

# REFORM OF AUSTRALIA'S PAYMENTS SYSTEM

ISSUES FOR THE 2007/08 REVIEW

MAY 2007

---

## CONTENTS

- 1 Timing and Scope of the Review
- 3 Background to the Review
- 5 The Bank's Reforms and Rationale
- 13 Regulatory Developments Overseas
- 16 Developments in the Market for Payment Cards
- 24 Issues
- 31 References

*Reserve Bank*

© Reserve Bank of Australia 2007. All rights reserved.

The contents of this publication shall not be reproduced, sold or distributed without the prior consent of the Reserve Bank of Australia.

ISBN 0-9775353-3-9 (PRINT)

ISBN 0-9775353-4-7 (ONLINE)

# Reform of Australia's Payments System: Issues for the 2007/08 Review

1. As announced on 13 September 2006, the Reserve Bank is conducting a review of its reforms to Australia's card payment systems. It is seeking the views of interested parties on the effects of the reforms to date, and on how the regulatory arrangements can best promote competition and efficiency in the Australian payments system over the years ahead.
2. This paper sets out details on the timing and scope of the review and provides a summary of the Bank's reforms and their rationale. The paper also raises a number of specific issues on which the Bank is seeking comment from interested parties. Submissions on other relevant issues are also welcome.
3. The paper is structured as follows. Section I outlines the timetable for and scope of the review, while Section II provides some relevant background information. Section III summarises the Bank's reforms and the analysis that led to those reforms. Section IV summarises regulatory developments overseas, while Section V provides details of developments in the Australian market over the past five years. Finally, Section VI sets out the specific issues on which the Bank is seeking comment.

## I. Timing and Scope of the Review

### *Review timetable*

4. The release of this paper begins the formal processes of the review. Interested parties are invited to make submissions by 31 August 2007. All submissions will be posted on the Bank's website ([www.rba.gov.au](http://www.rba.gov.au)) and parties making submissions will have the opportunity to discuss them with the Bank. Submissions should be sent to:

Head of Payments Policy Department      or      [pysubmissions@rba.gov.au](mailto:pysubmissions@rba.gov.au)  
Reserve Bank of Australia  
GPO Box 3947  
SYDNEY NSW 2001

5. As part of the review process, the Bank will co-host a conference with the Centre for Business and Public Policy at the Melbourne Business School on 29 November 2007. This conference will bring together academics, practitioners and policy makers to address a number of key issues regarding the Bank's reforms.
6. The Bank anticipates releasing its preliminary conclusions – including details of the general direction the Board is considering – for consultation in April 2008. If, at the end of that consultation, the Board were to propose making specific changes to the current standards or access regimes, the draft changes would be released for public comment. While there is inevitably some uncertainty as to the exact timing, it is anticipated that any changes to standards and access regimes would be finalised by the end of 2008.

### *Scope of the review*

7. The genesis of the review is a commitment the Bank made when it announced the credit card reforms in 2002. At the time, the Bank said that ‘The [Payments System] Board will also undertake a major review of credit and debit card schemes in Australia after five years, updating the findings of the Joint Study. On the basis of that review, it will consider whether the standards and access regime for the designated credit card schemes remain appropriate.’<sup>1</sup>
8. In a media release on 13 September 2006 the Bank sought views on the content of the review.<sup>2</sup> Most submissions called for the review to be broad in nature and to cover all the Bank’s reforms, not just those relating to the credit card system. The Bank agrees with these submissions and is committed to an open and wide-ranging review that provides scope for all interested parties to be involved.
9. The review will not only examine the effects of the reforms to date, but will also examine how, looking forward, the regulatory regime can best contribute to competition and efficiency in the Australian payments system. In particular, the Board is interested in what has changed since the reforms were introduced and how this might bear on the appropriate regulatory regime in the future. Reflecting this broad scope, the review will address three interrelated questions:
  - (i) what have been the effects of the reforms to date?
  - (ii) what is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach? and
  - (iii) if the current regulatory approach is retained, what changes, if any, should be made to the standards and access regimes?
10. The review will consider all the reforms to date. These include: the interchange standards for the credit card, scheme debit and EFTPOS systems; the standards requiring the removal of the no-surcharge rule and the modification of the honour-all-cards rule; the access reforms to the credit and debit card systems; and the increased transparency of information. The review will also consider a number of issues that the Board has previously discussed, but where a regulatory response was not considered appropriate at the time. In particular, it will include consideration of the payment systems operated by American Express, Diners Club and BPAY. The review will also consider the ATM system, although the extent of this consideration will depend upon how the current industry-based reform process develops over coming months.
11. In conducting the review the Board will pay particular attention to the effects of the various reforms on the overall efficiency of Australia’s payments system. The Board has always seen the various reforms as part of a package and is especially interested in the way the configuration of interchange fees across the various payment systems influences relative prices for payment services.

---

1 Reserve Bank of Australia (2002), p.40.

2 Reserve Bank of Australia (2006).

### *Gathering relevant information*

12. The Bank is conducting two significant studies as inputs to the review.
13. The first is a study of the resource costs associated with different methods of payment. The study will update and extend the data on costs collected as part of the Joint Study in 1999 and 2000.<sup>3</sup> In addition to the costs of financial institutions, the study will consider the costs incurred by other participants in the payments system, and will include consideration of the costs of payments by cash, as well as by credit cards, scheme debit cards, EFTPOS, cheques, direct entry and BPAY.
14. This study is being undertaken in close co-operation with financial institutions, merchants and billers. The ability of many organisations to provide cost data in a systematic fashion has increased substantially since the Joint Study, and the Bank appreciates the co-operation it is receiving from the organisations contributing to this aspect of the review.
15. The second study is of how various payment methods are used by consumers in different situations. The Bank is currently working with financial institutions, merchants and billers, and conducting a survey of consumers to provide more information on how consumers actually use various payment methods.
16. It is anticipated the results of both these studies will be available at the time of the conference in November 2007.

## **II. Background to the Review**

### *The Financial System Inquiry*

17. The Reserve Bank's current responsibilities in the payments system stem from the Financial System Inquiry findings and recommendations released in 1997. The Inquiry found that, while earlier deregulation had improved competition and efficiency, further gains were possible. To that end, it recommended the establishment of the Payments System Board at the Reserve Bank with responsibility and powers to promote greater competition, efficiency and stability in the payments system. The Government accepted those recommendations and established the Payments System Board in 1998.

### *The Payments System Board*

18. The early work of the Board involved extensive data collection and analysis, with that work focussing on the following four broad areas:
  - (i) the effect of interchange fees on price signals in the payments system;
  - (ii) the effect of restrictions placed on participants (most notably merchants) in payment systems;
  - (iii) access arrangements for potential providers of payment services; and
  - (iv) the availability of information about the pricing and operation of different payment systems.

---

<sup>3</sup> Reserve Bank of Australia and Australian Competition and Consumer Commission (2000). Section II provides more detail on the Joint Study.

19. This early work culminated in the publication (with the Australian Competition and Consumer Commission (ACCC)) of *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (the Joint Study) in October 2000.<sup>4</sup>
20. The Joint Study concluded that: the relative prices to cardholders for card payments did not generally reflect relative costs; restrictions on merchants' ability to charge for credit card transactions impeded competition and efficiency; access arrangements for a number of payment systems were more restrictive than necessary to ensure the stability of those systems; and important information on the operation of payment systems was not always readily available.
21. In addressing these issues, the Bank has sought to achieve change through working co-operatively with industry, viewing regulation as a last resort. This is consistent with the Government's intention that the Payments System Board should adopt a co-regulatory model, with industry self-regulation to be considered before explicit regulation is imposed. In a number of cases, voluntary reform has proved possible, while in others it has not, and the Bank has used its regulatory powers.
22. Although the individual reforms have been implemented at different times, partly reflecting the desire to pursue voluntary processes wherever possible, the Bank considers the various reforms to be a package. The Bank has consistently emphasised a whole-of-system approach with, for example, reforms to interchange fees considered in the context of the impact of these fees on the *relative* prices for various payment services.
23. While this is the first formal review, the Bank's reforms have been subject to considerable scrutiny over the past few years. In 2002, MasterCard and Visa challenged the legality of the Bank's regulatory actions with respect to credit cards in the Federal Court and, in 2004, a group of merchants mounted a similar challenge to the designation of the EFTPOS system. Both challenges to the Bank's jurisdiction and regulatory processes were dismissed on all counts.<sup>5</sup>
24. In May 2006, the reforms were also considered in a 1½ day special hearing by the House of Representatives Standing Committee on Economics, Finance and Public Administration. This hearing took submissions from the Reserve Bank, industry participants and academics. The Committee's report recognised that there are a wide range of views about the reforms, but concluded that 'the benefits of the reform, at this point, outweigh any alleged disadvantages'.<sup>6</sup>
25. In addition, a number of interested parties and academics have published assessments of the reforms.<sup>7</sup> The Payments System Board also regularly reports on the reforms and their effects through its Annual Reports.

---

4 This work was also, in part, a response to two specific recommendations of the Financial System Inquiry (1997): that 'The PSB [Payments System Board] should consider whether interchange pricing arrangements are appropriate for credit and debit cards. A review of arrangements by the ACCC is warranted where such arrangements are priced contrary to efficiency principles.' (Recommendation 67); and that 'Access to clearing systems should be widened to include all institutions fulfilling objective criteria set by the regulator, the PSB.' (Recommendation 69).

