around 55 basis points higher than the interchange rate applying to preferred merchants in the September quarter of 2015. For MasterCard and Visa debit cards, the average interchange rate paid by the non-preferred group of merchants is estimated to have been around 13 cents per transaction higher than the rate applying to the preferred group. These differences in interchange rates have a corresponding effect on the merchant service fees faced by the two groups which is in addition to the higher margin that acquiring banks would normally apply to small merchants relative to large merchants. For both debit and credit cards, the tendency has been for the differences in interchange fees applying to the two groups to have widened significantly since merchant specific rates were first introduced.

The second consequence of the complex interchange fee schedules is that the non-preferred merchants have little transparency over the cost of particular transactions. In the case of a

MasterCard or Visa credit card transaction, the interchange rate will be around 0.3 per cent on a standard card but will be up to 2.0 per cent if the transaction involves a premium card. In the case of a debit transaction, the interchange payment would be as low as 6 cents on a standard debit card transaction but will be up to 50 cents for an average-sized transaction on a premium or commercial card.[4] Without visibility over the cost of the particular card used in the transaction, a merchant that wishes to surcharge, to reflect the much higher cost of some cards, is unable to do so.

3.2.3 Need for government action

The difference in interchange fees between preferred merchants and non-preferred merchants translates into much higher merchant service fees for non-preferred merchants. While the precise amounts are difficult to quantify, a simple approximation can be useful to provide context on the magnitudes involved. Based on data for average merchant service fees for the different schemes during 2015, a 1 basis point reduction in merchant service fees would have saved non-preferred merchants about $15 million. This could translate into material savings for merchants over time. For example, if merchant service fees for non-preferred merchants were to fall by just 5 basis points, over 10 years this would result in possible savings of $750 million. Naturally, greater reductions in merchant service fees would translate into larger savings for non-preferred merchants.

The increased complexity and dispersion of interchange fees, which reduce transparency to merchants, are not likely to be resolved without government regulatory action. Schemes are likely to continue to respond to competitive pressures by creating new interchange categories and to strategically differentiate between merchants according to their market power. This would continue to drive interchange fees higher, to the detriment of smaller merchants and consumers that do not use high-rewards cards.

3.3 Excessive surcharging

The ability of merchants to levy surcharges on different types of payment instruments is an important mechanism for promoting the efficient allocation of resources in the payments system. It allows merchants to signal the costs of different payment choices and to pass on these costs to users, aligning end users' private costs more closely to social costs and thereby contributing to a more efficient payments system. The outcome is that merchants are able to set prices for goods and services lower than would be the case if surcharging was prohibited, and the extent to which users of lower-cost payment methods subsidise users of higher-cost methods is reduced. The ability to surcharge also potentially improves merchants' bargaining position with schemes and acquirers, which can help keep downward pressure on merchant service fees and interchange fees.

However, the Bank and other stakeholders have been concerned that, in a small number of cases in particular industries, surcharge levels on some transactions appear to be well in excess of the merchants' likely acceptance costs. This was highlighted during the recent FSI, which received over 5 000 submissions on the topic as part of a public campaign. Concerns were largely focused on surcharging in the taxi industry and airline industries.

While supporting the practice of surcharging in promoting payments system efficiency, the FSI acknowledged that existing 'reasonable cost' rules had been difficult to enforce and had the potential to cause confusion for consumers. It cited complexity in calculating merchants' reasonable cost of

4 The 50 cents interchange fee reflects a rate of 1.05 per cent on an average transaction of around 50 dollars.

acceptance and the associated lack of transparency as contributing factors towards the limited enforcement of the current rules. A 2013 report by the Commonwealth Consumer Affairs Advisory Council also noted the potential benefits of card surcharging, but was of the view that consumer dissatisfaction towards excessive surcharging was concentrated on industries typically seen to lack strong competitive pressures, particularly in online environments (Commonwealth Consumer Affairs Advisory Council 2013).

The Bank has also received over 1 000 emails from individuals on surcharging as part of its consultation to the Review; this is in addition to enquiries that the Bank receives on occasion from members of the public in relation to the practice of surcharging at particular merchants. In one such example, an individual expressed concern to the Bank after paying $21 in surcharges on a $16 card transaction made at an Australian airline (the majority of the transaction value was paid in flyer points). This reflects the fixed-dollar nature of surcharges in the airline industry (Table 1). Further, data collected by the Bank on surcharging rates charged by merchants with an online presence indicates that surcharging rates of 4 per cent and above are sometimes seen in some industries.

Table 1: Online Domestic Airline Surcharges

Airline	Name of surcharge	Standard surcharge per return ticket, per person		Non-surcharged payment methods[(a)]
		Debit card	Credit card	
Jetstar	Booking and service fee	$17 (2 x $8.50)	$17 (2 x $8.50)	• Jetstar MasterCard • POLi • Direct deposit (>14 days before flight) • Voucher
Qantas	Card payment fee	$2.50	$7	• BPAY (>7 days before flight) • Debit or prepaid card/'Qantas Cash' (<7 days) • Credit voucher • POLi • Qantas UATP card
Tiger	Booking and service fee	$17 (2 x $8.50)	$17 (2 x $8.50)	• Debit MasterCard
Virgin	Booking and service fee	$7.70	$7.70	• POLi • Voucher

(a) Some payment options may not be available to customers of all financial institutions.

Source: Airlines' websites, information sourced on 4 May 2016

3.3.1 Need for government action

In the absence of regulation, schemes apply 'no-surcharge' rules. These are actions of private sector regulation that constrain merchants from providing price signals to cardholders. For example, a merchant selling a TV for $1 000 could accept payment by a number of means. Where the cardholder pays using a low-cost debit card, the merchant might receive $998 of the amount paid. If the cardholder uses a high-cost premium card, the merchant might receive $980 of the purchase price. Surcharging enables the merchant to signal to the cardholder that their payment method is more or less expensive. Until the Bank's reforms in 2003, the international card schemes prevented merchants from surcharging on card transactions.

The current regime provides merchants with the ability to surcharge card transactions. This has been a valuable means of providing price signals to end users. However, in a limited number of industries, surcharging practices have emerged such that surcharges for some transactions may be excessive.

Under the current standards, the schemes and acquirers must do all things necessary on their part to ensure compliance with surcharging rules. However, there is wide agreement that the enforcement of these standards has been inadequate. The FSI Final Report cited the complexity of calculating merchants' reasonable cost of acceptance and the associated lack of transparency as factors that have contributed to the limited enforcement of the current regime by schemes and acquirers.

On 20 October 2015, the Government released its response to the FSI, indicating its expectations that the Board – through this Review – would provide clarity around what constitutes excessive customer surcharges on card payments (Australian Government 2015). It also indicated that it would phase in a legislated ban on excessive surcharges, with enforcement to be undertaken by the ACCC. Amendments to the Competition and Consumer Act were passed by Parliament on 22 February and prohibit excessive payment surcharges on payments covered by a Reserve Bank standard. Accordingly, the Bank is amending its existing standard to make it simpler and more enforceable.

3.4 Competitive neutrality and companion cards

American Express companion cards became a feature of the card product market following implementation of the Bank's initial card payment regulations.[5] A companion card arrangement is one where a three-party scheme acquires transactions, but partners with financial institutions to issue cards. As part of the arrangement, bilaterally negotiated 'interchange-like' fees are paid from the scheme to the issuer, and – as with traditional four-party arrangements (such as MasterCard and Visa) – may involve other incentive or marketing payments to issuers. This contrasts with a typical 'three-party' scheme such as American Express's proprietary business or Diners Club, where the scheme is both issuer and acquirer, with no role for interchange fees. Accordingly, while American Express and Diners Club are subject (by voluntary undertaking) to the Bank's standard on merchant pricing which prevents them from having no-surcharge rules, these schemes have not been subject to the Bank's interchange standards.

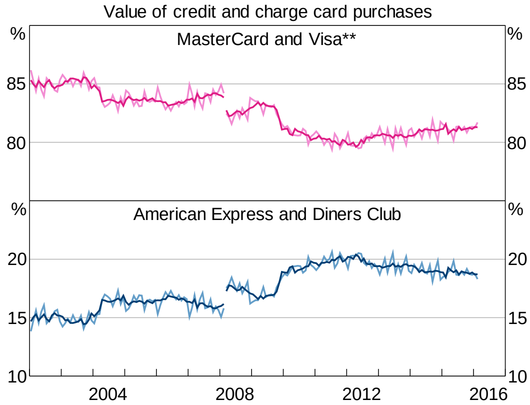
American Express companion cards have proven a popular financial product. In the 2013 Consumer Payments Use Study around 37 per cent of respondents with at least one credit card held an American Express companion card. The introduction of American Express companion cards by the major banks in 2004 and 2009 coincided with noticeable changes in market shares in the credit and charge cards market. While the data include a series break, the share of the value of credit and charge card transactions held by Master Card and Visa schemes is estimated to have fallen by several percentage points since 2002, to around 81 per cent recently (Graph 7). At the same time the share of American Express and Diners' transactions has increased to around 19 percent (during this period, a fall in the market share of Diners Club was offset by a rise in the American Express market share).

