REFORM OF AUSTRALIA'S PAYMENTS SYSTEM

PRELIMINARY CONCLUSIONS OF THE 2007/08 REVIEW

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Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review

1. Introduction

This document sets out the Payments System Board's preliminary conclusions of its review of the regulation of Australia's card payment systems. It is the product of a process that commenced with the publication of an Issues Paper in May 2007 and has involved a large number of submissions and extensive consultation with industry participants, including a conference in November 2007. The document discusses the main options considered and the Board's preferred course of action.

The origin of the Review was a commitment made by the Payments System Board when it released its final reforms for the credit card systems in 2002. The Review has been wide ranging, and has covered all the reforms to the card-based payment systems in Australia. The Board thanks all those who made submissions and took time to meet with the Bank's staff as part of the Review.

The structure of this document is as follows. Section 2 sets out the Board's mandate and objectives, and Section 3 provides details on the current regulatory landscape. Section 4 then summarises the consultation process and the various views raised by industry participants. The Board's assessment of the main issues is set out in Section 5, while Section 6 discusses the various options regarding interchange fees, including the Board's preferred approach. The main conclusions of the Review are then summarised in Section 7, while Section 8 provides details of the next steps in the process.

The conclusions set out in this document are preliminary. The Board is seeking submissions on these conclusions and on the analysis set out below. Further details are provided in Section 8. The final conclusions of the Review will be published in late August/early September 2008.

2. The Payments System Board's Mandate and Objectives

The Payments System Board's responsibilities stem from the Financial System Inquiry, whose findings and recommendations were released in 1997.[1] The Inquiry found that, while earlier deregulation had improved competition and efficiency in Australia's payments system, further gains were possible. To that end, it recommended the establishment of the Payments System Board at the Reserve Bank with the 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 Board's responsibilities are set out in the *Reserve Bank Act 1959*. The Act requires the Board to determine the Bank's payments system policy so as to best contribute to: controlling risk in the financial system; promoting

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

the efficiency of the payments system; and promoting competition in the market for payment services, consistent with the overall stability of the financial system.

At the time the Board was established, the Government also provided the Bank with specific powers to regulate payment systems in order to implement the Board's policies. The most relevant powers in the context of the card payment reforms are those set out in the *Payment Systems (Regulation) Act 1998*. Under this Act, the Bank has the power to designate payment systems and to set standards and access regimes in designated systems. The Act also sets out the matters that the Bank must take into account when using these powers, including the desirability of payment systems: being financially safe for use by participants, efficient and competitive; and not materially causing or contributing to increased risk to the financial system.

The Bank's reforms to the card payment systems have aimed to improve the efficiency of the overall payments system and to promote competition. In particular, they have sought to: increase the transparency of the system; remove or modify restrictions that hinder competitive forces; liberalise access arrangements; and promote price signals to consumers that are conducive to the efficient evolution of the payments system. These reforms are discussed in the following section.

3. The Current Regulatory Landscape

3.1 The origin of the reforms

The current regulatory landscape has its origins in the findings of *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (the Joint Study) undertaken by the Bank and the Australian Competition and Consumer Commission (ACCC) and published in October 2000. The Joint Study emphasised both the substitutability of individual payment instruments, and the need for a system-wide approach. It found that credit card interchange fees had contributed to many holders of credit cards facing negative effective prices for credit card transactions, while interchange fees in the EFTPOS system contributed to many people facing positive effective prices for EFTPOS transactions. This higher price for EFTPOS transactions was despite the EFTPOS system having substantially lower operating costs per transaction than the credit card system. The Joint Study also concluded that the case for an interchange fee in debit card systems on the grounds of balancing issuers' and acquirers' costs (as advocated by the card schemes) was not strong.

In the years following the publication of the Joint Study, the Board introduced a number of reforms to address the issues identified. Although the Joint Study highlighted the interrelationship between the various card payment systems, these reforms have been sequential, rather than simultaneous. This reflects a variety of factors, including legal considerations and the Board's willingness to allow industry to explore solutions before regulatory solutions are considered.

The first reforms were those to the credit card system. In March 2000, an independent investigation by the ACCC concluded that the collective setting of interchange fees in the credit card schemes was in breach of the price-fixing provisions of the *Trade Practices Act 1974*. The ACCC advised the credit card schemes and their members that they should seek authorisation of the interchange fee agreements or cease collective setting of these fees. After a year of discussions with the banks, the ACCC concluded that the authorisation process was unlikely to meet its concerns about competition and efficiency and, in March 2001, asked the Bank to consider using its powers to address the issue of interchange fees.

After consultation, the Payments System Board formed the view that it would be in the public interest to bring the credit card schemes under the Bank's regulatory oversight. As a result, in April 2001, the Bankcard, MasterCard and Visa credit card systems were designated under the *Payment Systems (Regulation) Act* after it became clear that the Board's concerns were unlikely to be addressed voluntarily by the schemes. The Bank then commenced a process of consultation on potential standards and access regimes. These reforms were finalised in August 2002 and came into effect during 2003 and 2004.

After the reforms were finalised, MasterCard and Visa launched legal challenges to the Bank's powers to designate the credit card systems and impose standards and access regimes. The case was heard in 2003 in the Federal Court, with the decision, released in September 2003, finding in favour of the Bank on all grounds.

Reform of the debit card systems followed some time later. Following the Joint Study, the Bank's discussions with industry participants suggested that there was a reasonable probability that interchange fees in the EFTPOS system would be reduced without the need for regulation. Indeed, in February 2003 a group of industry participants agreed to set interchange fees in the EFTPOS system to zero, and sought ACCC authorisation for the proposal. The ACCC eventually approved the proposal, although the approval was subsequently overturned by the Australian Competition Tribunal (ACT) following an appeal by a group of merchants. After the ACT's decision, the Board judged that the prospect for further industry-based reform was limited, and it designated the EFTPOS system in September 2004. This designation was then challenged unsuccessfully in the Federal Court by the same group of merchants that had challenged the earlier industry agreement.

Given the strong potential substitutability between EFTPOS and scheme debit, the Board viewed it as important that changes to these systems occur at the same time. The Board designated the Visa Debit system in February 2004 and, once the industry reform proposal for EFTPOS had failed, proceeded to consider interchange fees in the two systems together.[2] In February 2005, the Bank released a consultation document, setting out the proposed reforms in the EFTPOS and scheme debit systems. Following consultation, the reforms were finalised in April 2006. The interchange fee Standards and the EFTPOS Access Regime came into effect in 2006, while the honour-all-cards Standard came into effect in January 2007. MasterCard agreed to implement equivalent reforms for its debit card system with voluntary undertakings rather than the Bank imposing standards.

3.2 The reforms

The Board's reforms to the card-based payment systems have been in three broad areas: the removal of various restrictions on merchants imposed by the card schemes; the regulation of interchange fees; and the introduction of more liberal access arrangements. The reforms are summarised in Table 1 and more detail is provided in the sub-sections below.

2 *At that time, Visa Debit was the only scheme debit system in operation in Australia. MasterCard's debit product was not launched in Australia until November 2005.*

3.2.1 *Merchant restrictions*

In its early work, the Board identified a number of restrictions on merchants that were detrimental to efficiency and competition in the payments system. These included rules that:

- prevented merchants from surcharging for credit card and scheme debit card transactions (the no-surcharge rule);
- 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
- prevented merchants from steering customers to other forms of payment (the no-steering rule).

The Board concluded that the no-surcharge rule masked the price signals to cardholders about relative costs of different payment methods and limited the ability of merchants to put downward pressure on interchange 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, as merchants charged a uniform price to all consumers regardless of the payment method used, with this uniform price needing to cover the relatively high costs of credit card acceptance.

MasterCard and Visa declined to voluntarily remove their no-surcharge rules and, as a result, the Bank imposed standards requiring the removal of these rules from 1 January 2003. American Express and Diners Club voluntarily agreed to remove their equivalent rules.

Table 1: Payments System Reforms - as at April 2008

Standards	
Interchange fees	
Credit cards	Weighted-average interchange fees in 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.
Visa 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.
Merchant restrictions	
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 *vice versa*. 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.

Access Regimes	
Credit cards and Visa 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 *vice versa*. 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 average merchant fee for each of the schemes as well as data on market shares.

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 Board 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.

Visa declined to modify voluntarily its honour-all-cards rule and, as a result, the Bank imposed a standard requiring that the rule be modified in the Visa system to allow merchants to make separate acceptance decisions for Visa credit and debit cards from 1 January 2007. In contrast, MasterCard provided a written undertaking to voluntarily comply with this Standard. Similarly, 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.

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 Diners Club, MasterCard and Visa schemes). Again, the Board saw this rule as inappropriately restricting competition and, after discussions, American Express agreed to remove the rule.

3.2.2 Interchange fees

When the Board first considered the regulation of the credit card system in 2001, it considered whether just requiring the removal of the no-surcharge rule would be sufficient to establish price signals that better promoted competition and efficiency in the payments system. Although recognising that removing the no-surcharge rule would be a positive step, the Board was not convinced that surcharging would become sufficiently commonplace within a reasonable time to materially alter the price signals facing most 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. The Board therefore came to the conclusion that both the removal of the no-surcharge rule *and* a reduction in the difference between interchange fees in the various systems were necessary to establish more appropriate price signals to cardholders.

Reflecting this view, the Board introduced a number of regulations to reduce interchange fees in the card payment systems and move them closer together. These reductions were achieved by the imposition of standards which capped the level of average interchange fees in the various systems.

The *credit card interchange fee Standard* specifies a benchmark, calculated by reference to issuers' costs, and requires that the weighted-average interchange fee of each scheme be no higher than the benchmark at specific points in time. Under the original Standards, the benchmarks differed slightly across the schemes, reflecting differences in issuers' costs. Following concerns by some industry participants that the scheme with the highest benchmark had a competitive advantage, a revised Standard was released in November 2005 after consultation with industry. Under this revised Standard, the same benchmark applies in both the MasterCard and Visa systems. That benchmark is currently 0.50 per cent of the value of a transaction.

The *EFTPOS interchange fee Standard* sets both a floor and a cap on interchange fees for EFTPOS transactions without a cash-out component. This approach reflects the bilateral nature of the EFTPOS system in which interchange fees are negotiated between each of the direct connectors in the system. The Board was concerned that these bilateral negotiations could be used to frustrate access or limit competition, with existing participants potentially offering arrangements to new participants on less attractive terms than were established with other existing participants. The cap is set as the average cost to an acquirer of authorisation and processing a transaction – currently $0.05 per transaction. The floor is 80 per cent of the cap – currently $0.04 per transaction.

The *Visa Debit interchange fee Standard* requires the weighted-average interchange fee in the Visa Debit system to be no higher than a benchmark set as the average cost to an issuer of processing and authorisation, expressed as cents per transaction. MasterCard's undertaking requires its debit interchange fees to meet the same benchmark. The benchmark is currently $0.12 per transaction.

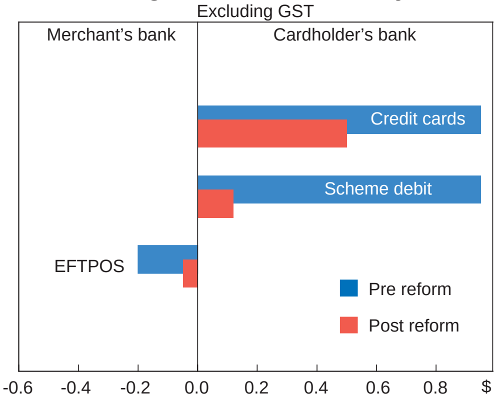
While the interchange fee Standards use costs to calculate the benchmarks, at a conceptual level the Board does not see interchange fees as a way for acquirers to compensate issuers (or *vice versa*) for specific costs. Rather, the Standards have been based on costs as a way of establishing transparent benchmarks that meet the legal requirement of a 'standard'.

The implementation of the set of interchange standards has resulted in lower levels of interchange fees and a smaller differential between the fees in the various systems (Graph 1). Interchange fees for credit card transactions have halved while those on scheme debit have fallen by a larger amount. Further, the difference in interchange fees between the EFTPOS and scheme debit systems has declined from around $1.15 on a $100 transaction prior to the reforms to around $0.17 currently.

Graph 1

Interchange Fees on a $100 Payment*

Excluding GST



* The post-reform data show the benchmark for each system.
Source: RBA

3.2.3 Access

In order to promote competition in the payments system, the Board has also introduced a number of reforms to access arrangements.

In the credit card system, the effect of the previous access rules was to restrict 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 then 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.

Given that the schemes did not 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, which established a new class of supervised institutions known as Specialist Credit Card Institutions. 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 prevent 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.

The Bank also concluded that access arrangements for the EFTPOS system were more restrictive than necessary, largely reflecting the bilateral nature of the system. While potential entrants could either negotiate access through an existing participant (which may also be a competitor) or establish their own direct links, existing participants were under no obligation to establish the necessary connections on reasonable terms and conditions, or to do so within a reasonable timeframe.