5 See Federal Court of Australia (2003) and Federal Court of Australia (2005).

6 House of Representatives Standing Committee on Economics, Finance and Public Administration (2006), p.iv.

7 See, for example, Australian Bankers' Association (2005), Chang, Evans and Garcia Swartz (2005), Citigroup (2006a, 2006b), Gans (2006, 2007) and Visa International (2005).

### III. The Bank's Reforms and Rationale

26. This section provides an overview of the main conclusions and policy decisions of the Payments System Board. More extensive discussion and analysis can be found in the documents previously released by the Bank.<sup>8</sup> A summary of the current regulatory arrangements is contained in Table 1.
27. The Bank's various reforms have addressed four general areas of the Australian payments system. These are:
  - (i) the effects of interchange fees on price signals, particularly to cardholders;
  - (ii) the effects of restrictions placed on participants (most notably merchants) in payment systems;
  - (iii) access arrangements for the credit and debit card systems; and
  - (iv) the availability of comprehensive information about the payments system.

The discussion below considers the reforms in each of these areas.

#### *Price signals and interchange fees*

28. An early finding of the Bank was that for many consumers, the effective price of using a credit card to make payments was less than that of using EFTPOS. This was despite the EFTPOS system having lower underlying (or resource) costs.<sup>9</sup>
29. While a number of factors contributed to this pricing structure, the Bank concluded that one important factor was the structure of interchange fees – the fees paid between the merchant's and cardholder's financial institutions each time a transaction is made. At the time, in the credit card (and scheme debit) systems, the interchange fee averaged around 0.95 per cent of the transaction value flowing from the merchant's financial institution to the cardholder's financial institution. In contrast, in the EFTPOS system the interchange fee flowed in the opposite direction – from the cardholder's financial institution to the merchant's financial institution – and averaged around 20 cents per transaction.
30. The Bank also concluded that interchange fees were not subject to the normal forces of competition. In the case of credit card and scheme debit systems, these fees were set collectively by the members of the scheme, and overseas evidence suggested that competition between schemes is more likely to put upward, rather than downward, pressure on fees. In particular, by increasing its interchange fees, a card scheme may be able to increase usage of its cards by providing issuers with additional revenue to support more attractive pricing to cardholders, most notably through reward points. This is more likely to be so if merchants' decisions to accept particular payment methods are not very sensitive to the costs involved.

---

<sup>8</sup> These documents can be found on the Reserve Bank's website in the section on payments system reforms.

<sup>9</sup> The Joint Study collected and published extensive data on the average costs incurred by financial institutions in the credit card and EFTPOS systems. It found that the effective price to many consumers of a \$100 credit card transaction was between -\$0.72 and -\$1.04 (reflecting the availability of reward points and an interest-free period) while the per-transaction charge for an EFTPOS transaction was between \$0 and \$0.60.

**Table 1: Payments System Reforms – as at May 2007**

<b>Standards</b>	
<i>Interchange fees</i>	
Credit cards	Weighted-average interchange fee in both the MasterCard and Visa schemes must not exceed 0.50 per cent of the value of transactions. MasterCard and Visa must publish their actual credit card interchange fees.
Scheme debit	The weighted-average interchange fee for Visa Debit transactions must not exceed 12 cents per transaction. Visa must publish its actual debit card interchange fees.
EFTPOS	EFTPOS interchange fees for transactions that do not involve a cash-out component must be between 4 and 5 cents per transaction.
<i>Merchant restrictions</i>	
Honour-all-cards	Visa is not permitted to require a merchant to accept Visa Debit cards as a condition of accepting Visa credit cards, or <i>vice versa</i> . Visa Debit cards must be visually and electronically identifiable as debit cards, and acquirers must provide merchants with information required to electronically distinguish Visa Debit and Visa credit card transactions.
Surcharges	The card schemes must not prohibit a merchant from imposing a surcharge for MasterCard or Visa credit card transactions, or for Visa Debit card transactions.
<b>Access regimes</b>	
Credit cards and scheme debit	Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit-taking institutions (ADIs). A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or <i>vice versa</i> . Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.
EFTPOS	The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently \$78 000 (ex GST). An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).



### Voluntary undertakings

American Express and Diners Club	American Express and Diners Club have provided the Bank with written undertakings to remove restrictions in their credit and/or charge card schemes preventing merchants from charging any fee or surcharge for the use of a card.
American Express	American Express has provided the Bank with a commitment to modify provisions in its merchant contracts that would otherwise prevent a merchant from 'steering' a customer's choice of payment instrument. Also, in the event that American Express introduces a debit card in Australia, the merchant agreements and pricing for that product will be separate to those for credit and charge cards.
MasterCard	MasterCard has provided the Bank with a written undertaking to voluntarily comply with the Visa Debit interchange Standard and the honour all cards Standard as they apply to credit and debit card transactions, as well as the Standard on surcharging as it applies to debit card transactions.

### Other

EFTPOS Access Code	Under the EFTPOS Access Code developed by the Australian Payments Clearing Association, new and existing EFTPOS participants have specific rights to establish direct connections with other participants within a set time frame.
Scheme data	Since August 2005 the Bank has published aggregated data on the schemes' merchant fees and market shares of transactions.

31. While the Bank concluded that interchange fees were having a significant effect on price signals to cardholders, and that the nature of competition in card payment systems was unusual, it also recognised that there were views that interchange fees could, under some circumstances, play a role in promoting an efficient payments system. In particular, it considered the argument that, in principle, interchange fees could promote efficiency where significant externalities exist, or where incentives are required to encourage the establishment and growth of a payment system.
32. The Bank's assessment, however, was that this argument did not support the view that the then current configuration of interchange fees was promoting efficiency. In particular, it judged that many of the externalities said to exist in card payment systems are equally applicable to both credit and debit card systems, and that these externalities could not justify the large differences in interchange fees in the credit card and EFTPOS systems.
33. In 2001, when the Bank first assessed the case for regulating interchange fees in the credit card system, it considered whether just requiring the removal of the no-surcharge rule would be sufficient to establish price signals that better promoted the efficiency of the system. Some submissions to the Bank suggested that if merchants were permitted to surcharge, then any benefit that cardholders received from high interchange fees – particularly in the form of reward points – would be offset by a surcharge at the point of sale. The argument was that by allowing surcharging, the net effective fee charged to cardholders would be independent of the interchange fee – the so-called 'neutrality' hypothesis.

34. The Bank agreed that removing the no-surcharge rule would be a positive step (see paragraph 43), but was not convinced that surcharging would become sufficiently commonplace within a reasonable time frame to materially alter the then current price signals facing cardholders. A particular concern was that surcharging was likely to develop only slowly given the strong expectation by cardholders that no surcharges would apply – an expectation built up over a number of decades in which the schemes prohibited the practice. In the end, the Bank came to the conclusion that both the removal of the no-surcharge rule *and* a reduction in credit card interchange fees were necessary to establish more appropriate price signals to cardholders.
35. The reduction in interchange fees has been achieved through the imposition of a Standard under the *Payment Systems (Regulation) Act 1998*. This Standard specifies a cost-based benchmark, and requires that the weighted-average interchange fee of each scheme be no higher than the benchmark at specific points in time. The use of a benchmark based on costs does 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 that is consistent with the powers the Bank has been granted. It was also an approach advocated by a number of industry participants. The inclusion of specific costs in the Standard does not reflect a view that there is some particular merit in these – and always these – costs being used to determine interchange fees.
36. As part of the package of reforms designed to promote more appropriate price signals, the Bank had long argued that a reduction in EFTPOS interchange fees was also appropriate. For a time, it appeared voluntary reform was likely, with a group of banks taking a proposal to the ACCC in February 2003 to set interchange fees to zero. The proposal was eventually approved in December 2003, after the ACCC was satisfied that concerns about access would be adequately addressed. A group of merchants then appealed the ACCC's decision in the Australian Competition Tribunal (ACT), with the ACT finding in the merchants' favour. This decision effectively ended prospects for voluntary reform and, after extensive consultation, the Bank designated the EFTPOS system and imposed a Standard on interchange fees.
37. Again the approach adopted was to establish a benchmark based on costs. This Standard has led to a significant reduction in the average EFTPOS interchange fee for transactions without a cash-out component from around 20 cents to around 5 cents. While the Bank has stated a number of times that it did not see a strong case for *any* interchange fees in the EFTPOS system, it adopted a small 'negative' fee largely due to uncertainty over whether a standard could be used to abolish the fee or, equivalently, set it at zero.
38. Unlike the credit card interchange Standard, the EFTPOS interchange Standard imposes both a floor and a cap on interchange fees (currently 4 and 5 cents respectively). This reflects the bilateral nature of the EFTPOS system in which interchange fees are negotiated between each of the direct connectors in the system. The Bank was concerned that these bilateral negotiations could be used to frustrate access or limit competition, with existing participants offering arrangements to new participants on less attractive terms than were established with existing participants. This issue was also addressed in the EFTPOS Access Regime (see paragraphs 51 and 52).