5 Bank-issued American Express cards were initially offered as stand-alone products. They are now issued as part of a companion arrangement where customers are provided an American Express card as part of a package with a MasterCard or Visa credit card, with both cards accessing the same line of credit.

Graph 7

Market Shares of Card Schemes*

Value of credit and charge card purchases



* Excludes scheme debit after March 2008, which resulted in a 1.5 percentage point break; darker lines are seasonally adjusted estimates

** Includes Bankcard before 2007

Source: RBA

3.4.1 Need for government action

Payments from American Express to banks issuing companion cards are not regulated, in contrast to the interchange fees paid in the four-party schemes. However, the two types of payments are, in many respects, economically equivalent, and both are aimed at encouraging banks to issue cards and supporting rewards programs and other benefits that promote use by consumers. The different regulatory treatment of three- and four-party cards is argued to have contributed to the issuance of American Express companion cards and the increase in the market share of three-party schemes over the past decade. Several submissions to the FSI and the Bank's consultation process have argued that the lack of formal regulation of companion card arrangements results in a lack of 'competitive neutrality' in the Bank's regulation. Furthermore, the popularity of companion card arrangements means that average payment costs in the economy are higher than envisaged under the Bank's weighted-average interchange cap of 0.50 per cent. Self-regulation of payments from the scheme to issuers in companion card arrangements is likely to be difficult to achieve and more difficult to monitor, so the Bank has consulted on regulatory changes that would treat all interchange-like fees and other payments to issuers in a similar way.

3.5 Regulatory uncertainty of prepaid cards

In many respects, prepaid cards are similar to debit cards. In 2006, the Board determined that it was not necessary to regulate prepaid cards at the time, but noted its expectations regarding their treatment, including that interchange fees for transactions on these cards would be published and set broadly in conformity with the Standard on interchange fees in the Visa Debit system, and that merchants would not be prevented from surcharging transactions on these cards if they chose. The Board also noted that merchants should not be required to accept a prepaid card with features substantially different from a scheme debit card.

Prepaid cards still represent a small proportion of the payment cards market compared with credit and debit cards, but there has been growth in the use of such cards in recent years. All three debit card networks have prepaid card products. A range of financial institution issuers and sponsored third-party issuers have marketed prepaid cards, both broadly and also to specifically targeted sectors (e.g. associated with frequent flyer programs or useable at certain shopping centres or within particular retail groups). More recently, ‘premium’ prepaid cards connected to airline frequent flyer programs have been introduced that not only allow for domestic use but also enable cardholders to load foreign currency balances for use overseas. These cards feature reward programs and are also associated with higher *ad valorem* interchange fees rather than the per transaction rates that apply to most other prepaid cards.

3.5.1 Need for government action

The main issue in the context of prepaid cards relates to regulatory certainty and associated behaviour in a market where there are a limited number of schemes. The expectation expressed by the Board in 2006 was that interchange fees in prepaid systems should be set broadly in conformity with the relevant debit card standard. The phrase ‘broadly in conformity’ was potentially ambiguous: as a result, schemes have tended to interpret it in different ways. Notably, at recent debit card resets (when the Board’s expectation might have implied that prepaid rates should also be reset to the benchmark), neither international scheme reset its prepaid rates. This suggests that it might be preferable for the Bank to provide greater certainty and replace the expectation with a clear obligation. This will assist in providing a level playing field between schemes and restrict the potential for distortions to payment patterns arising from interchange fees.

4. Policy Options

The Bank initially proposed a number of options for regulatory reform in the Consultation Paper published in December 2015. After an extensive consultation process with stakeholders the Bank has refined and condensed these proposals into three main policy options. In particular, Option 3 is the result of the Bank's discussion of various sub-options with interested parties. These options address all the issues discussed in this paper:

Option 1: No change – business as usual.

Option 2: Mostly deregulatory – remove interchange fee regulation but introduce measures to increase transparency of interchange fees to merchants, with real-time information, and strengthen the ability of merchants to surcharge and respond to higher interchange fee cards.

Option 3: Regulatory – this option comprises a number of components, which are as follows: modify the regulatory regime for credit cards to retain the existing weighted-average interchange benchmark but enforce it more effectively with more frequently observed (quarterly) compliance, and supplement it with maximum caps on individual interchange rates. American Express companion cards would be regulated in the same way as cards in the four-party schemes. The weighted-average benchmark for debit cards would be reduced consistent with changes in average transaction values and maximum caps would also apply to debit card rates. Prepaid cards would be brought formally into line with debit card interchange regulation. Permitted surcharge levels would be defined more narrowly to ensure more effective enforcement against excessive surcharging. Payment card acquirers would have to provide periodic statements which clearly identify costs of acceptance to merchants.[6]

4.1 Option 1: No change

- Interchange fee arrangements in the four-party schemes would continue to be formally regulated with a benchmark for the weighted-average interchange fee at 0.50 per cent of transaction value for credit cards and 12 cents per transaction for debit systems. There would continue to be no constraints on the levels of individual interchange categories.
- Under this option, the current 'quasi-regulation' of prepaid cards would continue, with no formal regulation. However, the schemes would be expected to ensure that interchange arrangements are broadly in conformity with the requirements of the existing debit standard.
- Interchange-like fees and other payments from three-party schemes to issuers of companion cards would continue to be unregulated.

6 During the course of the Review, the Board considered various options including various potential approaches identified by the FSI. The December Consultation Paper (RBA 2015b) sought responses to two variants of this option, with the main differences being the level of interchange benchmarks.

- No change would be made to the current compliance system for credit and debit cards. Every three years, or at the time of any other voluntary reset of interchange fees, the weighted-average of a scheme's new schedule of interchange fees must not exceed the benchmark set by the Bank. The weights ascribed to individual interchange fee categories would be based on the transactions of the most recent financial year.
- Under this option, merchants would retain the ability to surcharge up to the reasonable cost of accepting card payments based on a broad definition of eligible costs as in the Bank's current Guidance Note.

4.2 Option 2: Mostly deregulatory

- This option would remove all existing regulation of credit and debit card interchange fees. Under this option, card schemes would be able to set interchange fees without having to adhere to any restrictions or benchmarks.
- The Board would rescind its expectation around prepaid card arrangements. Schemes would be able to set prepaid interchange rates without reference to regulatory benchmarks.
- Consistency in regulation would be achieved by removing existing interchange fee regulation for the four-party schemes. The four-party schemes would be free to set interchange fees at their preferred levels to directly compete with American Express' companion cards.
- This option would be accompanied by requirements that schemes and acquirers provide real-time information about the interchange costs of individual transactions. It would also include requirements providing greater flexibility for merchants to respond in their acceptance decisions (for example by declining particular high-interchange cards). These measures would seek to address concerns, expressed by the Bank and many end users, regarding the dominant market position of the large schemes and the likelihood that schemes would seek to increase interchange rates in the absence of interchange fee regulation.
- Merchants would retain the ability to surcharge up to the cost of accepting card payments, but the cost of acceptance would be defined more narrowly as the average cost of that payment method in terms of costs paid by the merchant to the acquirer or other payments provider.

4.3 Option 3: Regulatory

- Introduce caps on individual interchange fees. No credit card interchange fee could be more than 0.80 per cent. For debit cards, a cap of 15 cents if the interchange fee is specified as a fixed amount and 0.20 per cent if the fee is specified as a percentage amount.
- The weighted-average benchmark for credit cards would remain at 0.50 per cent but the benchmark for debit cards would be lowered to 8 cents.
- Under this option, the Board's current 'expectation' for prepaid cards would be formalised into a standard, fully consistent with the treatment of debit card interchange fees.
- Payments to issuers of American Express companion credit cards would be subject to regulation. Interchange-like issuer fees would be subject to the same interchange fee caps as the four-party schemes. Other payments to issuers of companion cards – such as marketing fees, sign-on fees,

incentive fees and rebates – would be subject to rules on 'other net payments' to prevent circumvention of regulation.

- Similarly, non-interchange payments to issuers of cards from four-party schemes would be subject to rules on 'other net payments' to prevent circumvention of regulation.
- Schemes would be required to keep their rolling four-quarter average interchange fee below the benchmark. At the end of each quarter, the weighted-average interchange fee over the previous four quarters would be calculated. If this average fee was over the benchmark, schemes would be required to reset their rates so that the weighted-average interchange fee under the new schedule, using the transaction mix of the most recent four quarters, would have been below the benchmark. Schemes would have 60 days to amend their interchange rates.
- For surcharging, the proposed 'cost of acceptance' is narrower than the 'reasonable cost of acceptance' measure used in the previous standard. It is based on the fees paid to the merchant's acquirer or payment facilitator as expressed in statements from the merchant's acquirer or payments facilitator. A merchant could add, if they were relevant, fees paid to any other payment services provider for (i) fraud-related chargeback fees paid to the merchant's acquirer or payment facilitator; fees paid to any other payment services provider for (ii) terminal rental and servicing, (iii) gateway services and (iv) fraud prevention services; as well as (v) any cost of insurance for forward delivery risk on accepting cards. In all five of these cases, these elements must be verified by statements, accounts or invoices from an external provider. Furthermore they must be costs that apply to cards but not to other payment methods.
- Acquirers (or payment service providers) would be required to provide merchants with periodic statements on their cost of acceptance for each payment method (e.g. for eftpos debit cards, Debit MasterCard, Visa Debit, MasterCard credit and Visa credit).