Following prompting by the Bank and the ACCC, industry participants spent considerable time developing an EFTPOS Access Code to improve access arrangements. Under the Access Code, which was adopted in September 2006, existing participants have agreed to procedures and timetables under which they will negotiate and establish connections with new participants. The Access Code also imposes a cap on the price that current participants can charge for new connections. This cap is set in the EFTPOS Access Regime imposed by the Bank and is the lowest cost of connection from a survey of direct connectors undertaken by the Australian Payments Clearing Association (APCA) in 2004 – it is currently $78 000. The EFTPOS Access Regime also limits the ability of existing participants to use negotiations over interchange fees to impede competition by imposing 'no discrimination' requirements on existing participants.

4. The Review and Consultation

4.1 The scope of the Review

The origin of this Review is a commitment made by the Payments System Board when it released its final reforms for the credit card systems in 2002 that it would review the reforms in five years. The Review is, however, more wide ranging than was envisaged at that time, and covers all the reforms discussed in the preceding section. This wider scope reflects the interconnections between the various reforms, and the Board's view that the individual reforms are best viewed and assessed as part of a package, rather than on a stand-alone basis. Throughout the reform process, the Board's focus has very much been on the payments system as a whole, not just on the operation of individual payment systems within the overall system.

As important inputs to the Review, the Bank undertook extensive projects on the costs and use of payment instruments in Australia. The study on costs extended the work of the Joint Study by examining the end-to-end costs of a number of different payment instruments, including cards and cash. The study of payment patterns involved a survey of consumers on their use of various payment methods and an analysis of data supplied by financial institutions and merchants. The results of these studies were presented at the Payments System Review Conference in November 2007.

The Review is intentionally forward looking. While the Board has considered the effects of the reforms to date in detail, its main focus has been on how best to establish a set of arrangements that are conducive to ongoing strong competition in the Australian payments system and the efficient evolution of the system over the longer term.

4.2 The consultation process

The Board has been keen to ensure that the Review is as open and transparent as possible, and the Bank has consulted widely with interested parties.

The first step in the consultation process was in September 2006, with the Bank seeking submissions from interested parties on the scope and process of the Review. 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. This is reflected in the broad scope of the Review.

The second step was the publication of *Reform of Australia's Payments System: Issues for the 2007/08 Review* in May 2007 (the Issues Paper). This paper provided a summary of recent developments in card payment systems and sought industry feedback on 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?

In total, 27 submissions were received by the Bank and these are published on the Bank's website; Appendix 1 provides a list of those who made submissions. Twenty parties took up the invitation to discuss their submissions with the Bank. The Bank has also held a significant number of other related meetings with industry participants, including consumer groups.

The third step was the Payments System Review Conference in November 2007, held jointly by the Bank and the Centre for Business and Public Policy at the Melbourne Business School. Around 90 participants were invited, representing financial institutions, merchants, card schemes, industry associations, consultants and academia. All members of the Payments System Board attended. The first part of the conference involved a discussion of two commissioned papers and the results of the Reserve Bank's studies of the use and cost of payment instruments. The second part took the form of an open forum discussing the reforms to the card payment systems, particularly the issues of interchange fee regulation, innovation and access. The conference proceedings are published separately and available on the Bank's website.

4.3 Views expressed during consultation

The Board has found the consultation process very helpful, although in a number of areas the views expressed have been diametrically opposed to one another. In part, these divergent views reflect the fact that the reforms have had quite different effects on the various parties. While it is difficult to accurately represent individual positions without reference to the complete submissions, in general the stances of the key stakeholders on the direction of policy can be characterised as follows:

- large financial institutions supported the relaxation of interchange fee regulation and potentially moving to a self-regulatory arrangement, but argued that the no-surcharge and honour-all-cards Standards should be retained;
- smaller financial institutions had concerns about the impact of interchange regulation on scheme debit and about the honour-all-cards Standard;
- merchants broadly supported the reforms and argued strongly for a move to zero interchange for all card payment systems; and
- the regulated card schemes argued for the removal of all regulations, although one indicated that it could accept an approach in which the no-surcharge and honour-all-cards Standards remained in place in their current form if interchange fee regulation were removed.

Given the strongly held positions there was little explicit support for the *status quo*.

The three sub-sections below set out the main points made in response to the questions in the Issues Paper.

4.3.1 The effects of the reforms

The consultation process revealed a general agreement on a number of effects of the reforms. These included: a substantial reduction in merchant service fees; a significant change in relative prices facing cardholders for credit cards and debit cards; an improvement in the competitive position of merchants; and a significant increase in the prevalence of surcharging for credit card payments, although the majority of merchants still do not levy a surcharge. In a number of other respects, views on the effects of the reforms were more varied.

On the removal of the no-surcharge rule, a number of parties, including the banks, argued that merchants' capacity to surcharge had increased competitive pressure on interchange and merchant service fees. Better price signals to consumers also resulted when merchants chose to surcharge. In contrast, others argued that, despite improving competition at the margin, surcharging is not yet sufficiently widespread for it to have had a substantial effect. In this context, it was noted that the capacity of merchants to surcharge varied. For instance, it was argued that both retailers with market power and billers are in a better position to surcharge than are many merchants in the retail sector where payments are made at the point of sale. It was also argued that surcharging is sometimes excessive and that there has been substantial damage to scheme brands.

Similarly, there were various views on the benefits of the modification of the honour-all-cards rule. Merchants generally argued that modification of the rule had been beneficial in providing the freedom to choose which cards they accept and, thereby, control costs. Against this, the schemes argued that the removal of the rule had provided no benefits to consumers and, if anything, had increased the potential for confusion. As a result, the change had caused damage to their brands. It was also noted that because the majority of merchants currently receive blended pricing – with a single merchant fee for all scheme card transactions – there is little incentive for most merchants to differentiate between cards and, thus, the modification of the rule has had limited effect.

Submissions put forward a variety of views about the effects of the reforms on individual payment systems. The four-party card schemes argued that the absence of regulation of three-party schemes provided a competitive advantage to these schemes. The fact that merchant service fees for the three-party schemes have declined by less than those for the four-party schemes was cited by some as evidence of this. The three-party schemes disputed this conclusion, noting that there had been a minimal shift in market share to three-party schemes, and that surcharging has had a particularly detrimental effect on their businesses because their surcharges tend to be higher. Furthermore, the decline in merchant service fees for the three-party schemes was argued to be evidence that these schemes have come under competitive pressure.

In relation to competition between the regulated card schemes, some submissions argued that the common interchange fee benchmark limits the ability of these schemes to compete effectively for issuers. Furthermore, it was argued that the backward-looking nature of the weights used in the compliance calculation can provide a competitive advantage where a scheme chooses to apply a high interchange fee to a card category in which it has relatively few cards on issue.

Submissions on the effects of the reforms on financial institutions highlighted the perceived disproportionate effects on smaller institutions. Some argued that the honour-all-cards Standard had a significant effect on smaller financial institutions which typically offer a more limited range of payment products than larger institutions, and rely more heavily on scheme debit products for which interchange fees have declined significantly.

4.3.2 The case for ongoing regulation and alternatives

Submissions tended to focus on the case for relaxing or removing regulation and specific regulatory approaches. The issue that attracted most attention was the regulation of interchange fees. As with other aspects of the reforms, a variety of views were expressed.

Some submissions arguing for a removal of interchange regulation stated that consumers are worse off as a result of the reforms. In support, these submissions cited the rise in annual fees on credit cards, reductions in the value of loyalty programs and surcharges. They also typically argued that merchants have not reduced their prices in response to lower interchange fees, but have instead increased their profits.

In addition, a number of other arguments were raised, including the following:

- the regulations have added significant cost, complexity and uncertainty to financial institutions' businesses;
- it is difficult to implement competitively neutral interchange regulation, both among card systems and against other platforms;

- participants will inevitably find ways around the regulations, leading to the prospect of further distortions and/or further regulation; and
- the regulations have impeded innovation, with effort being diverted to managing interchange fees rather than developing new products.

A number of submissions argued that the increase in competition in the market over recent years means that interchange regulation can be removed or relaxed, or that additional changes could further increase competition sufficiently to allow this to occur. A common argument in favour of this approach was that the combination of regulations on the no-surcharge and honour-all-cards rules means that there is now sufficient competition in the market to address the Board's concerns about the setting of interchange fees. Merchants disagreed with this argument. They argued that despite the removal of the no-surcharge and honour-all-cards rules, regulation is still necessary to ensure interchange fees do not rise substantially. In their view, the competitive forces on interchange fees remain very weak.

In the Issues Paper, the Bank asked specifically whether the no-surcharge Standard alone could address its concerns over interchange fees. The large banks, in particular, suggested that this Standard had sufficiently changed the competitive environment to allow interchange regulation to be removed. In contrast, merchants argued that, while the abolition of the no-surcharge rule has been beneficial, surcharging is not yet sufficiently widespread for there to be confidence that surcharging is effective in constraining interchange fees.

Financial institutions generally supported some form of self-regulation taking the place of formal regulation, although for some (typically smaller) institutions, support was contingent on how representative the governance of those self-regulatory arrangements would be. In contrast, the merchants argued against self-regulation, and even some supporters of self-regulation said that they could not see it working for interchange fees. There was greater support, however, for self-regulation with respect to technical standards, payment system rules and access, encouraging competition and coordinating innovation.

The main self-regulatory proposal was put by APCA, which envisages a self-regulatory body working in conjunction with the Bank. At this stage, however, details on how such a body might work are still being developed by industry, and no specific model has been put to the Bank.

Another factor identified as having a bearing on the prospects for successful relaxation of regulation is the capacity of the EFTPOS system to provide effective competition to scheme products. Some submissions, including from representatives of the banking industry, argued that competition from EFTPOS had the potential to exert competitive pressure on fees, but that changes to EFTPOS governance arrangements would be required for it to do so. At the same time, some banks indicated a reluctance to spend money on marketing or innovation with respect to EFTPOS, arguing that returns on investment from scheme products were significantly greater than for EFTPOS.

Some submissions also raised the possibility that competition in acquiring could be prompted by requiring three-party schemes to open up acquiring of their cards. Another option raised was allowing merchants, rather than cardholders, to choose the network over which a card transaction is processed.

While interchange regulation drew the most comment, the schemes' submissions argued for the removal of all regulation, including the no-surcharge and honour-all-cards Standards. These submissions cited the benefits of a prohibition on surcharging in terms of ensuring consistency of cardholder treatment regardless of payment choice, as well as protecting cardholders from price gouging by merchants with market power. In addition, some submissions suggested that surcharging inappropriately limited the ability of card systems to use pricing structures to promote network growth and/or provide incentives to engage in cost-reducing practices.

The schemes and the smaller financial institutions argued for the removal of regulations governing honour-all-cards rules. The schemes argued that honour-all-cards rules enhance convenience and competition by reducing search costs to cardholders, and facilitate greater competition among issuers and acquirers. As significant issuers of scheme debit cards, the smaller financial institutions emphasised the detrimental effect of the honour-all-cards Standard on their competitive position.

4.3.3 Changes to the Standards and Access Regimes

The issues addressed under this question included: whether interchange fees should be reduced further, perhaps to zero; the transparency of scheme fees; and a number of technical issues related to the operation of existing regulation.

Merchant submissions advocated a further reduction in interchange fees. Their preference was for these fees to be set to zero (or equivalently abolished), with one submission arguing that, if this did not occur, the costs of the interest-free period and of fraud prevention should be removed from the benchmark calculations for the credit card schemes.

Financial institutions and the card schemes opposed moving to zero interchange, arguing that interchange fees play an ongoing part in developing and maintaining a card system.

Some submissions approached this question from an analytical perspective. One argued that interchange fees are not essential to the operation of card systems and are unlikely to be set efficiently by the schemes. A second argued that econometric evidence supported the 'neutrality hypothesis' – that interchange fees have no long-run effect on merchants' and consumers' choices when surcharging is possible. Interchange fees could, therefore, be set at any level, including zero. It was also noted, however, that there are costs of imposing regulation and if a cap is imposed, it should be done in a way that minimises regulatory costs.

A number of parties suggested that the interchange differential between scheme debit and EFTPOS is putting EFTPOS at a competitive disadvantage, especially by failing to provide issuers with the incentive to invest in the EFTPOS system. As such, consistency in the setting of debit card interchange fees would put EFTPOS and scheme debit on a more even footing.

Comments were also provided on the way in which interchange benchmarks are set, with a number of calls for greater consistency between payment instruments. Comments included the following:

- the current credit card methodology should be applied to all card payment systems;
- fraud costs and the cost of the interest-free period should be removed from the credit card benchmark;

- fraud costs should be included in the scheme debit benchmark;
- the methodology should take account of relevant costs of both issuers and acquirers; and
- a cost-based approach is a prerequisite for the survival of new entrants that are only issuers or acquirers because these organisations do not have the capacity for cross-subsidisation between issuing and acquiring functions.

