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The Chairman
Financial System Inquiry
By on-line submission

Dear Sir,

Submission Concerning Competition in Credit Card Payment Systems in Australia and the Formation of the Australian Payments Council

Thank you for considering this submission on the impact of Australian regulation of credit card payments and systems on our business, and for the opportunity to address the issues raised in the Inquiry's interim report in relation to improving the economic efficiency of the credit card system.

Cards are firmly entrenched as a payment mechanism in the Australian economy, for both consumer transactions and business to business payments. The dollar value of purchases made in the 2013/14 financial year exceeded \$230 billion¹. To achieve economically efficient payment systems, it is important that the regulatory framework:

- Deters inbuilt economic cross subsidisation between system participants within a payment mechanism
- Impedes anti-competitive business structures and structural barriers to system competition
- Incentivises competitive market structures, encourages innovation, and entry of new card schemes, card issuers and acceptors
- Delivers competitive and transparent transaction costs to all system participants in a timely way
- Provides open and non-discriminatory access to new system participants, and
- Permits the use of existing infrastructure by others, as seen in other areas of infrastructure.

We recommend that the existing (stability-focused) regulatory structure governing this critical payment mechanism be reformed to address this framework.



The most significant issues arising out of the current structure are:

- the very high cost to the merchant of accepting cards as a form of payment relative to other forms of payment
- the high levels of cross subsidisation inherent in all card Schemes
- the anti-competitive playing field created by the two tiered merchant structure, strategic and non-strategic
- the difficulties in recovering the excessive costs of processing card payments from card holders in an economically efficient and equitable manner, and
- the fact that the non-card holding participants in the economy inevitably bear some of the costs associated with this high cost payment method when merchant & interchange fees are not recovered from the card holder.

Cross subsidisation occurs from non-strategic to strategic merchants, from merchants to cardholders, between card holders, and between card holders and those paying by other mechanisms because:

- Interchange fees on many card categories are set at levels multiple times higher than the cost of processing transactions to enable card issuers to incentivise those categories of card holders with reward points.
- Merchants designated as 'strategic' receive highly preferential treatment, being charged interchange fees that are many times lower than interchange fees charged to other merchants, and that are much lower than the interchange fee cap (refer Scheme websites²). The Schemes and card issuers ensure they charge fees at the aggregate system level equivalent to the system "cap". To achieve this, interchange fees charged to 'non-strategic' merchants are charged at levels many times higher than the system "cap", which by default becomes the system average (as adjusted over time). The direct result is that 'non-strategic' merchants subsidise both strategic merchants, and shoppers at strategic merchants. This is both anti-competitive and economically inefficient.
- Strategic merchants are accordingly incentivised to accept cards that provide reward benefits to their card holder customers, given doing so is at the relative expense of their competitors. To remain in the competitive race with strategic merchants, non-strategic merchants must also accept cards. However, as strategic merchants effectively set the competitive tone, there is little potential for merchants operating in the industries dominated by strategic merchants to recover the disproportionate interchange fees.
- The claim that a system cap has reduced overall fees paid reflects the relative shift in sales among merchant categories in the economy, not that the system has become more economically efficient and lower cost.
- For those merchants seeking to recover interchange and merchant fees to card holders, they can only do so at their average cost of accepting all cards. Merchants receive no information on the interchange cost of the particular card being presented, and Schemes and card acquirers and issuers provide no mechanism for merchants to recharge the

specific cost of use to the presented card. This subsidises the rewards holders of expensive, rewards rich cards.

- Card issuing organisations are highly incentivised to issue cards to which reward mechanisms are attached. This incentivises their card holder base to maintain loyalty to the card issuer at the economic cost of other participants in the system. We also understand that there is a significant delay between the accumulation of and claiming of rewards by card holders, providing further value transfer to card issuers.

Cards are an established payment mechanism, and are substantially more expensive for most merchants to accept compared to other forms payments, yet in most competitive circumstances, there is no opportunity to pass on the actual, differential cost.

In this context, our responses to questions and issues raised in the interim reports are:

- On interchange fees:
 - A. Interchange fees should reflect the cost of providing a payment mechanism, should not be ad valorem, and should be capped at a dollar amount reflecting the flat cost of processing a transaction.**

The cost for merchants of accepting credit cards should be brought into line with the cost of payment processing, evidenced by costs of accepting any other form of electronic payment, such as EFTPOS. There should be a \$ cap on fees to reflect the fact that the cost of processing a payment is not related to the size of the payment.