4.3.1 The taxi industry

The proposed cost of acceptance regulation does not apply to the taxi industry. Card payment processes in the taxi industry are complex and most aspects of the industry – including taxi fares (and surcharges in many cases) – are heavily regulated. As a result, it may be appropriate for the time being to leave to state authorities the regulation of surcharging in that industry. State regulators may be best placed to assess issues such as the actual cost of providing payment services in taxis and the appropriate rate of return for taxi payment providers. Authorities in five jurisdictions – Victoria, New South Wales, Western Australia, the Australian Capital Territory and South Australia – have now taken or announced decisions to cap surcharges to 5 per cent, which is likely to be closer to the actual cost of providing payments services in taxis than the surcharges of 10 per cent that have previously been typical.

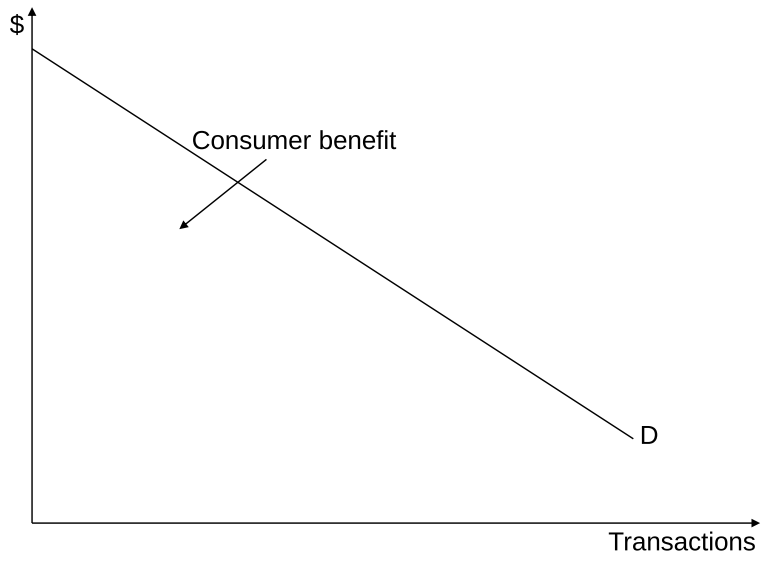
5. Costs and Benefits

5.1 Economic welfare costs and benefits

Ideally, in assessing the effects of the proposed policy options we would like to be able to precisely quantify the net welfare benefits. However, it is difficult to do so since changes in payment patterns can also arise from advances in technology, changes in end-user preferences and habits, and from broader macroeconomic factors. It is also difficult to estimate the effect of previous reforms on payment patterns to date, and it is similarly difficult to estimate the likely effect of new reforms on the future evolution of the system. The task is further complicated by the need to assess the overall benefit to society of any changes in payment patterns, taking into account both benefits derived from the various payment services and the costs of producing those services. However, the following simplified framework is useful for analysing the issues and conceptually understanding the welfare costs involved.

The basic building block is the consumer demand curve for a payment method, which shows, for each price, the number of transactions that will be undertaken using that method (Figure 2). The downward slope reflects the fact that different consumers value the use of the payment method differently; there are some consumers who would be willing to pay a high price because they highly value the services provided by the method and, conversely, there are some consumers who place a relatively low value on the services provided and thus would be prepared to pay only a low price. The area under the demand curve reflects the benefit consumers receive from using that payment method.

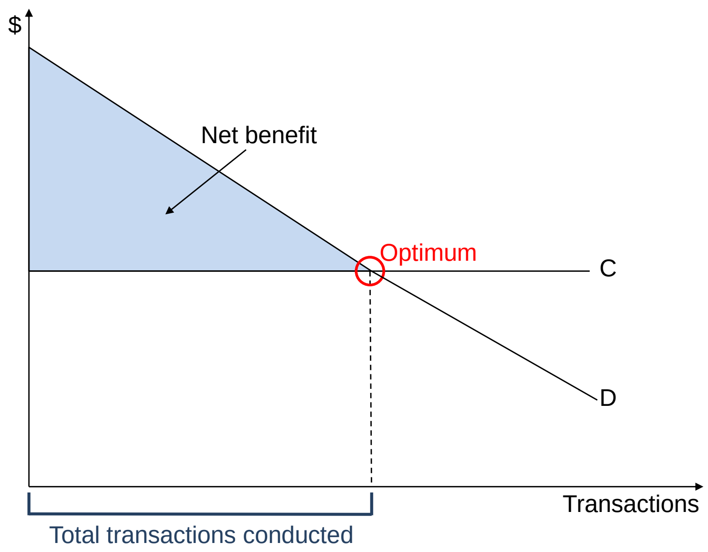
Figure 2: Demand for a Payment Method



Source: RBA

Payment services are, however, costly to produce, so the benefit to consumers does not entirely translate to a benefit to society – the costs of producing the payment services also need to be taken into account. If, for example, the cost of producing the payment services was $C, and the market was perfectly competitive so that the price charged for payment services was also $C, the net benefit to society would be represented by the shaded triangle in Figure 3. Only consumers who value the service above the cost of production would use this payment method.

Figure 3: Economic Efficiency

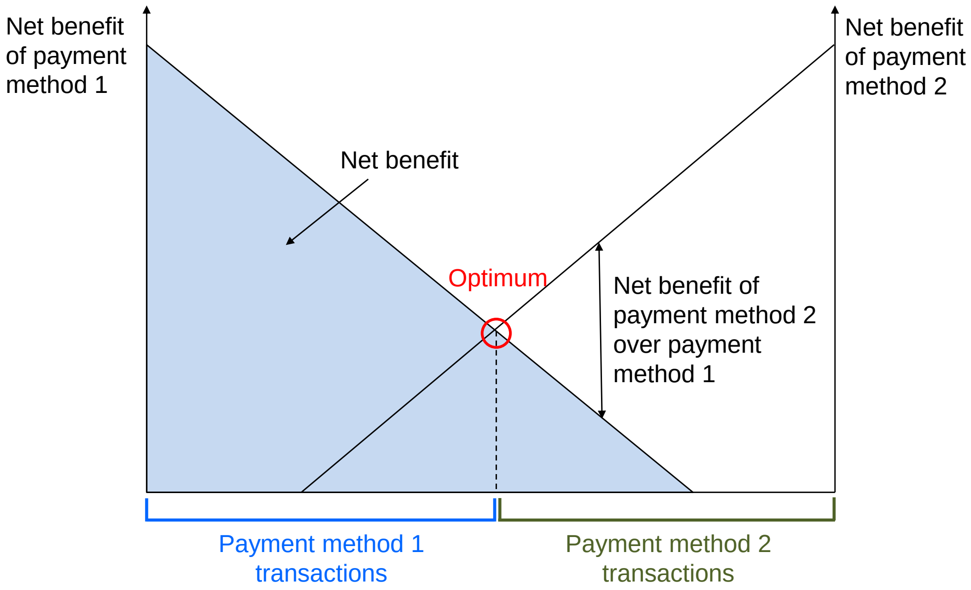


Source: RBA

In practice, consumers have multiple payment methods that they can use, and the demand for payment services is a derived demand – that is, payment services are not demanded in their own right, but as a consequence of purchasing goods or services. These aspects require some modifications to Figures 2 and 3.

First, we assume that there are a fixed number of payments, determined by the number of purchases of goods and services in the economy – this is given by the length of the horizontal axis in Figure 4. Second, we assume that there are just two payment methods available, payment method 1 and payment method 2. And third, the vertical axis in Figure 4 shows the net benefit from transactions with each payment method – that is the value of the benefit (as in Figure 3) less the cost of producing the payment method. The net benefit of transactions made with payment method 1 is drawn with respect to the left axis, and for transactions made with payment method 2, the net benefit is drawn with respect to the right axis. These net benefits take into account the benefits and costs incurred by consumers, financial institutions and merchants.