A number of submissions also commented on the current exclusion of cash-out transactions from the EFTPOS interchange fee Standard. Several argued that these transactions should be treated the same as EFTPOS purchases. Among other things, it was argued that the different treatment of cash-out transactions was complicating negotiations over EFTPOS access. Other submissions emphasised that EFTPOS cash-out transactions should receive regulatory treatment that is consistent with ATM transactions.

There were also a small number of submissions suggesting the need to review compliance aspects of the interchange Standards. One submission argued that, if interchange regulation is retained, common weights should be used for determining the schemes' weighted-average interchange fees for comparison with the benchmark. It argued that this would remove schemes' capacity to exploit differing compositions of card portfolios to gain market share in particular segments. Another submission raised concerns that the regulated schemes are exploiting the period between compliance calculations in a way that allows weighted-average interchange fees to rise between compliance dates.

A number of submissions expressed concern that scheme fees could be used in a manner similar to interchange fees – that is, to raise revenue from acquirers and merchants to pay to issuers and cardholders. These submissions called for structural changes to generate competition over scheme fees (for example, allowing acquirers to choose which network routes transactions to issuers) or to subject these fees to greater scrutiny.

The main issues prompting comment other than interchange regulation related to the honour-all-cards and no-surcharge Standards. Some submissions supported further modifications to the honour-all-cards Standard as a way of further improving the competitive environment. One suggestion was to extend the Standard to cover all categories of card with a different interchange fee, rather than simply debit and credit cards as covered currently.

Other submissions expressed concern that an extension of the honour-all-cards Standard would lead to high levels of confusion among consumers, particularly foreign visitors.

A number of parties raised the possibility of imposing a cap on any surcharge imposed by merchants, or requiring that surcharges bear a reasonable relationship to the cost of accepting a card. In particular, it was argued that such a cap could help limit the brand damage that can occur as a result of merchants surcharging excessively.

5. The Board's Assessment

This section sets out the Board's views on the major issues raised in the consultation process. First, it discusses the Board's assessment of the competitive forces acting on interchange fees, and in particular, why it is that close oversight of retail payments is warranted. Second, it discusses the main effects of the reforms. And third, it discusses the Board's proposed course of action in a number of areas. The options for interchange fees are discussed separately in the following section.

5.1 A central issue: the competitive forces acting on interchange fees

A central issue confronting the Review is the extent of the competitive forces acting on interchange fees. From the time of the Joint Study, the Board's view has been that the normal forces of competition have not acted effectively on interchange fees, and that the resulting configuration of fees was not conducive to the efficient evolution of the system. As noted above, during the consultation process a number of parties argued that, due to the Bank's reforms, the competitive environment is very different to that applying five years ago and that interchange regulation could now be removed. In contrast, others argued that because of the structure of the market, it was very difficult, if not impossible, to have confidence that competition could ever lead to an efficient configuration of interchange fees.

Following a careful consideration of this issue, the Board remains of the view that, in the absence of regulatory oversight, there is a significant risk that interchange fees in some systems will be set at levels that are too high from the point of view of the efficiency of the system. The main reason for this is that merchants find it difficult to exert sufficient downward pressure on interchange fees, largely as a result of the structure of incentives that they face. In essence, merchants face a co-ordination problem, and as a result are willing to pay more, in aggregate, for some payment methods than the aggregate benefit that they receive from accepting those methods. This difficulty is most apparent in the credit card system but, in principle, can arise in other payment systems as well.

While each merchant that accepts credit cards obviously judges the net benefit of doing so to be positive (otherwise it would not accept credit cards), the aggregate benefit to the merchant community of acceptance need not exceed the aggregate cost of acceptance. This is because part of the benefit that an individual merchant perceives from accepting cards is that of 'stealing' business from other merchants. But merchants cannot collectively steal business from themselves; one business's gain is another's loss. Further, the Board does not accept the idea that in the long run, credit card acceptance by merchants significantly increases the aggregate value of spending (although it is likely to bring forward some spending).

In a sense, merchants are in a game akin to the 'prisoner's dilemma': they would be better off if they could collectively agree on the terms of credit card acceptance, paying no more than their collective benefit, but instead they act individually and, as a result, can in aggregate potentially pay more for credit card acceptance than the benefit they receive.

Historically, merchants' ability to exert competitive pressure on interchange fees has been further diluted by scheme rules and a lack of transparency of interchange fees. In particular, the no-surcharge and honour-all-cards rules reduced the ability of merchants to put downward pressure on interchange fees by either threatening to impose a surcharge, or refusing acceptance of some cards with high interchange fees. The lack of transparency also made it difficult for merchants to know exactly what interchange fees were being paid on different transactions.

The Board's main concern about high interchange fees arises from the potential for these fees to distort payment patterns. In particular, a payment system with high interchange fees can effectively subsidise consumers to use that system, even if doing so generates a loss of welfare for society as a whole. In the Australian context, the cash, direct entry and cheque systems do not have interchange fees and there is no simple means by which such fees might be implemented in these systems. This puts these systems at a potential disadvantage.

Of more concern has been the structure of the EFTPOS debit card system, and in particular the existing governance and organisational structure of this system. The current arrangements have meant that, following the establishment of the system in the 1980s, it has been very difficult for industry participants to change the long-established interchange fees. Given that these fees were set up to be paid from the issuer to the acquirer (the reverse direction to almost all other interchange fees in the world), the EFTPOS system has been at a significant disadvantage to the credit card system. The result has been a set of price signals to consumers that have encouraged credit card use at the expense of debit card use.

It is important to note that the Board's concerns in this area have nothing to do with the level of credit card debt and do not reflect a view that 'debit is better than credit'. Rather they reflect a judgement that the structure of interchange fees in the Australian payments system has distorted payment patterns in Australia.

While the Board recognises that there may be a case for interchange fees in some payment systems, it has not been presented with any convincing evidence to suggest that the various externalities that might justify these fees are sufficiently different in the debit and credit card systems to justify substantially different fees in these systems.

The Board's central conclusion here is that merchants, as a group, will pay more for credit card acceptance than the benefit they receive, introducing a distortion into the system. Historically, this distortion has been amplified by the various scheme rules that have restricted merchants' choices. The Bank's reforms have required that these restrictions be removed, but they have not completely overcome the source of the distortion. Given this assessment, the Board's deliberations in this area have focussed on two broad issues:

(i) whether more can be done to give merchants greater influence over the levels at which interchange fees are set by encouraging, or requiring, further changes to scheme rules or the structure of the system; and

(ii) whether, in the long run, regulation of interchange fees will more effectively overcome the underlying distortion than other approaches.

These issues are taken up further below.

5.2 The effects of the reforms

As part of the Review, the Board has considered the broad effects of the reforms and the various views expressed through the consultation process. The following discusses the Board's assessment of the main effects of the reforms.

5.2.1 Price signals and payment patterns

In the Board's judgement, the reforms have met a key objective of improving the price signals that consumers face when choosing between use of credit and debit cards. In particular, the relative prices that consumers face for credit and debit transactions more closely reflect relative costs than was the case prior to the reforms. While the Board recognises that efficiency does not necessarily require an exact alignment of costs and prices in the various systems, its assessment is that the relative prices that consumers now face are a substantial improvement compared to those that existed prior to the reforms.

An important part of the Review has been a re-examination of the costs of the various payment instruments. This work has confirmed that the resource costs of credit card transactions are higher than for EFTPOS transactions for both financial institutions and merchants. In terms of the payment functionality, the cost of an average-sized credit card transaction is around $0.46 higher than for an average-sized EFTPOS transaction.[3] The fraud costs associated with credit cards are higher than on EFTPOS transactions – due to signature authorisation and the ability to use credit cards in remote environments – and there are higher costs associated with maintaining an international scheme. Merchants also incur higher costs mainly because credit card transactions take longer to process at the point of sale than do EFTPOS transactions.

The changes in price signals that have occurred reflect both changes in interchange fees and the introduction of surcharging on credit card transactions. Lower interchange fees in the MasterCard and Visa credit card systems have resulted in a reduction in the value of reward points and higher annual fees, increasing the effective price of credit card transactions facing many consumers. For example, the effective price of a $100 transaction where the credit card balance is paid off by the due date has increased from around -$1.30 prior to the reforms (reflecting the value of the interest-free credit and reward points) to around -$1.10 currently.[4]

Surcharging has also led to a significant rise in the effective price of some credit card transactions. Since the beginning of 2003, when the no-surcharge rule was removed, the number of merchants surcharging has risen substantially (Graph 2). At the end of 2007, around 23 per cent of very large merchants imposed a surcharge; for small or very small merchants, the percentage was closer to 10 per cent.[5] Although the size of the surcharge varies across merchants, the average surcharge imposed is currently around 1 per cent for MasterCard and Visa transactions, and around 2 per cent for American Express and Diners Club transactions.[6] At these levels, the

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3 *Including the costs related to the credit and reward functionality of credit cards, the differential is around $1.33 on average, half of which is due to the cost of credit collections and write-offs with credit cards. These calculations are based on costs for the average transaction size for each payment method. Using a consistent transaction size of $50, which is around the median for credit card and EFTPOS payments, the average cost of the payment functionality of a credit card transaction is around $0.35 higher than for an EFTPOS transaction. See Schwartz C, J Fabo, O Bailey and L Carter (2008), 'Payment Costs in Australia',* Payments System Review Conference*, Reserve Bank of Australia and Melbourne Business School, Sydney, pp 88-138.*

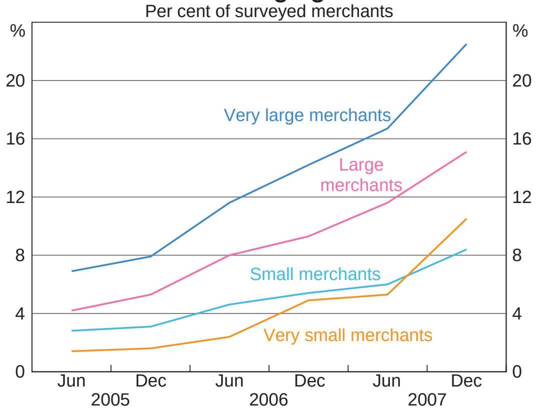
4 *These calculations abstract from changes in the general level of interest rates over time. The other component of these calculations, namely the length of the interest-free period, is directly controlled by issuers and on average has not changed significantly since 2003.*

5 *East & Partners (2007),* Australian Merchant Acquiring and Cards Markets*:* Special question placement report prepared for the Reserve Bank of Australia*, December.*

6 *East & Partners (2007).*

Graph 2

Merchants Surcharging Credit Cards*



* Very large merchants are those with annual turnover greater than $340 million, large merchants $20 million to $340 million, small merchants $5 million to $20 million and very small merchants $1 million to $5 million.

Source: East & Partners Pty Ltd

effective price of a MasterCard or Visa credit card transaction on which a surcharge is imposed and the balance is paid off in time is close to zero. For consumers who do not pay the balance by the due date, the effective price of a credit card transaction on which a surcharge is imposed is clearly positive.

For EFTPOS transactions, prior to the reforms most banks provided a certain number of fee-free transactions after which a charge of around $0.50 was levied. In contrast, most financial institutions now offer customers 'all you can eat' accounts, which offer unlimited fee-free transactions (usually electronic) for a fixed monthly account-keeping fee. While this change reflects a number of factors, the reduction in EFTPOS interchange fees from around $0.20 a transaction to $0.05 a transaction has made it more viable for institutions to offer accounts that do not have EFTPOS transaction fees.

While it is difficult to estimate precisely what effect these changes in price signals have had on payment patterns in Australia, the available evidence strongly supports the idea that relative prices matter to consumers' choice of payment instrument.

Confidential data from one card scheme indicate that when surcharges are imposed on a particular type of card, use of that card declines substantially. Where merchants have imposed a surcharge on one scheme only, or imposed a higher surcharge on one scheme than another, there have been large shifts in payment patterns away from the scheme with higher surcharges.

Similarly, data from the survey of individuals' payment patterns undertaken by the Bank as part of the Review indicate that those consumers that face a higher price for credit card transactions tend to use credit cards less than those that face a negative price. In particular, according to the survey results, credit card 'transactors' (who face a negative price) undertook around 22 per cent of their transactions on credit cards, while 'revolvers' (who face a positive price) undertook only around 12 per cent of their transactions on credit cards.[7] Conversely, revolvers are more likely to use a debit card for payments, while nearly 40 per cent of transactors did not use a debit card for any payments during the two-week survey period. The survey also indicated that credit and debit cards are used extensively for a wide range of transactions in the $25 to $200 range, suggesting significant substitution possibilities for some consumers.

7 *Emery D, T West and D Massey (2008), 'Household Payment Patterns in Australia',* Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 139-176.*

Aggregate data also show a slowing in growth of the number of credit card transactions over the past few years, while growth in the number of debit card transactions has increased (Graph 3).