39. Another element in establishing more appropriate price signals was a reduction in interchange fees in the scheme debit systems. Historically, these fees have been the same as those for credit cards and, while the Bank did not initially regulate them, they fell when the credit card interchange Standard became effective. Notwithstanding this fall, the Bank could not see a case for interchange fees for scheme debit transactions being the same as those for credit card transactions – a view shared by many industry participants. A particular concern was that the EFTPOS system was at a significant disadvantage to the scheme debit systems, simply because of the structure of interchange fees, which themselves were not subject to the normal forces of competition. The narrowing of the difference in interchange fees between the two types of debit card systems has been seen as an important step in promoting more soundly based competition between the systems.
40. The Bank's focus on the configuration of interchange fees in the credit card, scheme debit and EFTPOS systems has reflected concerns about the effect of these fees on the overall efficiency of the payments system. It has not, as has sometimes been suggested, reflected concerns about the level of credit card debt, or a desire to promote the use of the EFTPOS system because it has lower resource costs. The Bank has repeatedly acknowledged that an outcome in which individuals use a payment method which involves higher resource costs can be efficient, particularly if the prices individuals base their choices upon are broadly reflective of the costs of providing the payment method.
41. Further details of past and current interchange fees are provided in Section V.

#### *Price signals and merchant restrictions*

42. Early on in its deliberations, the Bank also concluded that price signals in the Australian payments system were being distorted not only by interchange fees, but also by restrictions placed on merchants by the card schemes. These restrictions included rules that:
  - (i) prevented merchants from surcharging for credit card transactions (the no-surcharge rule);
  - (ii) required a merchant to accept a scheme's debit card if it accepted its credit card and *vice versa* (the honour-all-cards rule); and
  - (iii) prevented merchants from steering customers to other forms of payment (the no-steering rule).
43. In the Bank's view, the no-surcharge rule dulled the price signals to cardholders about relative costs of different payment methods. The rule also limited the ability of merchants to put downward pressure on fees by threatening to charge the customer for using a credit card. It also contributed to the subsidisation of credit card users by all other customers, with the uniform prices charged by merchants for goods and services needing to cover the relatively high costs associated with credit card acceptance.
44. Neither MasterCard nor Visa agreed to voluntarily remove their no-surcharge rules for credit cards and, as a result, the Bank imposed Standards requiring the removal of these rules. In contrast, American Express and Diners Club voluntarily agreed to remove their equivalent rules.
45. The honour-all-cards rule in the MasterCard and Visa schemes had two distinct aspects: one relating to honouring all issuers and the other to honouring all products. The Bank

recognised the merits of the honour all *issuers* aspect of the rule, but concluded that the honour all *products* aspect was not in the public interest. It concluded that the tying of credit and debit card acceptance adversely affected competition, particularly between EFTPOS and scheme debit, by forcing merchants to accept a payment method they might not otherwise accept, at a price they might not otherwise pay.

46. Visa did not agree to voluntarily modify its honour-all-cards rule and, as a result, the Bank imposed a Standard requiring that the rule be modified in the Visa system. MasterCard provided a written undertaking to voluntarily comply with the requirement to modify the honour-all-cards rule. While American Express does not issue a debit product in Australia, it has agreed to voluntarily comply with the Standard if it introduces debit or pre-paid products in the future.
47. Finally, the no-steering rule prevented merchants that accepted American Express cards from encouraging customers to use another method of payment (equivalent rules did not exist in the MasterCard, Visa and Diners Club schemes). Again, the Bank saw this rule as inappropriately restricting competition and, after discussions, American Express agreed to remove the rule.

### *Access*

48. Another major area of reform has concerned access to payment systems, reflecting the Bank's view that access arrangements for a number of payment systems were more restrictive than was necessary to ensure the financial stability of those systems.
49. In the credit card system, the access rules effectively restricted membership of MasterCard and Visa to authorised deposit-taking institutions (ADIs) supervised by the Australian Prudential Regulation Authority (APRA). The credit card schemes argued that this was necessary for both their own protection and that of their members. While the Bank accepted the need for some entry criteria, it concluded that the existing criteria were unnecessarily restrictive. It also concluded that the scheme rules that prevented institutions acting as acquirers only, or levied penalties on institutions that were significant net acquirers, unduly restricted competition.
50. Given that the schemes were unwilling to address these issues voluntarily, the Bank imposed Access Regimes on both the MasterCard and Visa credit card schemes. In doing so, it worked closely with APRA, who established a new class of supervised institution known as a Specialist Credit Card Institution. The Access Regimes require the schemes to treat applications for membership from these specialist institutions on the same basis as those from the traditional ADIs, and prevents the schemes from imposing penalties on institutions on the basis of their issuing or acquiring volumes. Given the linkages between the credit and debit card schemes operated by Visa, and the structure of Visa's rules, it was also necessary for the Bank to impose a corresponding Access Regime on the Visa Debit system.
51. The Bank also concluded that access arrangements for the EFTPOS system were more restrictive than was necessary, largely reflecting the bilateral nature of the system. Potential entrants could either negotiate access through an existing participant or they could establish their own direct links to existing participants. Existing participants were, however, under

no obligation to establish the necessary connection on reasonable terms and conditions, and to do so within a reasonable amount of time.

52. Following prompting by the Bank and the ACCC, industry participants spent considerable time developing an EFTPOS Access Code to improve access arrangements. Under the Code, which was adopted in September 2006, existing participants have agreed to procedures and timetables under which they will negotiate connections with new participants. The industry also agreed to set a cap on the price that current participants can charge for new connections. The industry was concerned, however, that such an agreement might require authorisation by the ACCC, a potentially lengthy process, and asked the Bank to set the cap in an Access Regime. After consultation, the Bank did impose an Access Regime, establishing an initial cap of \$78 000 on the price that could be charged to establish a new connection. The Access Regime also limits the ability of existing participants to use negotiations over interchange fees to limit competition, by imposing 'no discrimination' requirements on existing participants.

### *Publication of information*

53. Throughout the reform process, the Bank has been keen to improve the transparency of the payments system. When the Bank first started investigating interchange fees in the credit and debit card systems, information on these fees was not publicly available. Similarly, scheme rules, particularly those setting out the conditions on which new entrants could participate, were held to be confidential to the schemes. There was also very limited information on market shares of the various card schemes and the costs to merchants of accepting various payment methods.
54. The Joint Study provided, for the first time, comprehensive reporting of interchange fees in Australia, as well as a description of the card schemes' rules dealing with access. The Bank has also engaged in other data gathering exercises. It publishes average merchant service fees for the Bankcard, MasterCard and Visa credit card schemes, and separate figures for American Express and for Diners Club. The Bank also publishes the combined market share of the American Express and Diners Club schemes and the combined market share of the Bankcard, MasterCard and Visa schemes. It also encouraged BPAY to publish its interchange fees. The Bank also reports regularly on developments in the payments system.

### *Additional investigations*

55. Over recent years, the Bank has also investigated a number of other payment systems but decided not to formally regulate these systems. Given the wide-ranging nature of the review, the Bank will once again examine these systems.

### *BPAY*

56. Other than the card systems, the only other payment system in Australia that has interchange fees is the BPAY system. In 2005, after investigating these fees, the Bank decided that there was not, at that time, a strong case to regulate these fees. In announcing its decision, the Bank noted that BPAY's interchange fees had: been reviewed regularly; fallen steadily; and were expected to fall further. In assessing the case for regulation, the Bank also considered likely changes in the *relative* pricing of various bill payment methods that might arise if BPAY's interchange fees were reduced through regulation. In particular, it concluded that

such a reduction in BPAY's interchange fees (which flow to the 'issuing' bank) would be likely to lead to higher costs to consumers for BPAY payments, and thus would be likely to encourage greater use of more costly means of payment.

57. While the Bank decided not to regulate interchange fees in the BPAY system, it strongly encouraged BPAY to publish its interchange fees, and BPAY now publishes its interchange fees (known as Capture Reimbursement Fees) on its website.

### *The ATM system*

58. The Bank has taken an interest in ATM interchange fees, pricing regimes and access since the time of the Joint Study. The Study noted that while the cost of providing a cash withdrawal averaged around \$0.50, interchange fees averaged around \$1.00 and foreign fees charged by financial institutions when their customers withdrew cash from another institution's ATM averaged around \$1.35. Furthermore, there appeared to be no competitive pressures driving prices closer to costs. Since that time, foreign fees have increased further with a number of institutions now charging \$2.00 per transaction despite there being no change in interchange fees.
59. In the Joint Study, the Bank suggested that direct charging could be an alternative to the current arrangements that could introduce more competition into the provision of foreign ATM services. Since then, participants in the ATM industry have had a number of attempts at designing alternative arrangements. During that process, the Bank has not sought to regulate to impose a particular solution, but has emphasised the importance of improved access, of ensuring that negotiations over interchange fees do not restrict access, and of allowing ATM owners that wish to direct charge the ability to do so. The industry is currently discussing with the Bank its plans for dealing with these issues.

### *American Express and Diners Club*

60. When the Bank initially investigated the setting of interchange fees in the Bankcard, MasterCard and Visa systems, both American Express and Diners Club operated as three-party systems, with no interchange fees being paid. As such, the interchange fee regulation implemented for the Bankcard, MasterCard and Visa systems was not applicable to the three-party systems. Subsequently, both American Express and Diners Club entered into partnerships with a number of Australian banks which, although quite different from one another, had some similarities to arrangements in the other systems.
61. At the time these partnerships were announced, the Bank investigated whether there was a case to regulate the payments between American Express/Diners Club and their partner banks. It concluded that, 'at this stage, such regulation would not improve the overall efficiency of the payments system. In its view, regulation of these payments would have relatively little effect on merchant charges. Further, the existing incentives facing issuers of these cards could only be addressed through considerably more extensive regulation than that currently existing in the credit card schemes.'<sup>10</sup>
62. In the MasterCard and Visa systems, interchange fees are an important determinant of merchant service fees, while in the American Express arrangement with its partner banks, the causation runs the other way – merchant service fees are an important determinant of

---

<sup>10</sup> Reserve Bank of Australia (2005).

interchange fees. This reflects differences in the nature of competition for acquiring services. In the MasterCard and Visa systems there are many banks competing for merchant acquiring business, with the interchange fee effectively putting a floor under merchant service fees. In contrast, in the American Express and Diners Club schemes, there is no competition in acquiring; merchants that wish to accept American Express cards, for example, must strike a deal with American Express. In these circumstances, the merchant service fee is determined by the ability of a merchant to bargain with the scheme. Interchange fees paid by these schemes to issuers are, in turn, not fixed but depend upon by the amount of revenue that can be earned through merchant service fees.