Figure 4: Choice of Payment Method

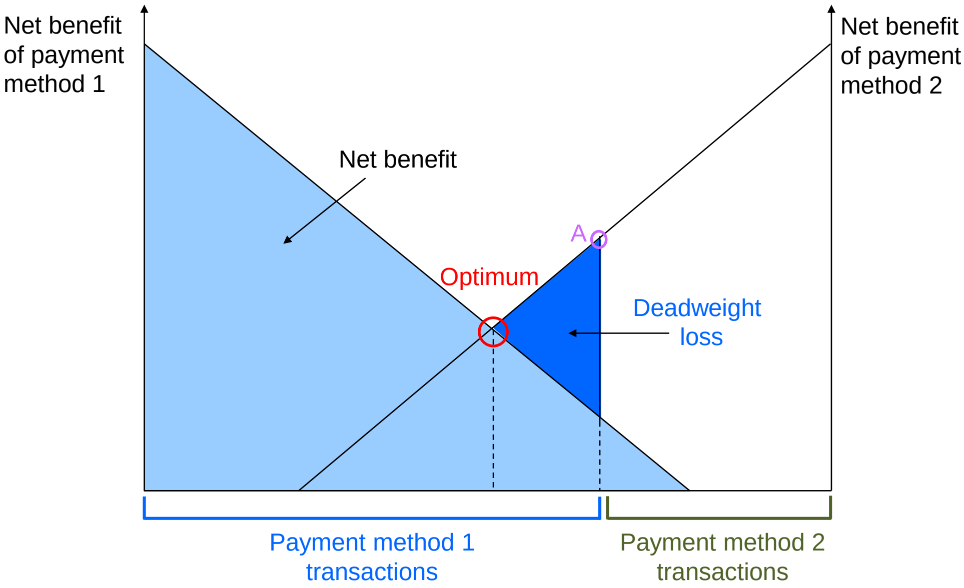


Source: RBA

For transactions on the left-hand side, the net benefit from using payment method 1 is above that of using payment method 2, perhaps because method 1 has some additional functionality compared to method 2. Conversely, for transactions on the right-hand side, the net benefit of payment method 2 is greater than that for payment method 1, perhaps because of a particular feature of method 2. The optimum outcome is where all transactions to the left of the point labelled 'Optimum' are performed on payment method 1, and all transactions to the right are performed on payment method 2.

Now, if the price signals facing consumers are such that payment method 1 transactions are priced below payment method 2 transactions, despite payment method 2 having lower costs, payment method 1 will be overused and welfare will be reduced. This is shown in Figure 5. At every point to the right of the social optimum, the net benefit to society of a payment method 1 transaction is less than the net benefit of a payment method 2 transaction. If the economy is operating at point A, the total loss is measured by the triangle identified as 'deadweight loss' – the cumulative loss from people using payment method 1 where the value they place on the payment services is less than the cost of producing those services.

Figure 5: Calculating Efficiency Losses



Source: RBA

To the extent that regulatory interventions can move the economy from point A towards the optimum mix of transactions, the deadweight loss is reduced. At the optimum, payment method 1 is only used by those people that value payment method 1 services above the cost of producing those services. Similarly, at the optimum, payment method 2 is used by those people that value payment method 2 services above the cost of producing those services. This maximises economic welfare.

While there are a range of factors that make it challenging to quantify the welfare effects from the Bank's reforms, the large size of the payment card market implies that any move towards the socially optimum mix of card transactions would likely result in substantial welfare gains. For instance, in 2015 total card transactions amounted to about $550 billion, so even a small adjustment may translate into a material welfare improvement. Similarly, the Bank's most recent Payment Costs Study showed that the aggregate resource costs incurred by large merchants and financial institutions in facilitating card payments were around $4.7 billion in 2013, or about 0.3 per cent of GDP.[7]

5.1.1 The optimal level of interchange fees

It is difficult to precisely determine the socially optimal level of interchange fees in practice. However, recent empirical evidence from Europe suggests that optimal interchange fees are likely to be lower rather than higher. Underpinning this evidence is the 'merchant indifference test' formulated by Rochet and Tirole (2011), which proposes that interchange fees be set at a level that makes a merchant indifferent between accepting cards and an alternative low-cost payment method, such as cash.

Using merchant surveys, the European Commission (2015) applied the test empirically and found that the credit and debit card interchange fees that satisfy the test are likely to be low (with some estimates suggesting slightly negative interchange rates could be optimal). The merchant indifference

7 Aggregate resource costs incurred by large merchants and financial institutions in facilitating *overall* consumer payments were 0.54 per cent of GDP in 2013.

test has influenced much of the Commission’s work on payment cards regulation, including the decision to cap EU interchange fees at 0.3 per cent for credit cards and 0.2 per cent for debit cards.

Data from the Bank’s 2013 Consumer Payments Use Study strongly suggest that, despite the Banks’ previous reforms which have significantly reduced average interchange fees, credit card rewards programs – funded by interchange revenue – still encourage the overuse of credit cards at the expense of cash and debit cards (see Section 3.1.1). Accordingly, the theoretical literature, the European evidence and the results of Bank’s Consumer Payments Use Study strongly suggest that a reduction in interchange fees would likely bring market outcomes closer to the socially optimal level.

5.2 Potential impacts on the payments market

5.2.1 Option 2: Mostly deregulatory

One benefit of this option would be that it would avoid the need for interchange regulation. While it seems highly likely that the removal of any interchange benchmarks would lead to very strong pressures for higher interchange rates, these might be somewhat contained if the power of merchants to respond to high interchange rates in their acceptance decisions could be strengthened sufficiently.[8] In particular, merchants would see the relevant fee at the moment the transaction is occurring. However, the downside of this option is that industry participants indicated that empowering merchants in this way would involve significant costs to industry. Additionally, the relatively limited adoption of surcharging in some sectors suggests that the discipline provided by this option may be at best uneven.

Under this option, payments in the American Express companion card system would remain unregulated by the Bank. A level playing field between the three- and four-party schemes would be achieved by the deregulation of interchange fees for four-party schemes. This would remove much of the incentive for banks to issue companion cards. As a result, it is likely that issuance of companion cards could slow down and the three-party schemes might find it harder to preserve their current market share.

5.2.2 Option 3: Regulatory

Interchange fees

As noted previously, average interchange fees in the MasterCard and Visa systems have typically been above the benchmarks and have drifted higher between compliance periods. Schemes have used the flexibility afforded by the weighted-average benchmark framework to set increasingly complex interchange schedules, with new higher fee categories and a wider range between the lowest and highest rates. The higher rates tend to be borne disproportionately by smaller and medium-sized businesses, most of which do not benefit from the ‘strategic’ and other preferential rates that are available to some larger merchants.

Supplementing the weighted-average benchmarks with a ceiling on individual interchange categories would potentially go a long way towards dealing with these issues. Stakeholders have generally acknowledged the Board’s concerns about the growing dispersion of interchange rates and many

8 For example, in the US market, unregulated credit card interchange fees are as high as 3.25 per cent plus 10 cents, while in Australia the highest interchange rate is 2.0 per cent (excluding GST).

indicated that a cap on the highest interchange rates could be an acceptable solution. The caps proposed under this option would result in a reduction in interchange fees on premium consumer cards and on commercial cards (with implications for the generosity of rewards packages and rebates on such cards). The option would be likely to result in a meaningful reduction in the interchange disadvantage of non-preferred merchants.

Reducing the weighted-average benchmark for debit cards would moderate the Bank's concern that interchange benchmarks may still be higher in Australia than is desirable for the overall efficiency of the payments system. It is likely that such a change would serve to bring interchange fees on the international scheme debit products and the domestic eftpos system closer together, reducing distortions arising from interchange fees. Reductions in the interchange benchmarks, however, may require some adjustments to industry business models.

Assessing the level of the benchmarks and caps

The 0.50 per cent weighted average benchmark for credit cards was based on a detailed issuer cost methodology, undertaken in 2006 by independent experts appointed by the schemes. The use of this cost benchmark methodology did not reflect a view by the Bank that interchange fees in the credit card system should be set in a way that compensates issuers for their costs in providing credit card accounts to cardholders. Rather this approach was adopted as a transparent and objective means of achieving lower interchange fees consistent with the powers the Bank has been granted. It was also an approach advocated by a number of industry participants.

While there are sound arguments for lowering this cap, including those considered by the Board during the 2007/08 and the current review, the Bank has decided against doing so at the present time, partly to reduce the risk of unexpected effects on the competitive balance between three- and four-party schemes or of a significant increase in circumvention efforts. There are, however, other elements of the new standards that would result in lower average interchange payments on credit transactions, in particular the tighter compliance requirements.

For individual credit card caps, a relevant consideration is that, when the weighted-average cap was introduced in November 2003, the highest interchange fee rates applied to commercial cards, with a simple average of around 1.0 per cent. Another consideration is that in their submissions and in consultation, some banks suggested that a cap for interchange fees in the range of 0.80–1.10 per cent would be consistent with a level playing field across four- and three-party schemes. A cap at the lower end of this range would achieve a significant reduction in payment acceptance costs for non-preferred merchants.

The reduction in the weighted-average debit card benchmark to 8 cents in part reflects the decrease in transaction sizes over the past decade. When the current benchmark of 12 cents was introduced in 2006 it represented about 0.15 per cent of the average debit transaction size for international schemes. As transaction sizes have decreased over time, the benchmark is now equivalent to around 0.22 per cent. The reduction of the benchmark to 8 cents would bring it back to around 0.15 per cent of the average transaction size for international schemes.

Benchmark compliance

By requiring observance of the benchmark on a quarterly basis, the upward drift in average interchange fees would be reduced and average interchange fees would be at levels intended under the benchmarks. Under the current system, before each three-yearly compliance date schemes put significant effort into determining a new interchange fee structure that will achieve compliance while best meeting their commercial objectives. These resets often result in significant changes to interchange fee schedules and result in costs to issuers who may have to reprice and potentially restructure their product offerings as a consequence. Under a quarterly compliance system, interchange resets might be more frequent but would be much more incremental in nature than the resets currently occurring every three years, resulting in fewer resources directed towards taking advantage of the flexibility in the regulatory framework.