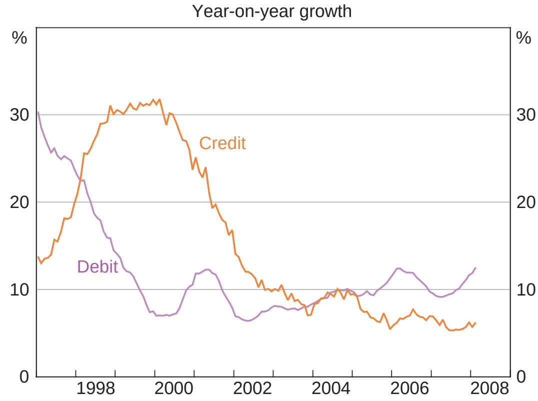
5.2.2 The effect on welfare

A number of submissions have argued that the reforms, particularly those to interchange fees, have reduced aggregate welfare, citing, among other things, the higher costs that credit card holders pay for credit cards. The Board does not accept this argument.

Graph 3

Number of Card Payments

Year-on-year growth



Source: RBA

While the reforms have clearly affected different groups differently, the Board's assessment is that the effect on overall welfare has been positive. In assessing the aggregate benefits it is important to recognise that simply altering the size of the transfers between different participants in the payments system has only a limited direct effect on overall welfare, although it obviously affects the groups involved. The major benefits to the Australian economy accrue not through changing the size of these transfers, but through the improved allocative efficiency resulting from more appropriate price signals, and an increase in the contestability of markets.

While it is relatively straightforward to measure the change in the transfers between different groups, measuring the overall benefits is inherently difficult, partly because it cannot be known precisely what would have happened in the absence of the reforms. One approach is to use the principle of revealed preference, which suggests that if consumers use a particular payment instrument at a given price, they must receive a benefit at least equal to that price. Further, if the price increases then it can be inferred that those consumers that stop using the payment instrument receive a benefit less than the new price.

Using this principle, together with some assumptions about the change in the use of the various instruments, some indicative measures of welfare gain can be produced. If, for example, it is assumed that the number of credit card transactions was around 5 per cent lower over the past year than would have otherwise been the case (with these transactions migrating to the EFTPOS system), the welfare gain could be in the order of \$100–\$150 million per annum.

An alternative assumption might be that in the absence of the reforms, the EFTPOS system would have gradually withered, with transactions migrating to the international card schemes. Based on the cost data collected as part of this Review, this would have resulted in an increase in annual costs to the economy of around \$300 million. To the extent that a number of EFTPOS users valued EFTPOS transactions more highly than scheme card transactions, the net benefit to society from the reforms would have been higher still.

The Board's overall assessment is that the welfare gains from the reforms are likely to have been substantial. Not only has the change in payment patterns *relative to what would have occurred in the absence of the reforms* resulted in lower costs, but there has also likely been an increase in welfare from consumers using a payment instrument from which they derive higher benefits. An estimate of the welfare gain of some hundreds of millions of dollars per annum would not be inconsistent with the available data.

5.2.3 Competitive position of the three-party schemes

One criticism of the credit card interchange fee regulations is that they have given a competitive advantage to American Express and Diners Club. While the Board has adopted a different approach to American Express and Diners Club than to the four-party schemes, this reflects differences in the structure of the schemes.[8] The Board does not accept the idea that the different approaches have given American Express and Diners Club a competitive advantage.

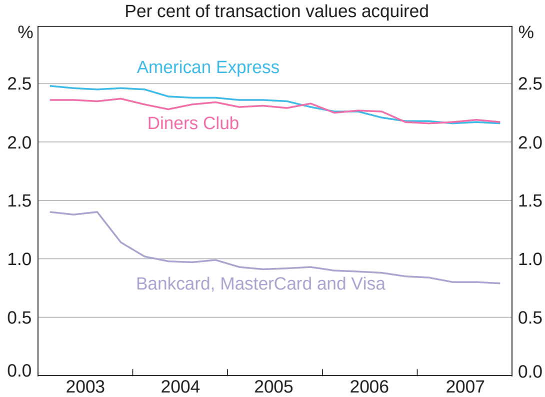
While neither American Express nor Diners Club has been designated under the *Payment Systems (Regulation) Act*, both agreed to voluntarily comply with the no-surcharge Standard. American Express also agreed to remove its no-steering provisions. These changes have had significant effects on the schemes. This is partly because they have higher merchant service fees than the four-party schemes which has meant that surcharges are more likely to be imposed, and where they are imposed, they tend to be relatively large. As noted earlier, survey data suggest that for those merchants that surcharge, the average surcharge for a transaction on a MasterCard or Visa card is around 1 per cent while for American Express and Diners Club cards it is around 2 per cent. Moreover, confidential evidence provided to the Bank by one card scheme indicates that where such differential surcharging has been applied it has had a marked effect on the use of the various cards.

Merchant service fees charged by both American Express and Diners Club have been under downward pressure as merchants have reviewed their acceptance of these cards given the increase in their relative costs compared to MasterCard and Visa cards. Since the reforms were introduced, average merchant service fees for American Express and Diners Club transactions have fallen from 2.44 per cent to 2.16 per cent (Graph 4). This decline is around half that of the four-party schemes and has occurred a little more slowly than the Bank originally expected. But at the same time, surcharging appears to be more prevalent for American Express and Diners Club than for MasterCard and Visa, suggesting that the three-

Graph 4

Merchant Service Fees

Per cent of transaction values acquired



Source: RBA

8 *For a discussion of why different approaches were adopted see: Reserve Bank of Australia (2002),* Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement, *August, p 2; and Reserve Bank of Australia (2005),* Media Release No. 2005-02, *'Payments System Reform', 24 February.*

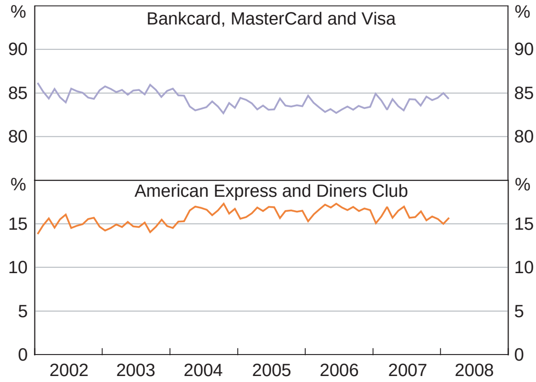
party schemes have been prepared to preserve higher merchant fees at the expense of more surcharging.

The available evidence on market shares of the three-party schemes does not suggest that these schemes have enjoyed a competitive advantage. While the combined market share of American Express and Diners Club did increase by 2 percentage points in 2004, coinciding with the issuance of American Express cards by two major banks and an arrangement between Diners Club and another major bank, over the past two years their market share has been broadly stable and has actually declined a little recently. Over the three months to February 2008, the market share of the three-party schemes was only around 1 percentage point higher than over the same period five years earlier, prior to the reforms (Graph 5).

Graph 5

Market Shares of Card Schemes

By value of purchases



Source: RBA

5.2.4 Competitive pressure on interchange fees

Evidence on the effect of the Bank's reforms on the competitive pressures on interchange fees is mixed. On the one hand, the modification of the honour-all-cards rule has resulted in a lowering of scheme debit interchange fees for some merchants, and the increased prevalence of surcharging has raised the prospect that future increases in interchange fees would be resisted by merchants. On the other hand, average interchange fees are still pushing up against the benchmarks, suggesting that upward pressure on these fees remains.

Increased competitive pressures flowing from the modification of the honour-all-cards rule have been evident mainly in the lowering of interchange fees on scheme debit products, at least for large merchants. Industry participants suggest that this outcome is partly attributable to the ability of these merchants to decline acceptance of scheme debit cards if the fees are too high. This ability reflects both the changes to the honour-all-cards rule and the existence of an alternative debit card system which the merchants can rely on if they decline to accept scheme debit.

In contrast, there is little evidence to suggest that surcharging has put direct downward pressure on interchange fees in the four-party schemes. However, in the Board's view, the increased willingness of merchants to surcharge suggests that, looking forward, the threat of surcharging could reduce the upward pressure on interchange fees. This would be consistent with the experience of the three-party schemes discussed above.

Notwithstanding these factors, the benchmarks set by the Board are binding and there is no suggestion that competitive pressure is leading to average interchange fees being set *below* the relevant benchmarks. Indeed, confidential data provided to the Bank suggest that average interchange fees are currently above the relevant benchmarks. Although large merchants have had some success in bargaining down interchange fees, these lower fees have tended to be offset by higher interchange fees for other categories of transactions, in particular interchange fees faced by smaller retailers. This experience suggests that despite some increased competitive pressures at the margin, the more important factor keeping interchange fees low is the regulatory caps.

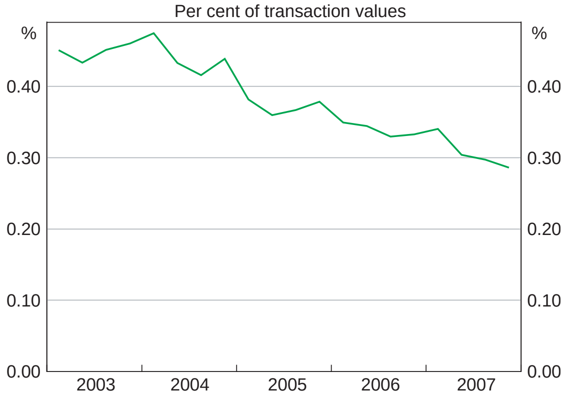
5.2.5 Competition in acquiring

The reforms appear to have contributed to increased competition in acquiring. This is suggested by a significant decline in the margin between average merchant service fees and average interchange fees. The margin for the four-party credit cards has fallen from 0.45 per cent of the transaction value in the September quarter of 2003 to 0.29 per cent of the transaction value in the December quarter 2007. For EFTPOS, it has fallen from $0.18 per transaction in the September quarter of 2006 to $0.13 per transaction at the end of 2007 (Graphs 6 and 7).

Graph 6

Credit Card Merchant Service Fee Margin Over Interchange Fee

Per cent of transaction values

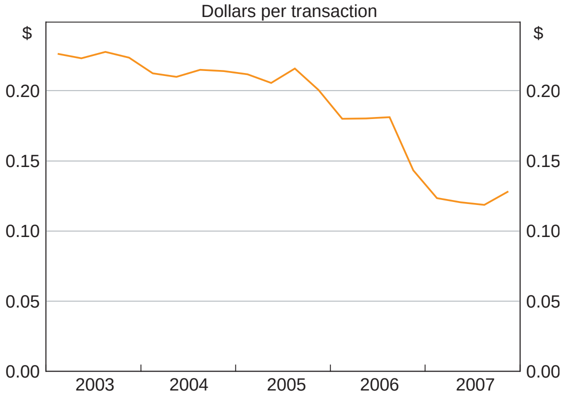


Source: RBA

Graph 7

EFTPOS Merchant Service Fee Margin Over Interchange Fee

Dollars per transaction



Source: RBA

In part this decline can be attributed to the increased focus that the Bank's reforms have brought to payments system issues, and the increased transparency that has resulted from the reform process. Merchants now understand more about the costs being incurred by acquirers and are in a better position to negotiate with acquirers. The access reforms may have also contributed to the lower margins (see Section 5.2.8 below).

5.2.6 Merchant pass-through of savings

One issue that has attracted considerable attention since the reforms were introduced is whether the cost savings that merchants have received from lower merchant service fees have been passed on to consumers in the form of lower prices for goods and services than would have otherwise been the case. The schemes argue that there has been no, or little, pass-through, while the merchants argue that the cost savings have been passed through. The Bank's estimate is that over the past year, these cost savings have amounted to around $1.1 billion.

No concrete evidence has been presented to the Board regarding the pass-through of these savings, although this is not surprising as the effect is difficult to isolate. The Bank had previously estimated that the cost savings would be likely to lead to the CPI being around 0.1 to 0.2 percentage points lower than would otherwise be the case over the longer term (all else constant). It is very difficult to detect this against a background where other costs are changing by much larger amounts and the CPI is increasing by around 2½ per cent per year on average.

Despite the difficulties of measurement, the Board's judgement remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers. This judgement is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge. A similar conclusion was reached by the House of Representatives Standing Committee on Economics, Finance and Public Administration when it considered the Bank's payments system reforms in 2006.[9]

5.2.7 Innovation

Another issue that has attracted considerable attention is the effect of the reforms on innovation in the payments system. In particular, some industry participants have argued that the introduction of chip and PIN on credit cards has been delayed in Australia because of the reduction in credit card interchange fees. The Board does not agree with this position.