63. In the Bank's view, regulation of interchange payments by American Express to its partner banks would have had little effect. Instead the Bank's focus has been on ensuring that there are not inappropriate restrictions in place that distort competition. The Bank has therefore concentrated on removing restrictions imposed on merchants, including the no-surcharge and no-steering rules.

#### *Pre-paid and gift cards*

64. Pre-paid cards – particularly those that are reloadable – currently have substantially the same functionality as the scheme debit cards that were included in the Bank's reforms. The Payments System Board decided in August 2006 not to regulate pre-paid cards at that time. This reflected an expectation 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. The Bank also expected that, if a pre-paid card were to be introduced with features substantially different from a scheme debit card, merchants would not be required to accept that card.

## **IV. Regulatory Developments Overseas**

65. Australia is not the only country to have been examining the appropriate regulation of payment systems. In a number of countries, either the courts or the competition regulator have become involved in disputes about the appropriate level of interchange fees and the details of various payment scheme rules (Table 2). Most notably, the MasterCard and Visa card schemes have been subject to a number of investigations and actions because of concerns about their rules and practices.

#### *Interchange fees*

66. The setting of interchange fees has been an issue in many jurisdictions over the past decade. Competition authorities have been concerned about the implications of centrally set interchange fees, and merchants have been concerned about the high costs of accepting credit card payments. In Europe, competition authorities have been at the forefront of investigating the setting of interchange fees, while in the United States the issue has been mainly addressed through legal action by merchants.
67. In some cases, the competition authorities have come to the view that the multilateral setting of interchange fees is illegal and that the practice must cease or be 'authorised' by the authorities. The Spanish Competition Tribunal denied authorisation of the interchange

**Table 2: Regulatory Developments Overseas – as at May 2007**

<b>Interchange Fees</b>	
European Union	2002: The European Commission (EC) reached agreement with Visa to reduce its cross-border interchange fees by December 2007. An investigation into MasterCard's interchange fees is ongoing.
Spain	2005: Authorisation of the interchange fee arrangements of the Spanish card schemes denied by the Spanish Competition Tribunal.  Agreement reached between the Spanish card networks and merchants, co-ordinated by the Spanish Ministry of Industry, Tourism and Trade, for interchange fees to be reduced from a maximum of 2.32% to 1.1% by 2008.
Switzerland	2005: Agreement between the Swiss Competition Commission and credit card issuers to cut interchange fees from 1.65-1.70% to 1.30-1.35%.
United Kingdom	2005: The Office of Fair Trading (OFT) found that MasterCard's interchange fee arrangements were illegal. The finding was appealed but, since MasterCard had changed its method of setting interchange fees, the OFT consented to its decision being set aside by the Competition Appeals Tribunal.  The OFT is continuing to investigate the setting of interchange fees in the MasterCard and Visa schemes.
Israel	2006: Agreement between the banks and the competition authority to reduce interchange fees from 1.25% to 0.875% by 2012.
Mexico	2006: Interchange fee reductions agreed between the Mexican Bankers Association and the Bank of Mexico.
United States	2006: Consolidated litigation by merchants alleging that interchange fees in the MasterCard and Visa schemes breach anti-trust laws.
New Zealand	2007: Proceedings initiated by the New Zealand Commerce Commission against Visa, MasterCard and member institutions of the two schemes, alleging price-fixing in the setting of interchange fees.
Poland	2007: Banks ordered by the Polish Office of Competition and Consumer Protection to discontinue their multilateral interchange arrangements.
<b>Honour-all-cards</b>	
United States	2003: A class action led by Wal-Mart was settled resulting in a modification of the honour-all-cards rule, allowing merchants to make separate acceptance decisions between scheme debit cards and credit cards.
<b>Surcharges</b>	
United Kingdom	1989: Prohibition on surcharging lifted.
Sweden	1995: Prohibition on surcharging lifted.
Netherlands	1997: Prohibition on surcharging lifted.
Switzerland	2005: Prohibition on surcharging lifted.
<b>Access</b>	
Canada	1996: Consent Order issued by the Canadian Competition Bureau requiring that the EFTPOS and ATM network Interac open its membership to non-financial institutions.
United Kingdom	2003: The OFT found that the Visa and MasterCard scheme rules unduly restrict access to the schemes.
European Union	2007: The European Parliament passed the Payment Services Directive which sets minimum access standards for all European payment scheme operators.



fee arrangements of the Spanish card schemes in 2005, requiring the schemes to submit a new methodology for authorisation.<sup>11</sup> More recently, the Polish Office of Competition and Consumer Protection ruled that interchange fee agreements between banks in the MasterCard and Visa schemes were illegal, imposing fines on the Polish banks involved and requiring them to discontinue their interchange arrangements. The ruling has been appealed but it remains in effect pending the outcome.<sup>12</sup> The New Zealand Commerce Commission has also recently launched an action against MasterCard, Visa and their members, alleging that the setting of interchange fees is price fixing and illegal.<sup>13</sup> In the United Kingdom, the Office of Fair Trading (OFT) decided in 2005 that MasterCard's setting of the multilateral interchange fee was in breach of competition laws.<sup>14</sup> MasterCard appealed the decision but, since MasterCard had changed its method of setting interchange fees, the OFT consented to its decision being set aside by the Competition Appeals Tribunal. The OFT is now investigating MasterCard's new method of setting interchange fees, as well as the setting of Visa's interchange fees.<sup>15</sup>

68. In other cases, the authorities have reached agreements with the schemes on how interchange fees should be set. The European Commission (EC), for example, entered into an agreement with Visa in 2002 that required Visa to introduce a cost-based method of determining cross-border interchange fees and to reduce those fees by December 2007.<sup>16</sup> A similar EC investigation into MasterCard's cross-border interchange fees is ongoing. The Swiss Competition Commission ruled in 2005 that interchange fees should cover only the costs of a card network and, as a result, entered into an agreement with credit card issuers that they reduce interchange fees from an initial range of 1.65-1.70 per cent to a maximum of 1.30-1.35 per cent.<sup>17</sup> In Mexico, the central bank has achieved reductions in interchange fees through negotiations with the Mexican Bankers Association, although it also has regulatory powers in this area that have not been formally invoked to date.<sup>18</sup>
69. In contrast, action on interchange fees in the United States has been driven by private litigation. Over recent years, merchants have launched a large number of actions against MasterCard, Visa and their members, alleging that the setting of interchange fees constitutes price fixing, and requires merchants to pay for services that they do not want. Due to the similarity of many of the actions, a large number have been combined into a consolidated case which is ongoing.
70. There has also been increasing interest in analysis of interchange fees. The EC published a report on payment cards in 2006 as part of an inquiry into retail banking.<sup>19</sup> The report contained several findings relating to the level and efficiency of interchange fees. In particular, it found: that interchange fees did not seem necessary for the profitability of

---

11 Tribunal de Defensa de la Competencia (2006).

12 Office of Competition and Consumer Protection (2007).

13 Commerce Commission (2006).

14 Office of Fair Trading (2005a).

15 Office of Fair Trading (2005b, 2006).

16 European Commission (2002).

17 Swiss Competition Commission (2005a, 2005b).

18 Ortiz (2005).

19 European Commission (2006).

card businesses at a majority of banks; that many domestic payment systems operated without interchange fees; large variations across countries in interchange fees, suggesting a lack of an objective basis for the fees; and there was little evidence of competitive forces between schemes affecting interchange fees. The EC inquiry's final report, released in January 2007, suggests that anti-trust enforcement action may be appropriate to address the level of interchange fees in some networks.<sup>20</sup>

### *Merchant restrictions*

71. Restrictions on merchants have also received some attention in overseas jurisdictions, with the no-surcharge rule (or no-discrimination rule) being examined in a number of countries prior to investigations into interchange fees. Surcharging on credit card transactions has been permitted in the United Kingdom since 1989 when the Monopolies and Mergers Commission decided that the prohibition on surcharging was anti-competitive in restricting the freedom of merchants to set their own prices.<sup>21</sup> The no-surcharge rule has also been removed in a number of other countries including Switzerland, the Netherlands and Sweden.<sup>22</sup>
72. In other cases, the rule has been found to be benign. In 2001, the EC ruled that, while Visa's prohibition on surcharging had the potential to restrict competition, the evidence was that any anti-competitive effect was not appreciable.<sup>23</sup> The EC's more recent inquiry into retail banking has, however, found that further investigation may be required to establish whether the no-surcharge rule is in the public interest.<sup>24</sup>
73. The honour-all-cards rule has received most attention in the United States where a private anti-trust class action led by Wal-Mart succeeded in modifying the rule through the terms of a settlement reached in 2003.<sup>25</sup> This agreement allowed for separate acceptance decisions for scheme credit cards and scheme debit cards and is similar in substance to the Visa Debit Standard introduced by the Bank. The EC, however, ruled in 2001 that the honour-all-cards rule in the Visa system was necessary with respect to cross-border transactions. It did not consider the rule to be anti-competitive, as it considered the Visa brand to represent a group of related products, albeit with different prices.