Surcharging

This option represents an attempt to determine a definition of acceptance costs that strikes a balance between the aims of promoting efficient price signals and avoiding excessive complexity. While a comprehensive definition that encompasses the wide range of costs faced by diverse merchants may be conceptually appealing, experience with the current regime suggests that erring on the side of simplicity is likely to lead to an approach to surcharging that is more efficient and enforceable in practice. In particular, costs that are internal to the merchant are not readily observable to a third party and are likely to be difficult to verify in an enforcement context.

Under this option, the Bank’s standard would also require acquirers (or payment service providers) to provide merchant statements with separate information on the average cost of accepting each card type. In most cases this would imply providing average costs of acceptance for Visa credit, Visa debit/prepaid, MasterCard credit, MasterCard debit/prepaid and eftpos (with American Express cards billed separately).

This information should facilitate greater understanding by merchants of the cost of accepting different card schemes and would be relevant for merchants in considering potentially surcharging.[9] The greater transparency of acceptance costs under this option would allow a third party, including the ACCC, to easily verify whether a merchant was surcharging excessively. Overall, this option would improve price signals in the payments market, resulting in a better allocation of resources and downward pressure on payment costs.

Competitive neutrality and companion cards

The regulation of all payments to issuers would represent a significant change from the status quo for the current companion card issuance model. The growth of companion cards in large part reflects the significant payments from American Express to issuing banks. These payments comprise not only transaction-based ‘issuer fees’ (the most direct equivalent to interchange fees) but also other payments to issuers. Regulation of these fees would imply a reduction in the payments from American Express to its bank partners and could alter the relative appeal of companion cards to issuers and cardholders, probably implying a decrease in rewards and other benefits offered. It is possible that some banks would cease to see a commercial advantage in issuing companion cards, while for American Express, promotion of proprietary cards might become relatively more attractive.

While this option would likely result in a reduction in benefits to holders of companion cards, price signals and resource allocation in the payments system would improve. The use of companion cards

9 Merchants would in principle be able to set different surcharges for different schemes, though it is likely that a desire for simplicity would limit the number of different rates. In the event that a merchant chose to surcharge different types of cards at the same rate, the surcharge could not be above the average cost for the lowest-cost scheme.

would be likely to decline, reducing acceptance costs for merchants. This in turn would result in downward pressure on the prices of goods and services to consumers. In addition to these benefits in terms of the efficiency of the payments system, this option would also entail an equity benefit. American Express companion cards are more common among higher-income individuals. As a result, people on lower incomes are often effectively subsidising those on higher incomes. To the extent that this effect is reduced, equity will be enhanced in the payments system.

5.3 Potential impacts across stakeholders

Following on the previous discussion of payment markets impacts, this section summarises the likely effects of the policy options on various stakeholders.

5.3.1 Option 2: Mostly deregulatory

Industry participants

- Interchange fees in the four-party schemes are likely to increase significantly, although this might be partly offset by merchants' enhanced ability to surcharge and decline high-interchange cards.
- The regulatory treatment of four-party schemes and the three-party schemes would be similar.
- The relative attractiveness for banks to issue companion cards from the three-party schemes is likely to diminish as four-party schemes would be able to set higher interchange fees.

Consumers

- The general price of goods and services would increase reflecting higher payment costs from the higher interchange fees.
- Consumers that hold credit cards might see an increase in the generosity of their rewards, funded by higher interchange fees.
- Cross-subsidisation across consumers is likely to increase with those consumers not using credit cards subsidising, via higher prices for goods and services, the rewards of those consumers using credit cards.
- Consumers that have high-cost, high-rewards credit cards may find that their payments are more often surcharged or that sometimes their credit cards are not accepted.
- There would be fewer instances of excessive surcharging, owing to simpler, more transparent surcharging arrangements and enhanced enforceability.

Businesses

- Merchant service fees are likely to increase to reflect higher interchange fees.
- Merchants would have enhanced powers to resist high-interchange cards with enhanced real-time visibility of their costs at the point of sale and the ability to selectively refuse acceptance of some cards from a given scheme.
- In sectors where surcharging is feasible merchants may surcharge more often, and these surcharges are likely to more accurately reflect their payment costs.

- In sectors where surcharging is more difficult, some merchants may pass on the higher merchant service fees to consumers in the form of higher prices at the point of sale; others may directly absorb the higher merchant service fees.

5.3.2 Option 3: Regulatory

Industry participants

- A change in the nature of competition between three- and four-party card schemes would be expected. For example, with issuer fees in companion cards subject to the credit card interchange benchmark, there may be a reduction in companion card issuance and usage.
- Quarterly enforcement of the benchmark would likely result in reductions in the overall level of interchange payments for credit card transactions.
- A lower level of interchange fees would be expected to flow through into falls in four-party merchant service fees.
- Changes to the debit interchange cap could result in higher card acceptance for low-value transactions.
- A fall in merchant service fees for the four-party schemes and reforms that ensure surcharging is more linked to payment costs are likely to result – as in the Bank's initial reforms – in downward pressure on three-party merchant service fees.
- The caps on maximum interchange rates would bring down interchange fees on some commercial cards issued under four-party schemes and there is likely to be some reduction in rebates.
- Smaller ADIs (e.g. credit unions and building societies) do not generally issue high-interchange, high-rewards cards, and so are likely to be much less affected by caps on the highest interchange rates than the large banks.
- Reductions in interchange fees (and the generosity of rewards packages) would reduce the obstacles facing new payment methods in the future.

Consumers

- Lower merchant service fees would be expected to lead over time to slightly lower overall prices of final goods and services to consumers.
- Changes to the interchange fee benchmark frameworks and a reduction in merchant service fees would result in less cross-subsidisation/price discrimination between different types of cardholders and consumers.
- There would be fewer instances of excessive surcharging, owing to simpler, more transparent surcharging arrangements and enhanced enforceability (including, as recently announced by the Government, by the ACCC).
- The reduction in merchant service fees may also result in some reduction in the frequency of surcharging on some cards.

- The cap on the highest credit card rates is likely to result in some reduction in the generosity of rewards programs on premium cards. It is likely, however, that there would be only limited changes to other elements of the credit card package (e.g. interest rates, interest-free periods).
- Similarly, the reductions in the high percentage debit/prepaid interchange categories may result in some reduction in rewards generosity for some of the new debit/prepaid rewards cards. There are unlikely to be other material changes to arrangements for transaction accounts.

Businesses

- As noted above, it is likely that merchant service fees would fall due to a reduction in interchange payments.
- The difference between interchange fees on transactions at preferred and non-preferred (mainly smaller) merchants would be expected to narrow significantly. Caps on maximum interchange fees would likely benefit small businesses that currently bear most of the cost of 'super premium' cards.
- Transparency of payment costs for merchants would be enhanced by changes to surcharging standards and associated disclosure requirements. The improved disclosure of scheme costs would result in greater merchant awareness of the cost of different payments and surcharging practices that more accurately reflected the cost of different schemes.

Impact on small merchants' rates

The fee structure for a small merchant to accept card payments can vary considerably. Some merchants receive 'bundled' pricing arrangements (i.e. a single rate across all cards accepted) from their acquiring institution, while others may be on 'interchange plus' pricing arrangements (i.e. the merchant pays the interchange rate plus a margin). The most significant cost for a small merchant in accepting card payments is the interchange fee associated with the payment card presented.

The highest credit card interchange fee is currently 2.0 per cent of transaction value, which is around double the highest rate when the Bank's reforms were first introduced (Table 2). In the case of debit cards, both international schemes have introduced *ad valorem* or percentage-based interchange categories which can be particularly costly for large-value transactions. Due to the hierarchy of interchange fees, the cost of these high-rate categories falls on merchants that do not qualify for 'strategic' and other preferential interchange fees – typically small and medium-sized retailers. In the September quarter 2015, the average credit card interchange fee faced by non-preferred merchants was around 55 basis points higher than the rate faced by preferred merchants; for debit cards the spread was around 13 cents.

Table 2: Range of interchange fees[(a)] – MasterCard and Visa

Advertised strategic vs non-strategic merchants, May 2016[(b)]

Credit card (%)		Debit card	
Strategic merchants	Non-strategic merchants	Strategic merchants	Non-strategic merchants
0.2 – 0.3	0.25 – 2.0	2 cents – 8 cents	6 cents – 12.7 cents and 0.27% – 1.05%

(a) Exclusive of GST.

(b) The 'Charity' category has been excluded; it attracts an interchange rate of 0 per cent. MasterCard's micropayment category (for payments less than $15) has also been excluded.

Sources: schemes websites; RBA

Under the Bank's proposed reforms, a ceiling (or cap) would be introduced for credit card interchange rates, so that no individual interchange fee category could exceed 0.80 per cent. For debit cards, the weighted-average benchmark would be reduced from 12 cents to 8 cents. Additionally, for debit cards, a cap would be introduced – 15 cents if the interchange fee is specified as a fixed amount and 0.20 per cent if the fee is specified as a percentage amount. Since these caps are generally below the current fees for non-preferred merchants, their payment costs would decrease. In particular, non-preferred merchants would see a reduction in interchange fees on premium consumer cards and on commercial cards.