Many industry participants have noted that, until recently, there has been only a weak business case for the introduction of chip and PIN on credit cards. This primarily reflects the fact that fraud rates in Australia have been very low. Data collated by APCA indicate that, over the year to June 2007, fraud on credit and charge cards amounted to around 39 cents per $1 000 transacted, around the same as in previous years. This is very low compared with overseas jurisdictions in which chip and PIN have been implemented, most notably the United Kingdom. Given this low rate of fraud, few industry participants have seen a strong case to incur the substantial expenditure required to implement these technologies.

In addition, in the Board's view it is unlikely that the level of interchange fees paid to issuers is an important determinant of investment in chip and PIN technology. Confidential information provided to the Bank in 2003 showed that around 80 per cent of the expenditure required to upgrade the Australian system to chip technology would be borne by acquirers. Raising interchange fees paid by acquirers would not seem to be consistent with encouraging those same acquirers to undertake significant additional capital expenditure. Furthermore, countries with higher interchange fees than Australia, most notably the United States, have not upgraded to chip and PIN.

No concrete evidence has been presented to the Board to suggest that innovation has been slowed by the reforms, although a number of general claims have been made. Some industry participants have argued that the reforms have actually promoted innovation, by making the market more contestable, although again few concrete examples have been provided.

9 *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.*

The Board's general conclusion in this area is that the reforms have had little effect on the pace of innovation, either negatively or positively. The Board does, however, recognise that regulatory uncertainty and the regulatory environment can affect the pace of innovation, and this is discussed further in Section 6.

One related issue that the Board has drawn attention to on a number of occasions is the governance arrangements that apply to Australia's bilateral payment systems. As has been argued previously, the current arrangements are not always conducive to innovation, and the Board urges the industry to examine these structures as a matter of priority.

5.2.8 Access

The access reforms have made it easier for new participants to enter the payments system, although further progress is required. Two new acquirers and one new issuer have been authorised by APRA as Specialist Credit Card Institutions. In addition, there have been a number of cards issued under co-branding arrangements with established issuers; for example, rather than joining the schemes in their own right, a number of large retailers have chosen to partner with financial institutions to issue cards on their behalf.

The EFTPOS Access Regime has improved access at the margin for new entrants but the bilateral architecture of this system still makes access to this system difficult. Since its establishment in September 2006, there have been two applications for access under the APCA Access Code. In both these cases, however, access was ultimately negotiated outside the Code, suggesting that, while the provisions might not be used, the Access Code and Regime have provided a negotiating backstop for new entrants.

The experience of recent years has demonstrated that the ability to compete in one payment system is often conditional on being able to obtain access to another system. When a merchant is choosing an acquirer, it typically wants a firm that is able to acquire all its card transactions, requiring access to all the credit card and debit card systems. In the absence of more comprehensive access reform than has currently been undertaken, particularly to Australia's bilateral payment systems, access will remain relatively difficult, although substantially easier than was previously the case.

5.2.9 The use of cash

Over recent years, a criticism of the Bank's reforms is that they have not addressed what some see as a significant distortion in the payments system, namely the heavy use of cash. Some industry participants have gone further and argued that the reduction in interchange fees has promoted the use of cash, and that this has harmed the overall efficiency of the payments system. The Board's judgement is that the evidence does not support these views.

The Bank's research on payment patterns in Australia showed that cash is the most commonly used payment method, accounting for around 70 per cent of transactions by individuals.[10] It is used particularly extensively for small transactions, accounting for nearly all transactions under $10 and three-quarters of transactions between $11 and $25. Importantly, information

10 *Emery D, T West and D Massey (2008), 'Household Payment Patterns in Australia',* Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 139-176.*

on the cost of various payment instruments shows that for these low-value transactions, cash has a lower average cost than other payment methods.[11] This is partly explained by the fact that small cash payments have faster tender time than electronic payments, and that a single cash withdrawal can support multiple cash transactions in contrast to the electronic payment systems which require use of the electronic infrastructure each time a payment is made.

In addition, there are no restrictive practices in the provision of cash. Banks supply cash to individuals and merchants in a competitive market place and, while it is true that the costs of producing cash are not explicitly charged to the users of cash, the effect of this is more than offset by the interest forgone in holding cash. Indeed, in many cases, given the interest forgone and charges on foreign ATM withdrawals, cash represents a more expensive payment instrument for consumers than either debit or credit cards.

Despite this higher effective price, cash is used frequently, presumably reflecting the benefits that individuals derive from cash payments. Foremost amongst these are the quicker tender time and, to a lesser extent, the anonymity of cash payments. Perhaps at some point in the future an alternative low-cost payment instrument will emerge that can offer these same benefits. To date, however, the various schemes that have been proposed or trialled have not been able to gain sufficient merchant or cardholder acceptance. And, importantly, the costs have either been too high or the functionality too limited compared with cash.

The Board's assessment, therefore, is that there is no major distortion in the payments system that encourages or discourages the use of cash. For the low-value transactions for which cash is predominantly used, it is a low-cost, efficient payment instrument.

5.3 Major policy issues

This section discusses the Board's main conclusions about the various standards and access regimes introduced over recent years and, in particular, whether these standards and access regimes should be retained, and if so, whether they should be modified. It also discusses some further suggestions for reform.

5.3.1 Interchange fees

As noted above, the Board's judgement is that there are strong public policy grounds for continued close regulatory oversight of interchange fees in card payment systems. The nature of the incentives facing merchants means that there is a significant risk that, in the absence of such oversight, interchange fees will be set at levels that distort payment patterns. The likelihood of this outcome is increased by the current governance arrangements in the EFTPOS system which limit the capability of the EFTPOS system to be an effective competitor to the international card schemes.

The Board does not, however, view interchange fees as undesirable in all circumstances. While it remains unconvinced that interchange fees are needed in mature systems, it can see an argument for interchange fees in emerging systems or, potentially, in systems that are being upgraded. In the start-up phase, a payment system may find that it cannot attract consumers to

11 *Schwartz C, J Fabo, O Bailey and L Carter (2008), 'Payment Costs in Australia'*, Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 88-138.*

use the system without subsidising use. An interchange fee may assist in establishing a payment network and realising the benefits to the economy. Once the system is established, however, there seems to be less reason to maintain the fees at their original level.

This assessment rules out the Board stepping back completely and unconditionally from the regulations introduced over recent years. The issue facing the Board, therefore, is how to best build on the progress that has been made in improving the competitive environment and in establishing less distortionary interchange fees. Looking forward, the Board has considered three broad options with respect to interchange fees. These are discussed in Section 6.

5.3.2 The no-surcharge Standard

The Board sees no case for allowing the schemes to reintroduce the no-surcharge rule. Given that the schemes have argued strongly against the no-surcharge Standard, it is the Board's expectation that if the Standard were removed the schemes would seek to re-establish the rule. The Board is, however, prepared to consider removing the Standard if the schemes provided an enforceable undertaking that they would alter their rules to allow surcharging.

In the Board's view, the benefit of the no-surcharge Standard has been substantial. It has improved price signals to consumers and, in time, might be expected to add to the downward pressure on interchange fees. The schemes' no-surcharge rules had long restricted merchants from passing on the costs of card acceptance to cardholders, and had reinforced the underlying distortion discussed in Section 5.1.

While the Board is proposing to retain the Standard, it has considered modifying the Standard to place a cap on the size of any surcharge imposed by merchants. This reflects concerns expressed through the consultation process that surcharging is being exploited by firms with market power. The Board's assessment, however, is that the case for such a cap is relatively weak, and it is not persuaded that the isolated examples of high surcharges are sufficient grounds to reimpose restrictions on merchant pricing for all merchants. The imposition of a cap would limit merchant flexibility and potentially remove a negotiating tool for merchants who might agree to limit the amount of their surcharge in exchange for a lower merchant service fee.

While surcharging might make more transparent any market power that already exists, it is a symptom not a cause: if a firm has market power, a limit on the surcharge is unlikely to affect the overall price charged by that firm. Furthermore, the evidence does not support the idea that surcharging is only used by firms with market power, with firms across a wide range of industries levying surcharges. By imposing a surcharge, some firms operating in very competitive markets are able to offer cardholders the choice of paying by credit card, without all their customers having to cover the higher costs of credit card acceptance. Finally, a confidential submission by one of the schemes provided the results of a survey that indicates that surcharges tend to be set with reference to merchant service fees.

5.3.3 The honour-all-cards Standard

The Board does not see a case to allow schemes to reinstate their earlier version of the honour-all-cards rule. The evidence to date suggests that the modification of the rule has, at the margin, been of benefit in exerting downward pressure on some interchange fees, and this benefit is expected to increase through time. As with the no-surcharge Standard, the Board is prepared to consider removing the Standard imposed on the Visa scheme if Visa provided an enforceable undertaking that it would alter its rules (MasterCard has already provided such an undertaking).

Since the introduction of the honour-all-cards Standard in 2007, there have been signs that some merchants have used their new freedom to negotiate lower interchange fees in the scheme debit systems. In particular, both schemes have introduced interchange fees for scheme debit transactions undertaken at large merchants significantly below the 12 cent cap.

This result is encouraging and in line with the Board's expectations at the time the Standard was introduced. It indicates that providing large merchants with more freedom on the conditions under which they take cards can result in more competitive pressure on the interchange fees applying to those merchants.

While the Board is proposing to maintain the Standard (and the associated Undertaking), it has considered modifications to address concerns raised during consultation about the treatment of scheme pre-paid cards. When the Board looked at pre-paid cards in 2006, it decided not to regulate interchange fees for these cards (which were, at the time, not in wide use) but did signal an expectation that interchange fees should be set broadly in conformity with those for scheme debit cards. Furthermore, it indicated that if a pre-paid card was introduced with features substantially different from a scheme debit card, merchants should not be required to accept that card.

Since then there has been an increase in the issuance of scheme pre-paid cards and the feedback through the consultation process is that the lack of an explicit reference to pre-paid cards in the Standard and Undertaking is causing confusion. Some industry participants have argued that the Standard and associated Undertaking should be modified to explicitly acknowledge that merchants are not required to accept pre-paid cards as a condition of accepting any other scheme card.

The forced acceptance of pre-paid cards is inconsistent with the general approach that the Board has taken. It has the potential to make it more difficult for other, non-scheme pre-paid cards to compete, and allows the schemes to tie the interchange fee to that applying to scheme debit. Given the potential for pre-paid cards to become a significant part of the payments system in the future, the Board sees a strong case for merchants being allowed to make independent acceptance decisions about this form of card. This could be achieved by the schemes voluntarily removing any rules that tie acceptance. In the event this did not occur, the Board would consider designation of the pre-paid schemes and regulation.

A further issue raised in the context of honour-all-cards rules is that one scheme has offered a discounted interchange fee to some merchants on the condition that they accept all the scheme's cards. Although not technically in breach of the honour-all-cards Standard or Undertaking, the requirement introduces a substantial penalty for a qualifying merchant who chooses not to accept all cards. In the Board's view, this is inconsistent with the spirit of the Standard and the principles that the Board discussed when it first introduced the honour-all-cards Standard.

Although the practice currently only applies to large merchants, it is possible that it could be extended more broadly, reintroducing a *de facto* honour-all-cards rule. For the same reasons that the Board viewed the original introduction of the honour-all-cards Standard to be in the public interest, it is of the view that this practice detracts from competition and efficiency by limiting merchant choice and, therefore, merchants' ability to impose downward pressure on interchange fees. The Board's preliminary conclusion is that the Standard and associated Undertaking by MasterCard should be modified to address this issue. Such a change would take place regardless of the final option chosen on interchange regulation.

Finally, the Board has considered whether a further modification of the rule to allow separate acceptance decisions for any product that has a separate interchange fee would promote competition and efficiency in the payments system. Its conclusion on this issue is discussed in the following section, given that the Board's proposed approach depends upon the direction taken with respect to interchange fee regulation.

5.3.4 Access Regimes

As noted in Section 3, a number of reforms to access have improved the ability of new entrants to compete in the card payment systems. The Board is proposing to retain all the existing access regimes.

Difficulties, however, remain particularly with payment systems built around bilateral technical links and business relationships. Even in the EFTPOS system where access reform has been helpful, access remains more difficult than is desirable.

The technology on which the bilateral payment systems are based is relatively old and is likely to need to be updated in the not too distant future. The Board is aware that there are alternative technologies available for exchanging payment messages, some of which do not require separate connections to all participants. Indeed, some of these new technologies only require entrants to establish a single technical connection in order to participate fully in a payment system. The Board has no specific views on the appropriate technology going forward and has no plans to impose an access regime or standards to implement a particular solution. It does, however, encourage the industry to consider seriously these new technologies and to assess which ones would provide the most open, transparent and cost-effective options for access by new entrants.

There is a minor issue related to the wording of the Visa Debit Access Regime that the Board will take the opportunity to modify at the same time as any changes related to the Review. This modification relates to the definition of a Specialist Credit Card Institution. The current definition includes an entity that proposes to engage in debit card issuing but does not otherwise conduct banking business. Such an entity could not exist because debit card issuing requires the taking of deposits. The change in the Access Regime will remove this anomaly but will have no practical effect.