## **V. Developments in the Market for Payment Cards**

74. This section summarises the significant developments in the Australian payments system over the past five or so years. Some of these developments are related to the reforms while others reflect more general factors.

---

20 European Commission (2007).

21 Monopolies and Mergers Commission (1989).

22 See Swiss Competition Commission (2005a, 2005b) for details relating to Switzerland. ITM Research (2000) and IMA Market Development (2000) report on the effects of removing the no-discrimination rules in the Netherlands and Sweden.

23 European Commission (2001).

24 European Commission (2006).

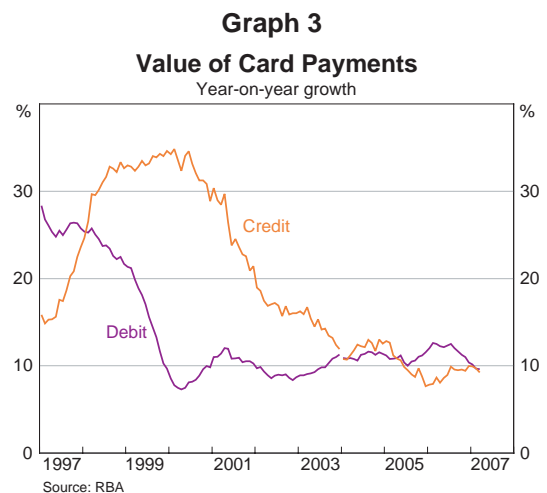
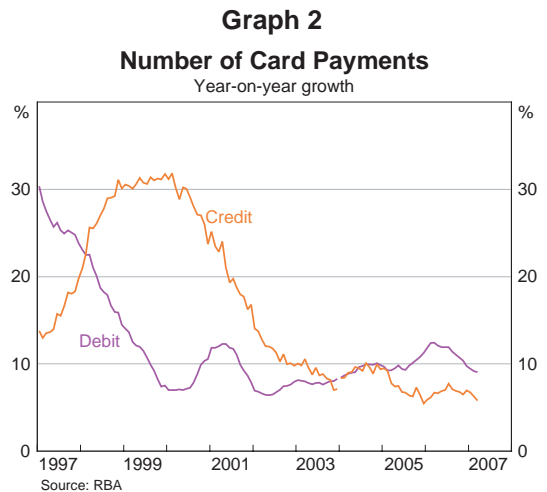
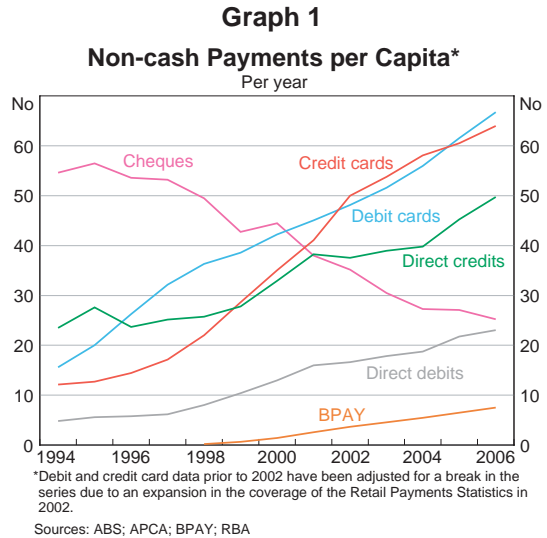
25 United States District Court, Eastern District of New York (2003).

## Payment patterns

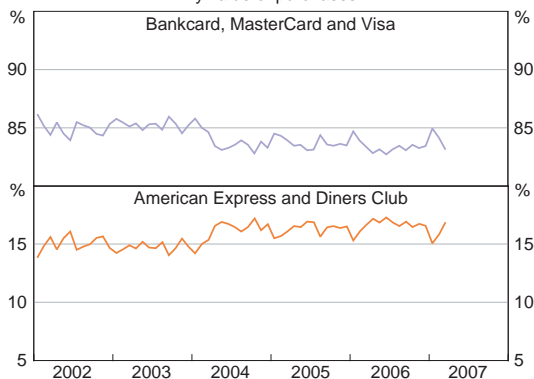
75. Recent years have seen a continuation of the trend towards electronic payments which has been evident for the past two decades (Graph 1). The number of cheques written in 2006 was 39 per cent lower than in 2000 and, while comprehensive data on the use of cash are not available, the value of cash withdrawn through ATMs, and the amount of currency in circulation, have generally grown in line with the value of consumption over recent years. In contrast, the value and number of credit and debit card, BPAY and direct entry transactions have all grown considerably faster than consumption.

76. Over the past couple of years, both the number and value of debit card payments have grown more quickly than for credit cards (Graphs 2 and 3). This is a reversal of the pattern seen from the late 1990s, when growth in credit card spending was particularly rapid. Although the number of debit card payments is roughly equal to the number of credit card payments, total spending on credit cards remains significantly higher, reflecting the larger average size of credit card transactions.

77. According to survey data from Roy Morgan Research, in the year to March 2007, 54 per cent of Australians aged 18 years and over held a credit or charge card, much the same as in 2001.



**Graph 4**  
**Market Shares of Card Schemes**  
 By value of purchases



Source: RBA

78. Within the credit card system, the combined market share of the Bankcard, MasterCard and Visa schemes was 83.4 per cent of the value of transactions over the year to March 2007. This is down around 2 percentage points since 2003. The bulk of this decline occurred in the second quarter of 2004 when two banks began issuing American Express credit cards. Since mid 2004, there has been little change in the combined market share of these schemes (Graph 4).

### *Payment products*

79. Over recent years, there have been a number of new card products offered to consumers. These include:
- (i) the introduction of pre-paid cards by the major credit card schemes. In November 2006, two of the major banks launched non-reloadable pre-paid cards which can be used at almost any merchant that accepts MasterCard or Visa credit cards. Some vendors also market non-reloadable cards as an alternative to travellers cheques, debit cards or credit cards when travelling overseas, including cards denominated in foreign currencies; and
  - (ii) the introduction in November 2005 of a MasterCard-branded debit card. This card operates in a similar way to the Visa Debit card already on issue.
80. In addition, credit card issuing institutions have expanded the range of 'premium' products, such as silver, gold and platinum cards and, in some cases, have marketed these cards extensively. According to survey data from Roy Morgan Research, in the 12 months to March 2007, 27 per cent of credit card holders had a silver, gold or platinum card, up from 17 per cent four years earlier.
81. Many credit card issuers have also issued low-rate cards, with interest rates on these cards averaging 11.45 per cent compared with rates of around 17 to 18 per cent on more traditional credit cards. Many of the low-rate cards have been marketed extensively, including through offering low, or even zero, interest rates on balances transferred from existing credit card accounts.
82. The domestic Bankcard credit card scheme closed in the first half of 2007 after many years of declining market share.

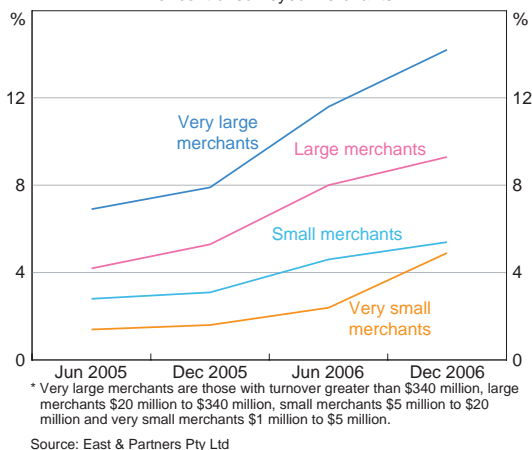
### *Surcharging*

83. Since the prohibition on surcharging of credit card transactions was lifted in 2003, there has been a steady increase in the number of merchants that levy a surcharge. Survey evidence suggests that surcharges are currently applied by around 14 per cent of very large

merchants and around 5 per cent of very small merchants (Graph 5). In some cases, merchants have begun to accept credit cards – with a surcharge – where they were previously too expensive to accept without the surcharge.

84. Most merchants that do surcharge apply the same percentage rate for all credit and charge cards. However, there are some merchants who choose to apply a higher rate for, or only apply a surcharge to, the more expensive American Express and Diners Club cards than for MasterCard or Visa. Survey evidence indicates that the average surcharge for MasterCard and Visa transactions is around 1 per cent, while the average surcharge for American Express and Diners Club cards is about 2 per cent.<sup>26</sup>

**Graph 5**  
**Merchants Surcharging Credit Cards\***  
 Per cent of surveyed merchants



### Interchange fees

85. As a result of the reforms, the average interchange fee in the MasterCard and Visa systems has fallen from around 0.95 per cent to around 0.50 per cent currently.
86. Under the credit card interchange Standard, MasterCard and Visa have the flexibility to set interchange fees as they see fit, subject to the requirement that the weighted-average fee is no higher than the benchmark established in the Standard at specific points in time. When the Standard was first introduced in 2003, both schemes chose to have three separate interchange rates. In 2006, when the benchmark was recalculated, both schemes introduced an additional interchange category for premium cards with a much higher interchange fee. Visa also introduced a range of other categories with different interchange fees, with some of these being flat fees. The various fees are shown in Table 3.
87. Historically, interchange fees were related to the method of processing. Recent changes have, however, meant that interchange fees are now also related to the type of merchant or, more significantly, the type of card. This has meant that in some cases, higher interchange fees apply because the cardholder has chosen one type of card over another.
88. In the scheme debit systems, interchange fees have historically been the same as for credit cards. Reflecting this, in November 2003 interchange fees in the Visa Debit system (the only scheme debit system then in operation) fell in line with the reduction in credit card interchange fees. When the Visa Debit interchange Standard became effective on 1 November 2006, the weighted-average interchange fee in that scheme was required to be no more than 12 cents. At the same time, MasterCard voluntarily agreed to set interchange fees for its debit card in accordance with this benchmark. The various interchange fees in the scheme debit systems are shown in Table 4.