5.4 Regulatory burden measure

In addition to the broader economic and payments market impacts, the options outlined above will involve some implementation and compliance costs. For the most part, compliance costs arise from changes to IT systems and reporting obligations. It is impossible to obtain an exact implementation cost for these changes. IT systems are different across schemes and financial institutions and the costs of adjusting them can vary substantially. In consultation, some stakeholders have provided high-level guidance and estimates which the Bank has taken into account when assessing potential compliance costs. These compliance costs estimates are subject to substantial uncertainty and are provided here as indicative yardsticks.

Using the regulatory burden measurement framework, it has been estimated that the measures under consideration could increase compliance costs (see below). While the Bank has not yet established 2016 offsets, the Treasury portfolio has reported net compliance cost reductions for 2014 and 2015. There is no reason why the portfolio will not continue to deliver on its red tape reduction targets this year, in line with the Government's regulatory reform agenda.

5.4.1 Option 2: Mostly deregulatory

Removing interchange fee regulation would eliminate existing compliance costs for four-party systems. Option 2 however, would generate compliance costs from the measures to allow merchants to easily determine their costs for accepting a particular transaction, such as via improvements to the information they receive from acquirers. In consultation and submissions, stakeholders have noted that regulation requiring the provision of real-time cost information would likely be difficult and expensive to implement. Overall, the removal of existing compliance costs would only partially offset the compliance costs introduced by the provision of real-time information.

Option 2: Regulatory burden estimate

Average annual regulatory costs (from business as usual)				
Change in costs ($million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$9.0	$0	$0	$9.0
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Agency	$1.4	$0	$0	$1.4
Are all new costs offset? ☐ **Yes, costs are offset** ☑ **No, costs are not offset** ☐ **Deregulatory—no offsets required**				
Total (Change in costs – Cost offset) ($million) = $7.6				

5.4.2 Option 3: Regulatory

Option 3 would involve some one-off costs for American Express and for companion card issuers, as they would need to ensure that their bilateral arrangements comply with relevant standards. There would also be some ongoing costs related to monitoring compliance and meeting reporting obligations under the regulations. However, based on experience with the existing regulatory framework, these costs are likely to be modest.

In terms of benchmark compliance, these options may impose some additional compliance costs on the MasterCard and Visa schemes. In particular, depending on how closely they choose to set their average rates to the benchmark, the international schemes may have to reset their interchange schedules more regularly than is required under the current three-yearly compliance cycle. However, quarterly compliance does not automatically lead to quarterly resets of interchange schedules; schemes could set their average interchange fee schedules sufficiently below the benchmark to significantly reduce the need for resets in the event of unforeseen changes in transaction patterns.

Moreover, there are reasons to suggest that the costs of incremental resets to meet the benchmarks may be relatively modest. While the schemes have been required to reset their Australian interchange schedules to the benchmark only once every three years, in practice they have tended to make changes more frequently. For instance, following resets that have been required every third year on 1 November, the schemes have typically undertaken a subsequent, voluntary, reset on the following 30 June.

Schemes have also made voluntary annual changes to their debit card interchange schedules since 2012. Additionally, they have implemented voluntary resets at short notice when deemed appropriate. For instance, following an unanticipated voluntary reset by MasterCard of its debit card interchange schedule in November 2013, Visa implemented similar changes to its schedule eight days later. Taken together, this suggests that the schemes do not see the cost of incremental resets of interchange fees as prohibitive. Given that the schemes will have a significant degree of control over when a reset will be required, the costs of the proposed quarterly compliance methodology appear to be moderate.

Discussions with acquirers also indicate that modifying merchant statements to facilitate surcharging would involve additional compliance costs, although there is a wide range of estimates across industry participants.

Option 3: Regulatory burden estimate

Average annual regulatory costs (from business as usual)				
Change in costs ($million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$5.8	$0	$0	$5.8
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Agency	$0	$0	$0	$0
Are all new costs offset? **☐ Yes, costs are offset ☑ No, costs are not offset ☐ Deregulatory—no offsets required**				
Total (Change in costs – Cost offset) ($million) = $5.8				

6. Consultation

In March 2015 the Bank published an Issues Paper noting some developments in the operation of the cards payment system that have caused concern for various stakeholders and also for the Bank. The Bank invited views from a wide range of interested parties, including both industry participants and end users, on possible policy responses. In total, more than 40 submissions were received from financial institutions, merchants, card schemes, consumer groups and individuals; 33 of these have been published on the Bank's website, with the remaining submissions received in confidence. Around 30 parties took up the invitation to have discussions with the Bank, with some major stakeholders having follow-up meetings.

As part of the consultation process, the Bank also convened a 'payments roundtable' on 23 June 2015, moderated by the Deputy Chair of the Payments System Board. Thirty-three organisations were represented at the roundtable, including schemes, card issuers and acquirers, merchants, government and regulatory agencies, and ministerial staff. The roundtable provided a forum to discuss views on the direction of regulation, focusing particularly on issues relating to interchange fee regulation, surcharging, companion cards and merchant routing of card transactions.

On 3 December 2015 the Bank published a Consultation Paper including draft standards for cards regulation.[10] The staff had numerous meetings with some of the key parties over December and January to discuss issues in the paper. The Bank received substantive submissions to the Consultation Paper from over 40 different stakeholders, with a number of parties providing both a public submission and additional confidential information. Thirty-four non-confidential submissions have been published on the Bank's website. Bank staff have had over 50 meetings with interested parties to discuss their submissions.

6.1 The level of interchange fees

While there was broad consensus on issues involving interchange fees, views diverged on other issues. The large international four-party schemes, for example, reiterated their long-held view that interchange regulation has been ineffective. Together with a number of other respondents (which included a number of financial institutions), they argued against a lowering of interchange caps. In contrast, there were a few submissions arguing for the complete elimination of interchange fees.

There was some resistance to the proposed reduction in weighted-average interchange fees for debit cards from 12 cents to 8 cents. Most of the arguments were consistent with previous claims regarding the Bank's reforms (e.g. interchange is needed to fund innovation and therefore any reduction in interchange will stifle innovation). Some cited the desirability of avoiding a reduction in revenue to the banking sector at a time when there were many industry projects underway (the NPP, ePAL hub, and online and contactless acceptance of eftpos). Two submissions from organisations representing

10 That same day, the Government introduced legislation to ban excessive surcharging. Amendments to the Competition and Consumer Act were passed by Parliament on 22 February.

smaller financial institutions argued against lowering the debit caps because it would increase the relative incentive to issue credit cards and/or put smaller issuers (which have a product mix that is more oriented toward debit rather than credit cards) at a competitive disadvantage relative to larger issuers.

6.1.1 Benchmark compliance

While end users were supportive of tighter compliance, financial institutions and the international four-party schemes were opposed to quarterly compliance on the grounds that frequent resets will be costly. A number of submissions appear to assume that quarterly compliance means quarterly resets, which, in some cases, may be simply a misunderstanding of the Bank's proposal.

The Bank's assumption has been that the schemes will not wish to impose the cost of quarterly resets on their members and will set interchange fees sufficiently below the benchmark to generate less regular resets – possibly annually, akin to their voluntary resets of debit interchange fees in recent years. Some respondents may, however, be assuming that the schemes will be prepared to reset more frequently in an attempt to generate higher interchange yields. Some submissions highlighted the potential for seasonal variations to trigger a reset. Similarly, it was noted that it would be undesirable to have changes over the peak transaction period of November to January.

A number of submissions, from both issuers and acquirers, expressed that allowing 45 days for a reset would to be too short. They argued that this would be very difficult to achieve given the need for a scheme decision process, system changes and then notification of any pricing changes to merchants and cardholders. However, the Bank understands from consultation that it may be less challenging to make small changes to rates, as opposed to wholesale changes to schemes' category definitions.

6.2 Transparency of card payments

Many submissions were of the view that the spread of interchange rates between small and large merchants should be reduced. In general terms, most stakeholders accepted the concerns raised in the Issues Paper about the lack of transparency in the cost of interchange payments and the widening in the schedules of interchange rates; many indicated that some form of a cap on the highest interchange rate could be considered. Some suggested that a cap could be combined with a floor on the lowest interchange rate, which, they argued, would ensure some degree of flexibility for schemes to set competitive interchange fees while potentially narrowing the spread between interchange fees faced by small and large merchants. An international scheme and other financial institution expressed a view that a hard cap of 0.80 per cent would be too low.

6.3 Surcharging

While schemes and some financial institutions would prefer to reintroduce no-surcharge rules, the objectives of the proposed changes to the regulation of surcharging received widespread support in submissions.[11] However, a number of parties raised concerns about particular elements.

11 Submissions to the Bank's Issues Paper were generally of the view that the FSI's proposed three-tier approach was overly complicated. Many submissions argued that it was important that a low-cost, non-surchargeable payment option be available and that the 'reasonable cost' rule on surcharges should be more enforceable, potentially by a public agency.