5.3.5 Bypass rules

MasterCard and Visa have both advised the Bank that there are no rules in Australia that prohibit the bypass of the scheme processor. This is supported by the fact that two large merchants in Australia have bypass arrangements in place whereby they utilise their own switches to send credit card transactions directly to the issuer, rather than through an acquirer and the scheme switch.

The Board is not aware of anything in the scheme rules that would prevent an independent switch from providing a similar service to smaller merchants that do not have their own switch. Also, there seems no reason why an acquirer could not choose to send its transactions to the issuer through an independent switch. In both cases, competition would be enhanced.

Although there are apparently no restrictions on this activity, there would seem to be some benefit in the schemes making a clear statement on the criteria that alternative switches need to meet. Such a requirement would seem to impose little cost on the schemes and would increase the transparency of the relevant requirements.

5.3.6 Merchant choice of scheme

One issue that was raised a number of times at the Payments System Review Conference was whether *merchants* should be able to choose the network through which a transaction is processed. Under such an arrangement, rather than the cardholder pre-selecting the network by presenting, say, a Visa branded card, the merchant would choose whether the transaction was processed through the MasterCard or Visa network. In theory, this would exert pressure on interchange fees and scheme fees because the merchant would tend to select the cheaper network.

Such a change would be expected to have a very significant effect on the competitive dynamics in the payments system. Instead of competing for consumers partly on the basis of reward programs (or equivalently competing for issuers by offering the highest interchange fees), the schemes would have an incentive to compete for merchants on the basis of who could offer their payment services at the lowest cost. Such an outcome could well achieve an efficient level of interchange fees because the current market failure – arising from the difficulty that merchants have in refusing credit card acceptance because of business stealing incentives – could be largely overcome by the competition between schemes for merchant business.

Despite the potential advantages of such an arrangement, in practice it would require very significant structural modifications to the existing system. On the issuing side, it would be likely to require credit cards to be issued with both MasterCard and Visa brands. While multifunction cards already exist in Australia in the form of EFTPOS and credit cards, co-branded MasterCard/Visa cards do not exist anywhere around the world, and would require significant system changes. There would also need to be significant changes on the acquiring side, including possibly to terminals.

On balance, while the Board's view is that such changes could have a profound effect on competition, there is not a strong case to require a move in this direction through regulation. It would require costly adjustments in existing systems and may well have significant unintended consequences for the future development of card-based payment systems in Australia.

5.3.7 Transparency of fees

A number of industry participants have expressed a concern that, in an attempt to circumvent the interchange regulations, the payment schemes might raise scheme fees to acquirers (and hence the cost of credit card acceptance to merchants) as a way of generating revenue which could ultimately be rebated to issuers. Concerns about these fees have been heightened by the general lack of transparency to merchants about their magnitude and how they are set. These fees have a number of dimensions, but they are mainly 'brand' fees and fees for the processing of transactions. The main concerns relate to the former, given that it is difficult for acquirers to avoid brand fees. In contrast, if the processing fees were increased significantly, bypass arrangements might be expected to become more common (see above).

The Board can see considerable merit in greater transparency surrounding these fees. This is consistent with its approach in other areas, where transparency is seen as a way of strengthening competitive forces. At the same time, the Board recognises that there is a degree of commercial sensitivity about some of these fees, and has considered how best to increase transparency without forcing schemes to publish information which is legitimately confidential. The Board proposes, therefore, that at a minimum, information on average scheme fees paid by issuers and acquirers should be publicly available. There may also be a case for schemes to publish the average compulsory scheme fee paid by acquirers (that is, fees that cannot be avoided by on-us transactions or using a third-party processor).

In addition to transparency of scheme fees, the Board also sees merit in the schemes publishing their weighted-average interchange fee on a quarterly basis. Again this could be required through regulation if the schemes were not prepared to publish this information voluntarily.

6. Options Regarding Interchange Fees

6.1 The options

As noted above, the Board sees strong public policy grounds for continued close regulatory oversight of card payment systems. The most contentious issue has been, and remains, the regulation of interchange fees. Looking forward, the Board has considered three broad options regarding these fees.

The first is to maintain the *status quo*. Under this option, the broad features of the current interchange regulations would be maintained, including the current caps on interchange fees, although modifications would be made to enhance the functioning of the existing regulations. The second option is to further reduce the allowable levels of interchange fees in the credit card system and to further narrow the difference in interchange fees between the debit card systems. The third option is to step back from the regulation of interchange fees on the condition that further changes are made by industry participants to enhance the competitive environment. The three options are set out and discussed below.

Option 1: Status quo

The first option is to retain the current credit and debit card interchange Standards, largely unchanged. This would mean that:

- the weighted-average interchange fee in the MasterCard and Visa credit card systems would continue to be capped at around 0.5 per cent;
- the weighted-average interchange fee in the MasterCard and Visa debit card systems would continue to be capped at around 12 cents; and
- interchange fees in the EFTPOS system (paid to the acquirer) would continue to be between 4 and 5 cents.

If this option were adopted a number of technical changes, aimed at improving the functioning of the existing regulations, would also be considered. These include:

- the removal of the requirement to conduct cost studies every three years;
- requiring that the weighted-average interchange fees be below the relevant benchmarks once a year, rather than once every three years (or when interchange fees are varied) as is currently the case; and
- removing the exemption of cash-out EFTPOS transactions from the EFTPOS interchange fee Standard.

These modifications are discussed in Appendix 2.

Option 2: Reduce interchange fees further

The second option is to retain interchange regulation, but reduce interchange fees further. This option is consistent with the direction that the Board indicated when the original credit card regulations were finalised in 2002. At that time, the Board stated that the reduction in credit card interchange fees (from around 0.95 per cent to around 0.55 per cent) was the first step towards lower interchange fees in Australia.[12] This option would also eliminate the existing difference in the average interchange fees in the debit card systems in Australia. If this option were adopted, the Board would also consider the technical changes to the Standards noted under Option 1.

If a common average interchange fee is to be established in the various debit card systems, the Board has considered two broad possibilities. The first is to set interchange fees in these systems to zero. The second is to cap interchange fees with a low, but common, benchmark, with fees flowing from acquirers to issuers in both the EFTPOS and scheme debit systems. There are arguments in favour of both approaches.

International experience suggests that debit card systems do not need interchange fees to operate effectively. Moreover, most other payment systems in Australia that draw on transaction accounts do not have interchange fees. This suggests a common fee of zero would be feasible and consistent with existing practice in other payment systems. On the other hand, setting a small positive benchmark for the weighted-average fees would allow the schemes some flexibility in setting different fees for different types of transactions. At the margin this may be useful, and could potentially allow the schemes to use interchange fees in a way that promotes innovation in the system. On balance, the Board considers this latter approach preferable with, perhaps, a benchmark of around 5 cents capping the weighted-average fee in the various debit card systems.

In considering interchange fees in the credit card systems, the Board assessed the case for setting interchange fees to zero, or at levels similar to those in the debit card systems. While it remains unconvinced of the need for significantly higher interchange fees for credit card systems than for debit card systems, it does recognise that there are some plausible arguments that might justify somewhat higher interchange fees in credit card systems. In particular, merchants, in aggregate, may gain some short-term benefit from consumers using credit cards over debit

12 *The Bank stated in* Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement *that 'The Reserve Bank is prepared to include the cost of funding the interest-free period as an "eligible cost", but only as part of the transition to a lower level of credit card interchange fees in Australia.' (p 37).*

cards, in that sales occur earlier than otherwise. While the Board recognises this possibility, the current difference in interchange fees in the credit and debit card systems is significantly higher than could reasonably be justified by this argument.

Given this assessment, this option involves a substantial narrowing of the existing difference in interchange fees in the debit and credit card systems. In particular, it envisages the benchmark applying to the credit card systems being reduced to around 0.30 per cent.

In summary, this option involves benchmarks which result in:

- a common cap of around 5 cents on the weighted-average interchange fee (paid to issuers) in each of the debit card systems; and
- a cap of no more than 0.30 per cent on the weighted-average interchange fee in the credit card systems.

Option 3: Remove explicit interchange regulation

The third option is for the Board to step back from interchange regulation if the industry is able to address a number of issues that would promote competition and efficiency in a timely fashion. Given its underlying concerns about the competitive forces in the payments system, the Board has ruled out the option of stepping back unconditionally.

If the Board were to step back, one important issue that would need to be addressed is the current structure of the EFTPOS system, given the potentially important role that this system plays as a competitor to the international card schemes. As discussed above, the Board's view is that the existing governance and technical arrangements mean that the EFTPOS system is at a structural disadvantage which limits its ability to provide effective competition longer term. Looking ahead, if the EFTPOS system is unable to provide effective competition (and another widely used and competitive payment system does not emerge), the Board's view is that the case for removal of interchange regulations is relatively weak.

While the Board does not wish to be prescriptive about exactly what is required, a number of developments would strengthen the case that the EFTPOS system was likely to provide meaningful competition in the Australian card payments system over the years ahead. These include:

(i) the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make decisions about multilateral interchange fees;

(ii) the creation of effective arrangements to promote the development of the system;

(iii) reform of current access arrangements; and

(iv) the development of alternative payment instruments for use in on-line payments (either by the EFTPOS scheme or through another channel).

For the Board to step back, it would need to have reasonable confidence that strong competition exists between the various card-based systems and that the environment is conducive to ongoing strong competition. The Board would want to see tangible progress towards establishing such an environment and not just statements of industry intention to work towards this outcome.

Another issue that would need to be addressed is the honour-all-cards rule. If the Board is to remove the existing interchange regulation, its view is that further steps would need to be taken to improve the ability of merchants to put downward pressure on interchange fees. Accordingly, in addition to the modifications to the honour-all-cards rule discussed in Section 5, the Board sees it as important that payment schemes allow merchants to make independent acceptance decisions for each type of card for which a separate interchange fee applies. This would allow a merchant to refuse acceptance of, say, premium cards if it thought the cost of acceptance was too high relative to the benefit gained. Ideally, such a change would be made voluntarily by the schemes, although the Board would consider imposing this requirement through regulation if the schemes did not change their rules and it was deemed appropriate to step back.

The Board recognises that a number of arguments have been made against this change. One is that it would have little benefit, as most merchants in Australia are charged a single merchant service fee regardless of the card type, and thus have little incentive to refuse acceptance of particular card categories. This may change over time, however, as more merchants move to 'interchange plus' contracts. Second, the change would involve additional costs for acquirers, as they would need to alter their systems to allow merchants to accept some cards, but not others. And third, it has been argued that further changes to the honour-all-cards rule would be confusing to customers and reduce the value of the international card brands.

While the Board recognises that additional costs would be incurred by this change, its judgement is that if interchange regulation is to be wound back, all feasible steps need to be taken to enhance the competitive environment. While this change might not have an immediate effect, over time it is likely to enhance competition, particularly if merchants become willing to threaten to decline acceptance of particular card types.

The Board is not proposing that this change to the honour-all-cards rule be made if either Option 1 or 2 were adopted. Under these options, the costs to financial institutions of making the necessary systems changes are likely to outweigh the benefits, given that interchange fees would be constrained at low levels through regulation.

A third avenue for improving the competitive environment is to further enhance the transparency of the system. In particular, the Board sees a strong case for greater transparency of scheme fees and average interchange fees, as well as the fees and procedures that apply if an acquirer wishes to bypass scheme switches. As discussed in Section 5, the schemes could voluntarily take steps to improve transparency in these areas, or the Bank could require greater transparency through regulation.

One other issue that the Board has considered is whether the case for this option would be strengthened if a framework was in place to ensure that the industry *itself* addressed issues of competition and efficiency. Some have argued in the consultation process that if such a framework were in place, direct regulation by the Board would be unnecessary.

The Board supports this approach in principle. As has been emphasised elsewhere in this document, the Board's clear preference is for the industry to address issues of competition and efficiency rather than for the Bank to impose regulations. Exactly how this might be done remains unclear. One possibility might be for industry to take meaningful steps to improve the competitive environment and promote innovation in the Australian payments system, perhaps through changes to access arrangements and upgrading of the existing technical infrastructure. Another might be for industry participants, including the international card schemes, to directly address the Board's concerns about interchange fees, transparency and merchant restrictions, reducing the need for regulation. Over the period ahead, the Board is prepared to work with industry on developing appropriate arrangements. However, it is not requiring that such a new framework be agreed and put in place before Option 3 could be considered, although clearly industry steps in this direction would strengthen the case for this option.

In summary, this option involves the Bank stepping back from the regulation of interchange fees subject to other changes to further improve the competitive environment, in particular by:

(i) putting in place arrangements that have a high probability of ensuring that there exists a strong effective competitor operating alongside the international card schemes;

(ii) further modifications to the honour-all-cards rule; and

(iii) greater transparency of scheme fees.