<sup>26</sup> East & Partners (2007).

**Table 3: Credit Card Interchange Fees**  
Exclusive of GST

MasterCard					
Pre-reform		31 Oct 2003 – 31 Oct 2006		1 Nov 2006 – Present	
Category	Rate	Category	Rate	Category	Rate
Electronic	0.80%	Electronic	0.46%	Consumer Electronic	0.46%
Standard	1.20%	Standard	0.62%	Consumer Standard	0.30%
				Premium	0.90%
		Commercial	1.12%	Commercial	1.12%
		Benchmark	0.55%	Benchmark	0.50%
Visa					
Pre-reform		31 Oct 2003 – 31 Oct 2006		1 Nov 2006 – Present	
Category	Rate	Category	Rate	Category	Rate
				Consumer Electronic	0.40%
Electronic	0.80%	Electronic	0.44%	Consumer Chip	0.50%
				Government & Utility: Electronic	30.0 ¢
Standard	1.20%	Standard	0.60%	Standard	0.55%
				Government & Utility: Standard	74.0 ¢
				Premium	0.90%
				Premium Chip	1.00%
				Micropayment (<\$5)	2.5 ¢
				Charity	0%
		Commercial	1.10%	Commercial	1.15%
		Benchmark	0.53%	Benchmark	0.50%

Sources: MasterCard and Visa websites; RBA.

89. In contrast to the systems operated by MasterCard and Visa, interchange fees are bilaterally negotiated in the EFTPOS system. Prior to the reforms, the average fee was around 20 cents, with the fee being paid by the cardholder's financial institution to the merchant's financial institution. Under the EFTPOS interchange Standard, bilateral interchange fees for EFTPOS transactions that do not involve a 'cash out' component are required to be between 4 and 5 cents. The interchange fee for transactions that involve a cash-out component is not regulated.
90. The net effect of these changes is to significantly lessen the differences in interchange fees across the various card-based payment systems. Graph 6 shows the average interchange

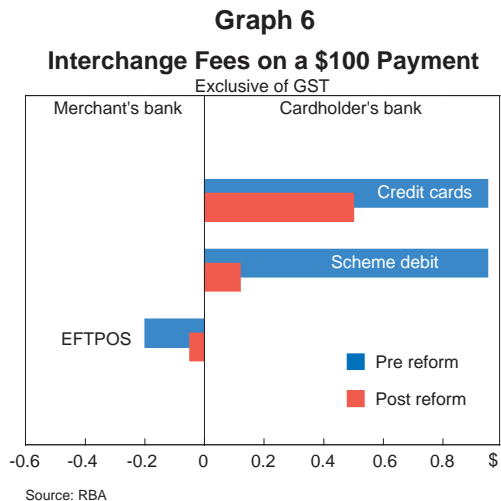
**Table 4: Scheme Debit Card Interchange Fees**

Exclusive of GST

MasterCard					
Pre-reform		25 Nov 2005 – 31 Oct 2006		1 Nov 2006 – Present	
Category	Rate	Category	Rate	Category	Rate
Electronic	n.a.	Electronic	0.46%	Consumer Electronic	10.0 ¢
Standard	n.a.	Standard	0.62%	Consumer Standard	24.5 ¢
		<b>Benchmark</b>	<b>0.55%</b>	<b>Benchmark</b>	<b>12.0 ¢</b>
Visa					
Pre-reform		31 Oct 2003 – 31 Oct 2006		1 Nov 2006 – Present	
Category	Rate	Category	Rate	Category	Rate
		Consumer Electronic		Consumer Electronic	8.0 ¢
Electronic	0.80%	Electronic	0.44%	Government & Utility: Electronic	8.0 ¢
				Electronic Incentive	4.0 ¢
Standard	1.20%	Standard	0.60%	Standard	0.31%
				Government & Utility: Standard	37.0 ¢
				Micropayment (<\$5)	2.5 ¢
				Charity	0%
		<b>Benchmark</b>	<b>0.53%</b>	<b>Benchmark</b>	<b>12.0 ¢</b>

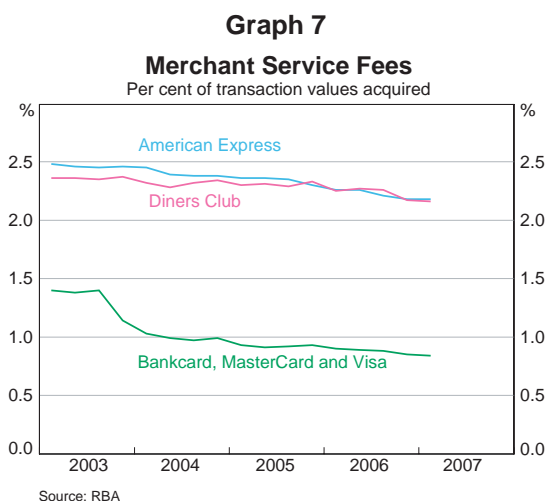
Sources: MasterCard and Visa websites; RBA.

fee on a \$100 payment for the three types of card-based payment systems and how they have changed since the Bank's reforms were introduced. On a \$100 payment, the difference between the average interchange fee for credit card and EFTPOS transactions has been more than halved from around \$1.15 to under \$0.55; and the difference between scheme debit and EFTPOS interchange fees has been reduced from around \$1.15 to under \$0.17.



## Merchant service fees

91. The decline in credit card interchange fees has led to a significant decline in merchant service fees for credit cards. Since the reforms, the average merchant service fee for Bankcard, MasterCard and Visa has fallen by around 0.56 percentage points to 0.84 per cent (Graph 7). This decline



is larger than the decline in interchange fees, suggesting increased competition between acquirers.

92. Merchant service fees for American Express and Diners Club have also fallen since the reforms, although the decline has been smaller than that in the other schemes. Since the September quarter 2003, the average fee in the American Express scheme has fallen by 0.27 percentage points, while the average fee in the Diners Club scheme has fallen by 0.19 percentage points.

93. The reduction in merchant service fees represents a significant cost saving to merchants. At current levels of spending, a 0.56 percentage point reduction in fees in the MasterCard and Visa schemes is worth around \$870 million per year, while the reduction in fees in the American Express and Diners Club schemes represents a further saving of \$80 million per year. These savings have been slightly offset by the small increase in the combined market share of American Express and Diners Club. In total, the Bank estimates that given patterns of card use over the past year, merchants' costs of accepting credit cards are around \$900 million lower than they would otherwise have been. Based on the levels of spending since the reforms were introduced, merchants have saved a total of around \$2.2 billion in lower merchant service fees. To the extent that customers have switched from using credit cards to debit cards there are likely to have been additional savings.

94. The changes to interchange fees in the debit card schemes are only recent. Preliminary evidence from merchants, however, suggests that merchant service fees for EFTPOS transactions have risen by around 15 cents, in line with the reduction in the interchange fee received by acquirers from around 20 cents to around 5 cents.

## Pricing to cardholders

95. Since 2003, there have been a number of changes to the effective pricing of credit cards to cardholders. For most cards, the value of reward points has been reduced. Currently, a cardholder using a standard card issued by the large banks needs to spend around \$16 200 to earn a \$100 shopping voucher. This is up from around \$12 400 in 2003, representing



an effective increase in the price of a credit card transaction of around 0.2 per cent of the transaction value (Table 5). Some issuers have also introduced caps on the number of points that a cardholder may accrue over a specified period.

**Table 5: Credit Card Rewards Programs**

Four major banks

	Average spending required for \$100 voucher	Benefit to cardholder as a proportion of spending (bp)
2003	12 400	81
2004	14 400	69
2005	15 100	66
2006	16 000	63
2007	16 200	62

Sources: Banks websites, ANZ Telstra Rewards Visa card, Commonwealth Bank MasterCard Awards card, National Australia Bank Visa Gold card, Westpac Altitude MasterCard.

96. Annual and other fees on credit cards have also increased. The average annual fee on a standard rewards card has increased from \$61 in June 2002 to \$85 in June 2006; and from \$98 to \$140 on gold rewards cards.<sup>27</sup> Cash advance fees, late payment fees and over-limit fees have also increased. In total, average fee revenue on bank-issued personal credit cards has risen from around \$40 per account in 2002 to around \$80 in 2006.<sup>28</sup>
97. As noted above, a number of issuers have introduced low-rate cards, reducing the cost of borrowing on a credit card. The interest rate margin on traditional cards remains high, at an average of around 11.3 percentage points above the cash rate, and has shown little change since the reforms.
98. The pricing of EFTPOS transactions has also changed, particularly with the introduction of ‘all you can eat’ transaction accounts. In the early part of this decade it was not uncommon for cardholders to face a fee of around 50 cents per EFTPOS transaction after a certain number of electronic transactions were made in a given month. While some transaction accounts still operate in this way, most now offer an unlimited number of electronic transactions for a fixed account keeping fee of around \$3 to \$7 per month.
99. Foreign ATM fees have also risen over the past few years. In 2001, foreign ATM fees charged by the five major banks in Australia ranged between \$1.25 and \$1.50 per withdrawal. Currently, these fees range between \$1.50 and \$2.00.<sup>29</sup> Interchange fees have not changed in this time.