Most financial institutions expressed concern about the burden that would be placed on them to provide clear statements to merchants on their acceptance costs. A number noted that the billing process drew on multiple systems within their organisations (and sometimes from third parties), so that it was not straightforward to provide the scheme-level average cost information proposed by the Bank. Some indicated that they do not currently provide annual statements to merchants, so this would be a significant change. Some suggested that it would be hard to get the internal resources to work on a project to change merchant statements given many other projects that are underway. There were different views on the amount of time it would require for acquirers to introduce merchant statements with the desired transparency of costs, with some banks suggesting it would take more than 12 months. A number of submissions called for the Bank to work closely with industry on the issue of merchant statements; indeed, the Bank has provided a draft guidance note and disclosure template to a few acquirers.

The submission from a major airline said that it does not fully recover its 'reasonable cost of acceptance' through card surcharging. It argued for the inclusion of more costs, in addition to the merchant service fee, within the definition of allowable costs. It also argued that the proposed approach does not achieve a level playing field given that only schemes subject to the Bank's standards will explicitly be covered in the surcharging framework.

6.4 Companion cards

While the Bank received representations both for and against extending the regulatory net in general, most respondents focused on the possibility of regulating American Express companion cards. The international four-party schemes argued that if four-party card systems continue to be regulated, then all the payments in bank-issued companion cards from three-party schemes should be subject to interchange regulation. One scheme went further, arguing that proprietary three-party cards (i.e. those issued by the scheme) should also be brought within equivalent regulation. Most merchants supported bringing companion cards under Bank regulation.

In contrast, American Express and most submissions from companion card issuers argued that companion card arrangements were negotiated bilaterally and did not entail multilateral interchange fees, so should remain outside the regulatory framework. More generally, it was argued that concerns about 'competitive neutrality' had been overstated because American Express had a much smaller share of the cards market than the two largest four-party card schemes, and because American Express cards are not considered 'must-take' cards by many merchants and are more often subject to a surcharge.

6.5 Prepaid cards

There was a range of views – but little strongly held opposition – on the question of whether prepaid cards should be explicitly included within the debit card interchange cap. While some submissions argued for some distinctions in the regulation of debit and prepaid cards, most submissions supported the explicit regulation of prepaid cards.

7. Preferred Option

After extensive consultation with industry and other stakeholders, and balancing the different costs and benefits, Bank staff consider that Option 3 (Regulatory) is the best approach to address the issues highlighted in the card payments market. This is consistent with the FSI's endorsement of the Bank's overall approach to interchange regulation, and the Board's conviction that interchange reforms have contributed to a more efficient and competitive payments system.[12]

7.1 The level of interchange fees

In considering the case for retaining the current standards (Option 1), the Bank has weighed the identified drawbacks of the current system against the potential costs to industry of adjusting to a change in regulation. The main benefit of maintaining the current interchange benchmark system would be that it is well understood by the industry. However, under Option 1 credit interchange fees would remain higher than envisaged by the benchmark and debit interchange fees would remain elevated in relation to the average transaction size.

The Bank is not attracted to Option 2, which would involve removing interchange regulation and relying instead on strengthened merchants' rights to respond to upward pressures on payment costs. The payments industry has indicated that significant systems changes would have to occur if it was required to provide merchants with real-time information on payment costs and greater ability to respond when high-interchange, high-cost cards were presented by cardholders – which would likely be necessary for a deregulated regime to be effective. Additionally, merchants in a range of sectors have indicated that the principle of merchant surcharging for higher-cost payment methods is still not well accepted, so that they find it very difficult to surcharge to offset the higher cost of particular payment methods. Furthermore, the experience of the 2007/08 Review suggests that an approach of stepping back from interchange regulation and relying on voluntary undertakings is unlikely to be a feasible way of achieving the Bank's policy objectives.

While Option 3 is not directly lowering the existing credit benchmark, it would still achieve some reduction in effective interchange rates due to tighter compliance requirements. The reduction in the debit benchmark to 8 cents would unwind the effective increase in percentage terms in the benchmark that has resulted from the fall in average transaction size since 2006. This reduction would likely bring interchange fees on the international scheme debit products and the domestic eftpos system closer together.

The Bank has seriously considered the case for also lowering the credit card benchmark. The current review has not altered the Bank's long-held view that there appears to be little justification for

12 One example is the fall in merchant costs, with average merchant service fees having fallen by more than 60 basis points for MasterCard and Visa transactions since interchange regulation was introduced. The Bank's most recent Payment Costs Study estimated that the costs involved in providing payment services to households have fallen from 0.80 per cent of GDP in 2006 to 0.54 per cent of GDP in 2013. At the same time, the use of cards has continued to grow strongly.

significant interchange fee payments in mature card systems. A large reduction in interchange rates would have a number of benefits including: a reduction in payment costs of merchants; downward pressure on retail prices of goods and services for consumers; reduced need for merchants to consider surcharging of more expensive cards; reduced focus on rewards programs and reduced incentives for the use of payment methods with higher resource costs; a reduction in barriers to entry for potential new methods of payment; and a reduction in the extent to which current arrangements, set by the two largest schemes in the payments system, favour large retailers and higher-income consumers. However, the Bank is of the view that a large reduction in credit card interchange fees may be more disruptive for existing participants in the payments industry than Option 3, at a time when there are a number of other initiatives underway (notably the New Payments Platform and the new ePAL hub). A large reduction in interchange fees may also entail the risk of unexpected effects on the competitive balance between three- and four-party schemes or of a significant increase in circumvention efforts.

7.1.1 Benchmark compliance

In the Bank's view, shifting to quarterly compliance (Option 3) would be the most effective approach for ensuring that schemes' average interchange fees remain close to the benchmark levels. As noted above, the current three-yearly compliance framework (Option 1) has significant shortcomings in that it allows average interchange fees to drift well above the benchmarks over time and encourages the expenditure of resources on maximising interchange fee flows. The cost of the upward drift falls on medium-sized and smaller merchants and other merchants that do not benefit from low strategic interchange rates.

The Bank recognises that quarterly benchmark observance may involve additional compliance costs if schemes are required to reset interchange schedules more frequently than is currently the case. However, Option 3 is the option most likely to effectively limit the type of strategic behaviour that has undermined the current system. Moreover, quarterly compliance does not automatically lead to quarterly resets of interchange schedules; the Bank's expectation is that schemes would set their interchange fee schedules so that average interchange fees are sufficiently below the benchmark to mostly avoid the need for resets in the event of unanticipated changes in transaction patterns.

7.2 Transparency of card payments

In the Banks' view, Option 1 would not be in the public interest because it would not adequately address the lack of transparency of payment costs and higher (and rising) average interchange fees faced by merchants who do not qualify for preferential interchange rates. It is uncertain if under Option 2 there would be a reduction in the complexity and spread of interchange fees. While the regulatory incentive to create new interchange categories would disappear, the experience of other jurisdictions suggests that schemes may continue to operate with a large number of interchange categories. However, it is highly likely that overall interchange fees would increase under Option 2.

The Bank favours Option 3 since it is likely to significantly reduce the existing dispersion in interchange fees, improving efficiency in the payments system and benefiting small merchants. A ceiling of 0.80 per cent for credit cards would bring a meaningful reduction in premium and commercial credit card interchange fees, and would still allow four-party schemes to compete effectively with three-party products, especially given that four-party schemes have higher acceptance. Similarly, a ceiling for debit cards (15 cents if the interchange fee is specified as a fixed amount and 0.20 per cent if the fee is specified as a percentage amount) would reduce dispersion in debit card interchange fees.

7.3 Surcharging

The removal of 'no-surcharge' rules has been a significant reform in the payment system, ensuring that merchants have the ability to provide price signals to end users to indicate that their choice of payment instrument may have considerable costs to the merchant. However, surcharging practices have emerged in a limited number of industries that have not necessarily been reflective of the costs of payment methods but have for some transactions been excessive, undermining price signals in the payments system.

While an approach to surcharging that allows merchants to recover their costs of card acceptance remains appropriate, the current framework (Option 1) is viewed by many stakeholders as complicated and inadequately enforced. A particular problem that has been identified is the lack of transparency surrounding the calculation of merchants' 'reasonable cost of acceptance' under the current relatively wide set of eligible acceptance costs.

Option 2 would represent an enhancement of merchants' powers to surcharge, if it were practicable. However, stakeholders have clearly expressed that this option would involve significant costs and technical complexity.

The staff's view is that Option 3 will represent a significant improvement to the framework. The central element of this option is a clearer and narrower definition of acceptance costs, which would be accompanied by various other measures to enhance transparency and facilitate improved price signals about payment costs. This transparency should reduce the likelihood that merchants seek to surcharge in excess of their cost of acceptance and should ensure that any cases of excessive surcharging can be readily addressed by the ACCC following recent changes to legislation to give it powers in this regard.

7.4 Companion cards

Option 1 would maintain the current distortions in competitive incentives in the card payments market, leading to further misallocation of resources. Most likely, banks will continue to issue companion cards with higher scheme payments to issuers reducing the efficiency of the payments system. Option 2 would place four-party and three-party schemes on the same regulatory footing. However, under Option 2 both schemes would face fewer restrictions on their ability to increase payments to issuers, which is also likely to result in reduced payments system efficiency.