In the event that transparency of scheme fees is not improved, the Board would consider regulation to require the schemes to provide the relevant information. The Board would also consider imposing the changes to the honour-all-cards rule discussed above as part of Option 3 if the relevant changes were made to the EFTPOS system but the schemes were unwilling to voluntarily change their scheme rules. In the event that the necessary improvements to the competitive environment are not forthcoming, the Board would consider either Option 1 or 2.

6.2 Advantages and disadvantages of the options

6.2.1 Options 1 and 2

Both Options 1 and 2 involve continued regulation of interchange fees.

The main advantage of Option 1 over Option 2 is that it involves minimal change to the existing arrangements. As such it should involve fewer adjustment costs. It also provides a stable and known environment for industry participants in which to make and implement business plans.

There are two main advantages of Option 2 over Option 1. The first is that under Option 2, a common benchmark in the EFTPOS and scheme debit systems would place these systems on a more equal competitive footing with each other than is the case under Option 1. The second is that Option 2 establishes more appropriate relativities between debit and credit card interchange fees than does Option 1.

The Board has had a long-standing concern that the relativities between interchange fees in the EFTPOS and scheme debit systems could contribute to the atrophy of the EFTPOS system, resulting in a diminution of competition and choice. This concern was one factor that led to the introduction of the EFTPOS and Visa Debit interchange Standards in 2006, with these standards narrowing the difference in interchange fees on a \$100 transaction from an average of around \$0.75 to \$0.17. While this change represents a significant levelling of the playing field, the Board remains concerned about the competitive effects of the current difference in interchange fees. In particular, the difference has the potential to lead issuers to promote scheme debit cards, not just on the basis of product characteristics, but also because of the more favourable interchange arrangements. By establishing similar interchange arrangements in the two systems, as is proposed under Option 2, competition between the schemes is likely to be more soundly based.

As discussed in Section 5, the Board's concerns in this area are not driven by a desire to promote the EFTPOS system: like other payment systems, the EFTPOS system should compete on the basis of the services and pricing it offers to cardholders and merchants. Notwithstanding this, an outcome in which the EFTPOS system declined partly because of the structure of interchange fees – and not because of the services it offers – could not be said to be in the public interest. In the Board's view, competition would be diminished if there were not a strong viable alternative to the international card schemes. The demise of the EFTPOS system would lead to higher costs in the payments system and would also lessen the competitive pressure on interchange fees. Indeed, recent experience suggests that the ability of merchants to offer the EFTPOS option to their customers has put downward pressure on at least some interchange fees in the scheme debit systems (see Section 5).

Option 2 would be expected to lead to a further realignment of relative prices of credit and debit cards. With interchange revenue for credit card transactions reduced, issuers would be expected to increase annual fees and further reduce the value of rewards programs. Since the decline in interchange fees would be around half that of the original reforms, the expected price changes would be correspondingly less. The changed interchange fees in the debit systems may also lead to some changes in pricing for debit card transactions. At the margin, these changes would be expected to lead to some further substitution away from credit cards and scheme debit to EFTPOS.

On balance, the Board favours Option 2 over Option 1. This reflects the fact that the benefits from Option 2, in the form of more appropriate interchange fees and price signals, would continue indefinitely while the benefits of Option 1 over Option 2 are relatively temporary.

6.2.2 Option 3

In contrast to Options 1 and 2, Option 3 envisages the Board stepping back from the regulation of interchange fees. The Board sees both advantages and disadvantages of this approach.

The main advantage is that it offers the prospect of a further improvement in the competitive environment, while allowing schemes more flexibility in the pricing of their payment services. It also provides a way for industry to address the Board's public-policy concerns regarding interchange fees, rather than these concerns being addressed through regulation. This is consistent with the Board's general approach.

Allowing card schemes to set their own interchange fees in an environment in which stronger competitive forces exist than has been the case historically would provide the various card payment systems with the flexibility to compete directly with one another for both acceptance and use. In the past the Board has expressed a concern that this type of competition could push up interchange fees, and this concern remains. There is, however, some prospect that the combination of the reforms to date and some further changes would result in an environment sufficiently competitive that interchange fees would no longer be under continual upward pressure.

One concern that the Board has previously expressed is that the same financial institutions effectively operate and control the various payment systems. This has led the Board to question whether competition between the various payment systems has been stifled. Recent changes to the ownership structure of the international card schemes has opened up the possibility of greater competition between these schemes and those operated and controlled by domestic institutions. The development of an EFTPOS system with appropriate governance arrangements may also be helpful in this regard.

In assessing this option, an important consideration has been the possibility that allowing schemes to set their own fees may increase the probability that the EFTPOS system will, over the longer term, remain a central part of the Australian payments landscape. While Option 2 would reduce the current disadvantage of the EFTPOS system in terms of interchange fees, there is a risk that, if the system remains subject to interchange regulation, financial institutions will not invest sufficiently in the maintenance and development of the system, and that ultimately competition may be weakened.

As noted above, the Board sees no evidence that the current arrangements have limited innovation to date. However, looking forward, it is possible that financial institutions may be more prepared to invest in systems which are able to set their own interchange fees. This might be because the regulatory risks are seen to be lower, or because interchange fees can be used to help finance the development of new and enhanced payment options (as has been the case for BPAY View for example). Allowing the EFTPOS system to set its own interchange fees might, for instance, allow it to develop an additional payment method for payments over the internet, with on-line merchants prepared to pay some of the costs through a higher interchange fee on these transactions.

A second potential advantage of Option 3 is that it removes the costs associated with industry attempting to circumvent the regulations and the Board responding to any circumvention. If interchange fees continue to be regulated, it is likely that the schemes will devote increased resources to seeking out ways of transferring funds from merchants to issuers, possibly through increases in scheme fees combined with a system of rebates to issuers. If such arrangements did emerge, regulation might need to become more far reaching and prescriptive – something the Board would prefer to avoid if possible.

There are also a couple of disadvantages of Option 3 compared to Option 2. The main disadvantage is that interchange fees are likely to be higher than under Option 2. Recent evidence suggests that, despite the improved competitive position of merchants, upward pressure on interchange fees remains. While some interchange fees have been reduced, the cap on weighted-average fees is binding, and indeed average interchange fees have risen above the benchmarks in both the credit and scheme debit card systems. In the Board's view, it is unlikely that the competitive environment will be sufficiently strong under Option 3 to deliver interchange fees lower than those being proposed under Option 2.

Higher interchange fees raise two distinct concerns. The first is that high fees can be associated with significant rent seeking and marketing which serves little useful purpose. The available evidence suggests that issuers' profits tend to rise with the level of interchange fees (indicating that this market is not perfectly competitive), prompting more marketing to attract cardholders. In the United States, for example, which has substantially higher average interchange fees than

Australia, 5.2 billion solicitations for new credit cards were mailed to households in 2007 – an average of around 45 solicitations per household.[13]

The second is that a potential distortion is created between the card-based systems with interchange fees and those systems without interchange fees. In particular, the direct cost to consumers of using the systems with interchange fees might be lower than that of the other systems, even though these systems might have higher underlying resource costs. This could lead to a migration of payments from these other systems even though such a migration would possibly reduce the overall efficiency of the payments system. It is important to note, however, that under Option 3, the Board's long-standing concerns about the relativity of interchange fees between the EFTPOS and scheme debit and credit card systems would be somewhat lessened. With all schemes free to set their own fees, there would be fewer grounds to be concerned that the resulting interchange fees were causing distortions, at least between these systems.

Another potential disadvantage of Option 3 is that it may provide less legal certainty. If the Board were to step back from regulation of interchange fees, the concerns over the setting of interchange fees that led to investigation by the ACCC over the course of 2000 and 2001 might remain. The exemption that currently exists in the *Trade Practices Act 1974* for interchange fees set in compliance with the Bank's Standards would no longer apply. It is therefore possible that the industry would need to seek authorisation from the ACCC for interchange fees. As has been demonstrated, for example in the case of EFTPOS interchange fees and cases currently underway in the United States, this can be a difficult and costly process. Furthermore, it may take many years to resolve, increasing uncertainty and potentially affecting investment and innovation in card payment systems.

6.3 Assessment

In the Board's view, the main consideration in deciding between Options 2 and 3 is whether the competitive environment can be made sufficiently strong to give the Board confidence that, in the absence of interchange fee regulation, the outcome would be one that promotes the efficiency of the payments system as a whole.

This is a difficult judgement. The Board recognises that the competitive forces on interchange fees are unusual and sees a strong case for Option 2. However, the potential advantages of Option 3 are such that the Board is prepared to remove interchange regulation if industry takes further steps to improve the competitive environment. If the necessary steps are not taken, the Board's current thinking is that interchange regulation will remain, and that the Standards will be altered to further reduce credit card interchange fees and eliminate the difference in fees between the various debit card systems as outlined under Option 2.

It is important to note that the Board is only contemplating the possibility of Option 3 as a result of the significant changes in the payments system that have occurred in response to the previous reforms. In particular, the increased transparency in the payments system and the growing prevalence of surcharging have changed the competitive environment and prompted better price signals to consumers. The Board's focus on interchange fees has also served to

13 *Mail Monitor (http://mailmonitor.synovate.com/news.asp); US Census Bureau.*

increase merchant understanding of these fees and this has helped improve the competitive environment.

Notwithstanding these changes, and the further changes required under Option 3, the Board remains concerned about the likely strength of the competitive forces acting on interchange fees. The possibility remains that these changes, while significant, may still not go far enough to create the competitive environment that is required. Therefore, if Option 3 were implemented and average interchange fees in the credit card systems were to increase materially, the Board would consider reimposition of interchange regulation, probably along the lines of Option 2. This reflects the Board's view that a rise in average interchange fees would likely be evidence that, despite its best efforts, insufficient competitive forces had been able to be brought to bear on these fees.

A significant issue with this option is timing. The Board understands that some of the changes being contemplated are substantial and will take time to implement. On the other hand, experience suggests that industry-based reforms can take longer than is strictly required.

The Board is proposing that the current interchange arrangements remain in place for the time being and that at its August 2009 meeting it re-assess the progress made in improving the competitive environment. If at that meeting it was decided that inadequate progress had been made, the Board would consider implementing arrangements similar to those outlined under Option 2. At that point it would release revised Standards for consultation, with a likely implementation date in the first quarter of 2010.

If instead, the various issues had been adequately addressed by August 2009, the Board would take steps to remove interchange regulation, with the likely implementation date in the first quarter of 2010.

In the interim, the Board intends to make a technical modification to the Standards to avoid industry undertaking the currently scheduled cost studies in 2009. The card schemes will, however, still be required to comply with the current benchmark on 1 November 2009.

The Board is prepared to implement any new arrangements earlier than indicated by the above timetable if industry is able to make the requisite changes relatively quickly. It is also prepared to require changes through regulation to the honour-all-cards rule and transparency before August 2009 if it is clear that the schemes are unwilling to make the necessary changes, and that doing so would allow a more timely implementation of a new regime. Achieving such changes voluntarily is, however, preferable.

7. Summary of the Main Conclusions

This section summarises the main preliminary conclusions of the Review and the Board's proposed direction for the regulation of card payment systems in Australia.

1. In the Board's view, the reforms have met their main objectives of: improving price signals in the Australian payments system; increasing transparency; improving access; and creating a more soundly based competitive environment. The reforms have improved competition and efficiency in the payments system, contributing to an improvement in overall resource allocation and substantial welfare gains to the community.

2. The Board acknowledges that the reforms have not affected all parties equally. In particular, those who use EFTPOS and cash are more likely to have been made better off as a result of the reforms than those who use credit cards extensively and pay their balances off by the due date. Previously, this latter group was receiving significant benefits, partly at the expense of the former.
3. Close oversight of retail payment systems will continue to be necessary. To a large extent, this stems from the way in which competition between merchants affects their ability to decline to accept payment cards. The competitive environment means that, in aggregate, merchants are prepared to pay more for credit card acceptance than the benefit they receive. In the past, this distortion has been amplified by various rules that have been imposed on merchants by the schemes.
4. The Board sees no case for allowing the schemes to re-impose their no-surcharge rules. It has considered altering the existing Standard to allow schemes to limit the size of any surcharge, but is of the view that such a restriction is unnecessary and would limit the competitive pressure on interchange fees that can be imposed by merchants.
5. The Board sees no case for allowing the schemes to re-impose their earlier honour-all-cards rules. Indeed, it is proposing further changes to scheme rules to ensure that merchants can make independent acceptance decisions about pre-paid cards. It is also proposing changes that would prohibit merchants being penalised with higher interchange fees if they do not accept all cards of a scheme. These changes could be made voluntarily by the schemes, but if this does not occur, the Board would consider imposing the changes through regulation.
6. The Board is proposing to retain the various Access Regimes. While access has been improved as a result of the reforms, further improvements are necessary, particularly to those systems based on bilateral contracts. With the current technology in a number of these systems nearing the end of its life, the Board encourages the industry, as a matter of priority, to examine alternative approaches that would address this issue and possibly allow entry on the basis of one connection only.
7. The Board sees a strong case for further improving the transparency of the payments system. In particular, average interchange fees and average scheme fees should be published regularly. The Board also sees advantages in clarifying the conditions surrounding bypass of scheme switches. Ideally, the schemes would provide this information voluntarily, although the Board is prepared to consider regulation if that is necessary.
8. While the Board sees a strong case for ongoing interchange regulation, it is prepared to step back from the regulation of these fees on the condition that industry takes further steps to improve the competitive environment. This option is now able to be considered as a result of the significant changes in the environment that have taken place over recent years as a result of the previous reforms. The Board remains of the view that these reforms – including the forced reduction of interchange fees – were appropriate given the state of competition that applied at the time.
9. The specifics of developments over the next year will be crucial in convincing the Board that its concerns about efficiency and competition would continue to be addressed if it removed interchange regulation. The Board has identified changes in three areas that would, in its opinion, further strengthen the competitive environment. These include: changes to the

EFTPOS system that would enhance competition; modifications to the honour-all-cards rule in addition to those discussed in point 5; and greater transparency around scheme fees and average interchange fees.