### Access

100. Over the past few years, there have been a number of new participants in the card payments industry.

<sup>27</sup> Source: Cannex. Averages for credit cards with an interest-free period issued by major banks. Reserve Bank of Australia (2007) provides additional detail.

<sup>28</sup> Reserve Bank of Australia (2007).

<sup>29</sup> Source: Cannex.

101. GE Money received authorisation from APRA in 2004 as a Specialist Credit Card Institution (SCCI), allowing it to undertake credit card issuing and acquiring. MoneySwitch received an SCCI authorisation from APRA in 2005, permitting it to acquire credit and debit card transactions. In 2006 MoneySwitch's authorisation was extended to allow it to provide BPAY and direct debit services in conjunction with its acquiring services.
102. A number of non-banks have also entered the credit card market by establishing partnerships with banks. Most of these participants have concentrated on attracting borrowers through low interest rate credit cards – an area that has also been the focus of many existing issuers.

## **VI. Issues**

103. The Bank is seeking views from interested parties on the key issues set out in paragraph 9 above, namely:
- (i) what have been the effects of the reforms to date?
  - (ii) what is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach? and
  - (iii) if the current regulatory approach is retained, what changes, if any, should be made to standards and access regimes?
104. This Section sets out these questions in more detail and raises a number of specific issues on which interested parties might wish to provide evidence, analysis and comment.

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

105. The Bank is seeking views on the effect of the reforms. It is particularly interested in evidence-based assessments of how the reforms have affected the overall efficiency of the Australian payments system. As discussed above, the reforms have sought to improve efficiency and competition by:
- (i) more closely aligning the relative prices for different payment services with the relative costs of providing those services;
  - (ii) addressing restrictions on merchant behaviour that limit competition;
  - (iii) liberalising access to payment systems; and
  - (iv) improving the transparency of the payments system.
106. Interested parties may wish to address the effect of the reforms on consumers, merchants, financial institutions, providers of payment services and payment schemes, as well as the system as a whole. In particular, interested parties may wish to address the following issues.

#### ***The effect of the interchange fee reforms on cardholders and merchants***

107. Submissions on this issue could usefully provide information on:

- (i) the extent to which the pricing of credit cards (including annual fees, interest rates and reward programs) to cardholders has changed as a result of the reforms, and the effect of any changes on cardholder behaviour;
- (ii) the extent to which the pricing of transaction accounts and per transaction charges for EFTPOS and scheme debit have changed as a result of the reforms, and the effect of any changes on the use of debit cards;
- (iii) the effect of the changes to interchange fees on merchants' costs of accepting credit and debit cards, and consequently, on the prices charged by merchants for goods and services;
- (iv) the extent to which changes in interchange fees have affected the payment methods accepted by various merchants; and
- (v) the effect of excluding EFTPOS transactions involving a cash-out component from the EFTPOS interchange Standard.

*The effect of the interchange fee reforms on financial institutions*

108. Submissions on this issue might address:

- (i) the effect of the reforms on the net revenue of financial institutions. (In many analyses of interchange fees it is assumed that these fees are a way of redistributing revenue from acquiring banks to issuing banks in a way that affects the prices facing cardholders and merchants, but not necessarily the net revenue of banks.);
- (ii) the extent to which the reforms have affected the type of payment methods promoted by financial institutions;
- (iii) the effect of the reforms on product innovation; and
- (iv) the compliance costs associated with the reforms.

*The effect of the removal of the no-surcharge rule*

109. Submissions on this issue could provide information on:

- (i) the extent of surcharging, the size of any surcharges relative to merchant service fees, and the extent to which merchants set different surcharges for different payment methods;
- (ii) the extent to which the ability to surcharge has led merchants who previously did not accept credit cards to now accept these cards; and
- (iii) the effect of surcharging on cardholder behaviour.

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

110. Submissions on this issue could address:

- (i) the extent to which the modification of the honour-all-cards rule has led merchants to decline acceptance of scheme debit (or credit) cards, and the effect of the modification of the rule on negotiations over merchant service fees or the setting of interchange fees;

- (ii) the effect on merchants of the expansion in the number of interchange categories, in particular the introduction of the premium interchange fee under the umbrella of the honour-all-cards rule; and
- (iii) any effects on product development.

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

111. Submissions on this issue might offer evidence and analysis on:

- (i) the extent to which the reforms have affected the competitive positions of MasterCard and Visa, relative to American Express and Diners Club;
- (ii) the extent to which the specific details of the interchange Standards have affected the competitive positions of MasterCard and Visa against one another;
- (iii) the extent to which the competitive positions of EFTPOS and scheme debit have been affected by the reforms; and
- (iv) any effects of the reforms on product innovation.

### *The effect of changes to access arrangements*

112. Submissions on this issue might wish to address:

- (i) the extent of competition between acquirers and whether this has changed as a result of the reforms; and
- (ii) any remaining obstacles to access.

## **Q2: What is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach?**

113. Looking forward, the Bank is seeking input on the public policy case for ongoing regulation of interchange fees, access arrangements and scheme rules. It is also seeking views on possible alternatives to the current regulatory framework. The Bank is particularly interested in views regarding payments system regulation that are based on new evidence and analysis and the experience of recent years.

114. As discussed above, a primary consideration in the Bank's decision to regulate credit card interchange fees in 2002 was the judgement that the then current configuration of fees and restrictions on merchants had created a set of price signals to cardholders that were not promoting the overall efficiency of the payments system. In addition, restrictions on access were judged to be limiting competition and were tighter than necessary to preserve the integrity of the payments system. In both these areas, the Bank explored voluntary changes and only opted for regulation once it was clear that such changes were unlikely.

115. In making submissions on the arguments for ongoing regulation and possible alternative approaches, interested parties may wish to comment on the following issues.

*What are the characteristics of payment systems that have given rise to public policy concerns, particularly over interchange fees?*

116. Submissions on this issue may wish to comment on any lessons from recent experience and insights from theoretical research about the influence of the market structure, conduct and performance of payment systems for the efficiency of the payments system as a whole.
117. As discussed in Section III, the Bank's rationale for regulating interchange fees has rested heavily on the ideas that these fees are not subject to the normal forces of competition and that the then configuration of interchange fees was distorting payment patterns. Submissions may therefore wish to comment on whether, given the current structure of the main payment systems, competition between, and within, these systems is likely to deliver a configuration of interchange fees that promotes the overall efficiency of the payments system. In addressing this issue, submissions might wish to offer evidence on the relative resource costs of different payment methods and the potential for substitution between payment methods.
118. Submissions might also address potential public policy concerns regarding access arrangements and scheme rules in payment systems.

*The conditions under which current regulations could be removed or relaxed*

119. Submissions on this issue might outline the conditions under which one might have reasonable confidence that the normal forces of competition would deliver a payments system that is competitive, efficient and innovative.
120. Submissions might also assess, based on evidence, whether there have been sufficient changes in market structure or conditions since the reforms were introduced to allow a relaxation or removal of some, or all, of the regulations (see, for example, the discussion of surcharging in paragraph 122). Submissions might also discuss future changes that would allow a relaxation or removal of the regulations. The Bank is also seeking views on alternatives to the current regulations that might address any public policy concerns.

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

121. As discussed above, the Bank has always been keen to explore voluntary solutions wherever possible. Submissions on this issue may therefore wish to comment on whether and why self-regulatory solutions are now feasible in a number of areas where, to date, regulation has been required. Submissions may wish to address any roadblocks to self-regulation and the nature of possible self-regulatory solutions.

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

122. As discussed above, when the regulation of credit card interchange fees was introduced, the Bank considered the case for leaving interchange fees to be set by the schemes and just removing the no-surcharge rule. At the time, it rejected this option, largely on the grounds that surcharging was unlikely to become sufficiently pervasive quickly enough to establish more appropriate price signals in a timely fashion. Submissions on this issue might therefore wish to outline under what conditions surcharging could be considered

sufficiently widespread to allow interchange fees to be set by the card schemes, rather than through regulation. Submissions might also address what would be the likely effect of removing interchange regulation, while leaving the no-surcharge rule in place.

123. In addressing these issues, submissions might also consider whether further modifications to the honour-all-cards rule, to allow merchants to make independent acceptance decisions about a broader range of cards, would strengthen any case for removing the regulation of interchange fees (also see paragraph 134).

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

124. Through the reform process the Bank has sought to remove restrictions on merchants that had the potential to reduce competition or lessen the efficiency of the payments system. Submissions on this issue might address whether there remain restrictions, or other structural constraints, on merchants that weaken competition.

125. Submissions might wish to consider the honour-all-cards rule and the merits of a potential model in which merchants were able to choose how to send a credit card transaction to the issuer. One option would be to allow merchants to send credit card transactions directly to the issuer of a card, rather than using the scheme to direct the transaction. Submissions might wish to assess the feasibility and desirability of this and other alternative options. They might also address whether providing merchants with greater control over how payments are processed would strengthen any case for removing the regulation of interchange fees.

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

126. As discussed above, the Bank has not formally regulated American Express and Diners Club, or the BPAY system. The Bank is seeking views on whether these schemes should be formally regulated. Submissions on this issue could usefully outline any public policy case for regulation of these schemes and consider what aspects of the schemes' activities might be subject to regulation and how they should be regulated.