The system level cap on interchange fees could be removed because it would be redundant. We note that the European Commission has instituted a regulatory structure which caps fees.

- B. An alternative, but less satisfactory solution would be to require Schemes and card issuers & acceptors to provide the mechanism to directly recharge interchange & merchant fees to the cardholder at the time of a transaction. This should be transparent to both merchant and cardholder.**

Direct recharge would ensure that card holders pay the economic cost of the card they present. Schemes and card issuers control the fee levels, and should use their system to provide the means to recharge fees to the card holder. This would provide more economically efficient price signalling to card holders, remove cross subsidisation between the card holders, and remove the question of overrecovery of costs by merchants.

Greater transparency, in conjunction with other initiatives, is also likely to facilitate the growth of competitive alternatives.

C. There should be no distinction between “strategic” and “non-strategic” merchants in interchange fees.

The distinction between “strategic” and “non-strategic” categories of merchant is anti-competitive, is a substantial value transfer from “non-strategic” merchants, and provides a very uneven playing field. The present system wide cap on interchange fees results in “non-strategic” merchants bearing the cost of cards over and above the interchange fee system level cap.

D. System level information published by the RBA should provide transparent reporting of interchange fees charged by categories of merchants, by categories of card, and on numbers of cards in each category.

This would provide all participants with greater clarity on costs of this important payment mechanism. Importantly, it would also provide information on the level of cross subsidisation taking place across the system.

E. There is no justification for limiting “surcharging” or recharging of merchant and interchange fees by merchants unless Schemes and card issuers provide clarity of fees to cardholders, and the mechanism to recharge the actual cost of fees to card holders at the time of the transaction.

This would provide both card holders and merchants with greater equity and economic efficiency.

Mechanisms to inhibit the recharge of interchange fees to the card holder are economically unjust under current card system arrangements. We oppose the reintroduction of limits on the recharge of interchange and merchant fees on the basis that inappropriate cost recovery by certain categories of merchant is best dealt with by the recovery mechanisms proposed above.

- In relation to competitiveness between Schemes and payment alternatives:

A. Existing payment systems should be open and available for incoming new competitors to use, similar to the approach in other areas of infrastructure.

The current “locks” on the system provide significant barriers to competition in this area. Barriers are evidenced by the 85% market share held by two Schemes, the parallels in pricing between Schemes for particular categories of cards, the lack of alternative mechanisms, and the lack of transparency to the merchant on the cost of accepting a card at the time of the card transaction takes place.

Merchants may or may not choose to pass through interchange and other merchant fees to card holder. However, when choices are correctly priced, consumers and business card holders will select the payment method that makes most economic sense. This will be to the benefit of the economy as a whole.

In summary, we ask the Inquiry to investigate this matter and recommend the steps necessary to ensure that card payments systems become economically efficient and competitive through the following:

- Remove obstacles to a competitive payments system environment by eliminating regulations and Scheme rules that support and enforce cross subsidisation
- Apply the same standards to economic infrastructure as other forms of infrastructure; force unbundling of costs, and correct economic allocation by capping the level of interchange fees at no higher than 0.33%, with a maximum charge of less than \$10, more reflective of transaction costs
- Remove distinctions between strategic and other merchants to remove anti-competitive structures
- Implement all necessary steps to ensure Schemes and card issuers provide automated differential fee recharging by merchants directly to the cardholder at the time of the transaction
- Roll out principles of open transparent pricing in real time, a level playing field for system users, remove regulation and system 'rules' which protect anti-competitive structures, and apply these principles to all payment systems and mechanisms
- Open and transparent publication and availability to the public of transaction data (including by merchant category, by Scheme, detailed fee data by merchant category, interchange fees paid to card issuers & retained by card acquirers).

Formation of the Australian Payments Council

We note the RBA's announced formation of the Australian Payments Council.

Disappointingly, the membership of the Council is drawn entirely from within the payments industry, and does not include any direct competition oversight, members of the business community, industry groups, or consumers. The existence of the Payments Community may somewhat mitigate the narrow composition of the Council, but it is not a substitute for a more broadly and appropriately constituted Council.

We would welcome the opportunity to discuss our submission and suggested solutions.

Yours sincerely



Marion Johnstone
Group Treasurer

Note 1 : <http://www.rba.gov.au/payments-system/resources/statistics/index.html>

Note 2 : <http://www.visa.com.au/aboutvisa/interchange/interchange.shtml>;

http://www.mastercard.com.au/merchant/getting_started/interchange_rates.html