Regulation under Option 3 addresses competitive neutrality between four-party and companion card arrangements, while building on the efficiency benefits of existing interchange regulation. While Option 3 would likely result in a reduction in benefits to holders of companion cards, price signals and resource allocation in the payments system would improve, and lower card acceptance costs to merchants would result in downward pressure on the prices of goods and services to consumers. More generally, this option is consistent with the view taken by the FSI that regulating payments to companion card issuers would enhance competitive neutrality in the payments system (p. 173):

> 'Incentive payments used in most systems and service fees used in companion cards systems can achieve the same outcomes as interchange fees; however, they are not currently captured by interchange fee caps. Applying interchange fee caps on a broader functional

basis would help prevent alternative payments from avoiding caps and provide competitive neutrality for four-party and companion card payments system providers.'

7.5 Prepaid cards

The current approach (Option 1) was adopted partly because of the relatively low values and volumes of prepaid card transactions a decade ago. However, growth in the use of prepaid cards has meant that the ambiguity associated with the current approach is potentially more problematic than it was in the past and it would be undesirable if the two international schemes were to interpret the Payments System Board's expectations regarding interchange fees in quite different ways. Accordingly, the Bank sees merit in addressing this ambiguity – a position broadly supported in consultation.

While Option 2 would remove the ambiguity, if prepaid interchange rates were unregulated there would likely be a significant increase in these rates, with adverse implications for payments system efficiency. Indeed, the recent experience with the setting of prepaid rates, in particular the development of 'premium' prepaid cards, suggests these incentives are already at work.

On balance, it seems appropriate to clarify that prepaid cards will be subject to the debit Standard (Option 3). Making the regulatory framework consistent between prepaid and debit cards recognises that they are close substitutes. This position also reflects the fact that prepaid transactions are functionally similar to standard debit transactions. Additionally, while prepaid transactions provide benefits to both sides of the transaction, they arguably provide greater benefits to the issuing side, which benefits from float and expired unspent balances on these cards. Accordingly, Bank staff do not believe there is any strong case for arguing that prepaid cards require a higher level of interchange than standard debit. Finally, recent developments in prepaid premium cards (such as those connected to frequent flyer programs) have indicated that the schemes may not strictly adhere to the Board's expectations for prepaid card fees in circumstances where each scheme considers that there is a reasonable probability that the other scheme may choose to take advantage of the unregulated nature of prepaid cards.

8. Implementation and Evaluation

8.1 Implementation

In deciding on an implementation timeline, the Bank has been mindful of submissions by industry that they would prefer some time to prepare for the new regulatory framework. The Bank has also considered that a range of stakeholders, most notably consumer groups, would like to see quick implementation of the new surcharging framework to eliminate excessive surcharging.

Schemes covered by existing regulation would remain subject to the requirements of the current interchange standards until mid 2017. The new interchange standards would be effective from mid 2017 for compliance with the new interchange benchmarks and the rules on net payments to issuers. Schemes would have to certify annually that they have complied with the interchange benchmarks and rules on net payments to issuers. With a mid-2017 implementation, the first certification would be due mid 2018 and would relate to the 2017/18 financial year.

The implementation of the surcharging standard would be in two stages, depending on the size of the merchants. The definition of 'permitted surcharge' for large merchants will take effect in the third quarter of 2016. Large merchants will need to ensure that they comply with the requirements of the Competition and Consumer Act from this point. The definition of 'permitted surcharge' takes effect for all other merchants in the third quarter of 2017.

8.2 Evaluation

The Reserve Bank will continue monitoring developments and risks in the card payments market through liaison with industry and collecting data on key indicators. This includes data in the Bank's retail payments collection and monitoring features of credit cards offered in the market. The Bank will also continue publishing data on merchant service fees and may consider publishing data on interchange fees, mindful of any confidentiality issues. Additionally, the Bank will analyse changes in surcharging practices and will liaise with the ACCC to remain aware of any developments concerning excessive surcharging and the enforcement of standards.

References

Australian Government (2015), 'Improving Australia's financial system: Government response to the Financial System Inquiry', October. Available at <http://treasury.gov.au/fsi>.

Commonwealth Consumer Affairs Advisory Council (2013), 'Credit card surcharges and non-transparent transaction fees: A study', July. Available at <http://ccaac.gov.au/files/2013/11/131106-Credit-Card-Surcharges.pdf>.

European Commission (2015), 'Survey on Merchants' Costs of Processing Cash and Card Payments – Final Results', European Commission Competition Publications. Available at <http://ec.europa.eu/competition/sectors/financial_services/dgcomp_final_report_en.pdf>.

FSI (Financial System Inquiry) (1997), *Financial System Inquiry Final Report (S Wallis, Chair)*, March. Available at <http://fsi.treasury.gov.au/content/FinalReport.asp>.

FSI (2014), *Financial System Inquiry Final Report (D Murray, Chair)*, November. Available at <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf >.

Ossolinski C, T Lam and D Emery (2014), 'The Changing Way We Pay: Trends in Consumer Payments', RBA Research Discussion Paper No 2014-05.

Parliament of Australia (2016), 'Competition and Consumer Amendment (Payment Surcharges) Act 2016', February. Available at <https://www.legislation.gov.au/Details/C2016A00009>.

RBA (2006), 'Update on Payments System Issues', 13 September. Available at <http://www.rba.gov.au/media-releases/2006/mr-06-06.html>.

RBA (2008), 'Reform of Australia's Payments System: Conclusions of the 2007/08 Review', RBA , September.

RBA (2012), 'Guidance Note: Interpretation of the Surcharging Standards', November. Available at <http://www.rba.gov.au/payments-and-infrastructure/cards/201211-var-surcharging-stnds-guidance/guidance-note.html>.

RBA (2014), 'Submission to the Financial System Inquiry', RBA , March.

RBA (2015a), 'Review of Card Payments Regulation - Issues Paper', March.

RBA (2015b), 'Review of Card Payments Regulation - Consultation Paper', December.

Rochet J and J Tirole (2011), 'Must-take Cards: Merchant Discounts and Avoided Costs', *Journal of the European Economic Association*, 9(3), pp 462–495.

Stewart C, I Chan, C Ossolinski, D Halperin and P Ryan (2014), 'The Evolution of Payment Costs in Australia', RBA Research Discussion Paper No 2014-14.

United States Government Accountability Office (2009), 'Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges', Report to Congressional Addressees, November. Available at <http://www.gao.gov/assets/300/298664.pdf>.

Annex: One Page RIS Executive Summary

RBA Review of Card Payments Regulation
Regulation Impact Statement Summary

Problem

There are five related policy issues that the Bank has identified:

- Whether there is scope for interchange fees to fall further, consistent with falls in overall resource costs and as was contemplated in the conclusions to the 2007/08 Review.
- The decline in transparency for some end users of the card systems, in part due to the increased complexity and the wider range of interchange fee categories.
- Widespread perceptions that card surcharges remain excessive in some industries.
- Perceptions that companion card arrangements may indicate that the current regulatory system is not fully competitively neutral.
- Some uncertainty in the regulatory treatment of prepaid cards.

Recommended option

Option 3 – Modifying the regulatory regime, retaining the existing weighted-average interchange benchmark for credit cards, but enforcing it more effectively with more frequently observed (quarterly) compliance, and supplementing it with maximum caps on interchange rates. Companion cards would be regulated in the same way as cards in the four-party schemes. The weighted-average benchmark for debit cards would be reduced consistent with changes in average transaction values, and maximum caps would also apply to debit card rates. Prepaid cards would be brought formally into line with debit card interchange regulation. Permitted surcharge levels would be defined more narrowly to ensure more effective enforcement against excessive surcharging. Payments card acquirers would have to provide periodic statements with more detailed costs of acceptance to merchants.

Benefits / Costs

The recommended option would be expected to reduce the existing dispersion in interchange fees across products and improve price signals in the payments system. The narrower fee range would benefit small merchants and others that do not qualify for strategic rates. While the weighted-average benchmark for credit cards will remain at current levels, the proposed quarterly compliance regime is likely to keep overall interchange fees much closer to the benchmark and materially lower than they currently are between resets. This may lead to some reduction in rewards for some holders of high-cost cards. The regulation of fees paid by three-party schemes to issuers of companion cards would improve competitive neutrality of interchange regulation. As a result, financial institutions may find it less attractive to issue companion cards and the three-party schemes may redirect their marketing efforts to proprietary cards. Instances of excessive surcharging are likely to be reduced by a stricter definition of payments costs and stronger enforcement by the ACCC.

Consultation Approach

The Bank has consulted extensively about options for reform of payment cards regulation. In March 2015 the Bank published an Issues Paper and received more than 40 submissions from financial institutions, merchants, card schemes, consumer groups and individuals. Around 30 parties took up the invitation to have discussions with the Bank, with some major stakeholders having follow-up meetings. The Bank also convened a Payments Roundtable on 23 June 2015 with representatives of schemes, card issuers and acquirers, merchants, government and regulatory agencies. On 3 December 2015, the Bank published a Consultation Paper including draft standards for cards regulation. The Bank received substantive submissions to the Consultation Paper from over 40 stakeholders. Following the Consultation Paper, Reserve Bank staff have held more than 50 meetings with over 30 interested parties to discuss their submissions.