*The effectiveness of existing access arrangements*

127. The Bank has introduced access regimes for a number of Australia's payment systems. In the case of the EFTPOS system, the regime was introduced to complement an industry-developed access code. The Bank is seeking evidence-based assessments of whether these reforms have achieved their objective of making access to Australia's payment systems more generally practicable. The Bank would also value comment on the extent to which the reforms have made the market more contestable even if there has been limited entry. In the event that shortcomings in access arrangements are identified, views are sought on improvements that could be implemented.

**Q3: If the current regulatory approach is retained, what changes, if any, should be made to standards and access regimes?**

128. The Bank is seeking views on a number of possible changes to the existing standards and access regimes. For the most part, these possible changes have been raised by various parties over the past few years. They include the following.

### *A further reduction in credit card interchange fees and/or the adoption of a uniform approach to the setting of all regulated interchange fees*

129. When the Bank initially introduced the reforms to the credit card system, it indicated that the reduction in interchange fees from an average of around 0.95 per cent to around 0.55 per cent was the *first step* towards establishing lower fees. The Bank is interested in views as to whether it is appropriate for credit card interchange fees now to be lowered further. Submissions on this issue might offer analysis of the appropriate level of interchange fees in the credit card system (see also paragraph 131).
130. A related issue is whether the various interchange Standards should be based on a common methodology, perhaps using the same set of cost categories. The current credit card Standard is based on the costs of issuers, while the EFTPOS Standard is based on the costs of acquirers. This outcome largely reflects the Bank's desire to pursue an evolutionary rather than revolutionary reform, and the fact that interchange fees in these two systems were historically very different, flowing in the opposite direction to one another. The Bank is interested in views as to whether a uniform approach to the setting of regulated interchange fees should now be adopted. Submissions on this issue might address how any uniform approach should be established and the consequence of establishing such an approach.

### *Setting all interchange fees to zero*

131. One uniform approach would be to set all interchange fees to zero. Accordingly, the Bank is seeking views on the merits of this approach, including views on the range of payment systems for which zero interchange fees might be appropriate. Submissions on this issue might wish to outline what the case is for ongoing interchange fees as payment systems mature and use and acceptance becomes widespread.

### *Modification of the compliance aspects of the interchange standards*

132. Recently, some industry participants have commented that the way in which the credit card interchange Standard works can provide a competitive advantage to one regulated scheme over another. In particular, it has been argued that the use of backward-looking, scheme-specific weights in the compliance calculations can distort the competitive landscape. As an example, some participants have pointed to the difficulties the Standard may create for a scheme with a relatively high (and possibly increasing) share of premium cards, which now attract relatively high interchange fees.
133. The Bank considered this issue at the beginning of 2007 after consulting with interested parties. It was decided, however, that no action would be taken at that time and the issue would be reconsidered as part of this review. Accordingly, the Bank is seeking views on the merits of a number of possible changes to the operation of the existing interchange standards for the credit and scheme debit systems. These include, but are not limited to: (i) more frequent compliance (perhaps yearly, rather than three-yearly as is the case currently); (ii) the use of industry-based, rather than scheme-specific weights; and (iii) requiring *all* interchange fees to be below the benchmark.

### *Modifications to the honour-all-cards rule to include premium and/or pre-paid cards*

134. As has been discussed above, over the past five years, there has been an increase in the range of credit cards offered by the credit card schemes, with relatively high interchange fees now applying to corporate and premium cards. Under the schemes' honour-all-cards rules, a merchant must accept all types of credit cards issued by a scheme if it wants to accept any credit cards. The Bank is interested in views as to whether the honour-all-cards Standard should be modified to allow merchants to accept some, but not all types of credit cards. Submissions are therefore sought on the possible scope of the honour-all-cards rule and how any modifications to the Standard would work in practice. One modification, for example, might allow merchants to accept standard cards but to decline acceptance of premium cards if they judged that the merchant service fees applying to these cards were too high. Another possible modification would be to allow a merchant to decline acceptance of a scheme's pre-paid cards, while accepting its debit cards.

### *The regulation of interchange fees on EFTPOS cash-out transactions*

135. At the time the Bank introduced its final Standard on EFTPOS interchange fees it elected not to regulate interchange fees on EFTPOS transactions with a cash-out component. The Bank welcomes views on whether it would be appropriate to treat all EFTPOS transactions uniformly, or otherwise regulate EFTPOS transactions with a cash-out component. Submissions might also wish to address whether interchange fees for EFTPOS cash-out transactions and ATM transactions should be treated in an equivalent manner.

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

136. The regulation of interchange fees has been by way of setting a standard under the *Payment Systems (Regulation) Act 1998*. The legal requirements for setting a standard have complicated the setting of interchange fees, and led to lengthy debates about what costs should and should not be included in the standard. It has also led to the industry having to undertake periodic cost studies to conform to the standard. Over recent years, some participants have suggested that the regulatory process would be more straightforward, and involve fewer costs, if the Bank were able to set interchange fees or an interchange benchmark directly. The Bank is therefore seeking views on the merits of a change to the legislation that would allow such an approach.

### *The availability of information on Australian payment systems*

137. An important aspect of the Bank's reforms has been to improve the transparency of the Australian payments system. The Bank is seeking views on whether there is a need for additional information to be available to market participants, and how best any additional information should be supplied.



# References

**Australian Bankers' Association** (2005), *Submission to the Taskforce on Reducing the Regulatory Burden on Business*, 16 December.

**Chang H, DS Evans and DD Garcia Swartz** (2005), 'The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia', *Review of Network Economics*, Volume 4, Issue 4, pp. 328-358.

**Citigroup** (2006a), *Australian banks: Payments reform – it's not over yet*, 27 June.

**Citigroup** (2006b), *Impact of EFTPOS reforms on retailers*, 2 May.

**Commerce Commission** (2006), 'Commission alleges price-fixing in credit card interchange fees', Press Release, 10 November.

**East & Partners** (2007), *Australian Merchant Acquiring and Cards Markets*, Special purpose market report prepared for the Reserve Bank of Australia, January.

**European Commission** (2001), 'Commission Decision of 9 August 2001 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (Case No COMP/29.373 – Visa International)', *Official Journal of the European Communities* L 293/24, 10 November.

**European Commission** (2002), Commission exempts multilateral interchange fees for cross-border Visa card payments, Press Release, 24 July.

**European Commission** (2006), *Interim Report I – Payment Cards*, 12 April.

**European Commission** (2007), *Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report)*, Brussels, 31 January.

**Federal Court of Australia** (2003), *Final Judgement in Visa International Service Association v Reserve Bank of Australia N 973 of 2002 and MasterCard International Incorporated v Reserve Bank of Australia N 987 of 2002*, Sydney.

**Federal Court of Australia** (2005), *Final Judgement in Australian Retailers Association v Reserve Bank of Australia FCA 1707*, Melbourne.

**Financial System Inquiry** (1997), Final Report, March.

**Gans J** (2006), *Submission to the House Standing Committee on Economics, Finance and Public Administration 'Review of the Reserve Bank & Payments System Annual Reports 2005'*, 24 April.

**Gans J** (2007), *Evaluating the Impact of the Payment System Reforms, Submission to the Reserve Bank of Australia's Payment System Board's 2007–08 Review of Payment System Reforms*, 19 January.

**House of Representatives Standing Committee on Economics, Finance and Public Administration** (2006), *Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005*, Canberra, June.

- IMA Market Development** (2000), *Study Regarding the Effects of the Abolition of the Non-discrimination Rule in Sweden*, Lerum, 29 February.
- ITM Research** (2000), *The Abolition of the No-discrimination Rule*, Amsterdam, March.
- Monopolies and Mergers Commission** (1989), *Credit Card Services: A Report on the Supply of Credit Card Services in the United Kingdom*, HMSO, London.
- Office of Competition and Consumer Protection** (2007), 'Unlawful Practices of Banks', Press Release, 4 January.
- Office of Fair Trading** (2005a), 'MasterCard agreement anti-competitive, rules OFT', Press Release 168/05, 6 September.
- Office of Fair Trading** (2005b), 'OFT issues statement of objections on Visa agreement', Press Release 195/05, 19 October.
- Office of Fair Trading** (2006), 'OFT to refocus credit card interchange fees work', Press Release 97/06, 20 June.
- Ortiz G** (2005), 'Remarks on Interchange Fees: Central Bank Perspectives and Options', paper presented at a Conference *Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?* Federal Reserve Bank of Kansas City, Santa Fe, New Mexico, 4–6 May.
- Reserve Bank of Australia and Australian Competition and Consumer Commission** (2000), *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, October.
- Reserve Bank of Australia** (2002), *Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement*, August.
- Reserve Bank of Australia** (2005), Media Release No. 2005-02, 'Payments System Reform', 24 February.
- Reserve Bank of Australia** (2006), Media Release No. 2006-06, 'Update on Payments System Issues', 13 September.
- Reserve Bank of Australia** (2007), 'Banking fees in Australia', *Bulletin*, May, pp. 59-62.
- Swiss Competition Commission** (2005a), 'Summary of the Decision by the Competition Commission dated 5 December 2005', 15 December.
- Swiss Competition Commission** (2005b), 'Amicable Settlement', 23 February.
- Tribunal de Defensa de la Competencia** (2006), *Report 2005*.
- United States District Court, Eastern District of New York** (2003), *In re Visa Check/MasterMoney Antitrust Litigation, Memorandum and Order*, 19 December.
- Visa International** (2005), *Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes: Is the market responding as the RBA predicted?* May.