10. In the Board's view, if changes are not made to the EFTPOS system there is a significant risk that, in the longer term, the current system will not be able to compete effectively with the international card schemes. Without an effective competitor, the Board's view is that the case for allowing the industry to set interchange fees free of regulation is significantly weakened. In terms of specifics, the Board has identified a number of changes to the EFTPOS system that would be expected to improve the competitive environment. These include:
    - (i) the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make decisions about multilateral interchange fees;
    - (ii) the creation of effective arrangements to promote the development of the system;
    - (iii) reform of current access arrangements; and
    - (iv) the development of alternative payment instruments for use in on-line payments (either by the EFTPOS scheme or through another channel).
11. If the Board is to step back from interchange regulation, it is proposing that the honour-all-cards rule be modified to allow merchants to make independent acceptance decisions for each type of card for which a separate interchange fee applies. This change could be made by the schemes. If this does not occur, the Board will consider the case for making this change through regulation.
12. If the above steps to improve the competitive environment are not made within a reasonable time, the Board's current thinking is that interchange regulation would continue, although changes would be made to the current Standards. In particular, the Board would consider establishing a common benchmark for interchange fees in the EFTPOS and scheme debit systems of around 5 cents (paid to the issuer) and a further reduction in the credit card interchange fee benchmark to around 0.30 per cent. A number of technical changes to the operation of the interchange Standards would also be made.
13. If interchange regulation is to continue, the Board would not require the modification of the honour-all-cards rule discussed in point 11 above, as interchange fees would be constrained primarily by regulation, rather than through competitive forces.
14. The Board is conscious that the changes being suggested will take time for the industry to implement. It is proposing to take stock of progress in August 2009. At that time, it would decide whether to proceed to modify the Standards along the lines outlined in point 12 or remove the existing interchange fee Standards. Changes to the arrangements would then likely be effective in the first quarter of 2010.
15. If the Board did remove its regulations on interchange fees, and average fees in the credit card systems subsequently rose materially, the Board would consider the reimposition of interchange regulation, along the lines discussed in point 12. Although the Board recognises that interchange fees may well be higher in a deregulated environment than in the regulated environment, a substantial rise in these fees would likely signal that insufficient competitive forces had been able to be brought to bear on these fees.

16. The Board welcomes initiatives by industry participants to develop arrangements that would allow the industry *itself* to address the Board's concerns around competition and efficiency. The Board notes, however, that specific proposals are yet to be agreed upon.

8. Next Steps

The Board's conclusions set out in this document are preliminary, and the Bank is now seeking submissions from interested parties on these conclusions and the analysis set out in this document. Submissions should be sent by 30 June 2008 to:

Head of Payments Policy Department   or   pysubmissions@rba.gov.au
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

All submissions will be posted on the Bank's website (www.rba.gov.au) and parties making submissions will have the opportunity to discuss them with the Bank. Following consultation, the Board aims to release a document setting out its final conclusions in late August/early September 2008.

Appendix 1: Submissions

The Reserve Bank received a total of 27 submissions from the following organisations or individuals in response to the Issues Paper. Submissions are available on the Bank's website.[14]

Abacus Australian Mutuals Pty Ltd

ACIL Tasman Pty Ltd (on behalf of American Express Australia Limited)

American Express Australia Limited

Australia and New Zealand Banking Group Limited

Australian Bankers' Association

Australian Merchant Payments Forum

Australian Payments Clearing Association

Australian Settlements Limited

Bank of Queensland Limited

BPAY Pty Ltd

Commonwealth Bank of Australia

Cuscal Limited

Diners Club

Dr Alan Frankel (on behalf of the Australian Merchant Payments Forum)

Professor Joshua Gans

GE Money

Indue Limited

Mr Peter Mair

MasterCard Worldwide

National Australia Bank Limited

PayPal Australia Pty Ltd

St George Bank Limited

Tyro Payments

Village Mall Pty Ltd

Visa International

Westpac Banking Corporation

Woolworths Limited

14 *http://www.rba.gov.au/PaymentsSystem/Reforms/RevCardPaySys/responses_issues_paper.html*

Appendix 2: Possible Modifications to Existing Standards

If Options 1 or 2 were adopted, the Board sees a strong case for making a number of changes to the existing Standards to enhance their functioning. These are discussed below.

1. The Frequency of Cost Studies and Benchmark Recalculations

Through the consultation process a number of institutions have argued that there are high compliance costs associated with having to undertake cost studies every three years for the interchange Standards. Estimates of these costs provided to the Bank suggest that complying with the initial benchmark in 2003 cost financial institutions in the order of $1 million.

In the Board's view, the benefit from frequent cost studies is relatively small. As has been discussed elsewhere, the Board does not see interchange as being explicit compensation for particular costs that institutions incur in providing payment services. Rather, the cost studies have been used to establish transparent benchmarks for the setting of interchange fees. Having established these benchmarks, the case for updating the cost studies on a regular basis is not particularly strong, especially given that changes in costs do not necessarily justify changes in interchange fees. By eliminating the need to undertake these cost studies, compliance costs would be reduced and, at the margin, less frequent recalculation of the benchmark might also assist in longer-term planning.

The Board's preferred approach is to simply remove the need for any further cost studies and recalculation of the benchmark. Under this approach, all interchange Standards would be based on the credit card cost studies conducted in 2006. If at some future point, the Board decided to review the level of average interchange fees a new cost study could be undertaken, or the costs included in the Standards could be amended.

2. Compliance Arrangements

One issue that was raised in the consultation process was whether the compliance aspects of the Standards (particularly the credit card interchange fee Standard) were affecting competition between schemes.

The compliance arrangements have been under review for some time, with the Board seeking submissions in December 2006. Of particular interest has been whether the use of backward-looking, scheme-specific weights to calculate each scheme's weighted-average interchange fee meant that a scheme with a relatively high weight in a category with a high interchange fee was disadvantaged. Some industry participants have also expressed a concern that the weighted-average interchange fee was moving above the benchmark between the three-yearly compliance dates.

The compliance arrangements will also need to be reviewed if, as is discussed above, the three-yearly cost studies are no longer undertaken, as the existing Standards only require the schemes to meet the benchmark when the benchmark is recalculated (or when interchange fees are changed).

Three main suggestions for changing the current arrangements have been proposed by industry participants:

(i) using industry, rather than scheme-specific, weights in the compliance calculations;

(ii) requiring all interchange fees (rather than the weighted-average) to be below the benchmark; and

(iii) more frequent compliance.

Modifying the Standards so that the weights in the compliance calculation are determined using proportions of transactions across the whole industry presents some considerable practical difficulties. In particular, the schemes would somehow need to agree on common categories for the compliance calculations, and the categories would probably need to be included in the Standards. The Board is of the view that this approach introduces considerable complexity to the regulations and increases compliance costs with no increase in efficiency and competition. It therefore is not in favour of such an approach.

Modifying the Standards to require that all interchange fees be below the benchmarks has the advantage of simplicity. However, this change may reduce competition by inhibiting the ability of the four-party card schemes to compete with three-party schemes in the premium and commercial cards markets. It could also lead to all interchange fees being set at the cap to maximise the interchange revenue available to issuers. This would reduce the likelihood of particular incentives, such as for the installation of chip-capable terminals, being created through the interchange fee structure. The Board is therefore not in favour of this approach.

Increasing the frequency of the compliance calculations could help address concerns about competitive neutrality by reducing the incentive for issuers to switch schemes to take advantage of a high interchange fee in a particular category. As the weight of the high-fee category grows, the scheme will have to lower its fee in order to meet the benchmark. But since this would happen on a shorter time frame than currently, it may reduce the benefit that issuers can obtain from exploiting the difference in fees. This approach would also limit the degree to which the average could drift above the benchmark between calculations.

The Board has considered two main possibilities: annual compliance and 'continuous' compliance. Annual compliance is administratively more straightforward and would avoid the possibility of schemes 'accidentally' being in breach of the Standard because of unanticipated changes in the composition of spending. A number of acquirers have, however, expressed concerns that a move to annual compliance might lead to more frequent changes in interchange fees and thus additional costs to them due to the more frequent need to reprice acquiring services.

The Board's preliminary conclusion is that if interchange regulation remains, compliance should be annual. It would welcome feedback on the costs and benefits of such a change and whether there are other schedules or options that would address concerns over the effect of the compliance arrangements on scheme competition and average interchange fees.

3. Cash-out for EFTPOS

Under the current arrangements, interchange fees on transactions involving a cash-out are excluded from the EFTPOS interchange fee Standard. This reflected a view by the Board that if ATM interchange fees were not regulated, the case for regulating interchange fees on cash-out transactions was not particularly strong. Since that time, however, the ATM industry has agreed to reform involving the removal of interchange fees in ATM networks. Given this development, the exemption for cash-out transactions could beneficially be removed. Doing so would simplify the setting of interchange fees in the EFTPOS system with correspondingly lower costs for industry participants and easier access, and would be unlikely to have any detrimental effect related to relativities with the ATM system.

The Board's preliminary conclusion is, therefore, that if interchange regulation is maintained the exemption for cash-out transactions in the EFTPOS interchange fee Standard be removed.

Glossary of Terms and Abbreviations

ACCC	Australian Competition and Consumer Commission
Acquirer	An institution that provides a merchant with facilities to accept card payments and clears and settles the resulting obligations with card issuers.
ADI	Authorised Deposit-taking Institution. A body corporate authorised to undertake banking business in Australia. ADIs are authorised and regulated by APRA under the *Banking Act 1959*.
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
BPAY	A payments organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay BPAY billers using electronic transfers initiated by phone or internet.
Card issuer	An institution that provides its customers with debit, credit or other payment cards.
Charge card	A card whose holder has been granted a non-revolving credit line, enabling the holder to make purchases and possibly cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.
Credit card	A card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit. The credit granted can be settled in full by the end of a specified period, or in part, with the balance taken as extended credit.
Debit card	A card that enables the holder to access funds in a deposit account at an ADI.
Designation	The first formal step by the Reserve Bank toward exercising powers conferred by the *Payment Systems (Regulation) Act 1998*. The Bank may subsequently impose standards or access regimes on a designated system, or arbitrate a dispute in relation to the system.
Direct entry system	A system used for bulk or batch-processed payment transfers between deposit accounts, typically on a next-day settling basis.
EFTPOS	Electronic Funds Transfer at Point of Sale. In Australia, EFTPOS transactions are authorised by personal identification number (PIN) and make use of processing infrastructure owned and operated by the domestic financial institutions.
Four-party card scheme	MasterCard and Visa are known as 'four-party' card schemes because four parties are typically involved in the payment process. The four parties are: the cardholder; the issuer; the acquirer; and the merchant.

Honour-all-cards rule	A rule that requires participating merchants to accept all cards issued under a particular scheme.
Interchange fee	A fee paid by the card acquirer to the card issuer, or *vice versa*, when a cardholder undertakes a transaction.
Merchant service fee	A per-transaction or *ad valorem* fee paid by a merchant to the acquirer when a cardholder undertakes a transaction.
No-steering rule	A rule that prevents merchants from steering cardholders to other forms of payment.
No-surcharge rule	A rule that prevents merchants from charging a fee for card transactions.
Pre-paid card	A card 'loaded' with a given value, paid for in advance. The card may be reloadable, or limited to initial purchase value.
Revolvers	Credit card holders who do not pay off their account in full by the end of the interest-free period.
Scheme debit card	A debit card issued under one of the international card schemes. Funds are drawn from the cardholder's deposit account at an ADI, utilising the processing infrastructure of the card scheme, rather than the EFTPOS system.
Scheme fees	Fees paid by both acquirers and card issuers to the card scheme.
Specialist Credit Card Institution	An ADI that engages in, or proposes to engage in, card issuing and/or acquiring, but does not otherwise conduct banking business.
Switch	A system that facilitates the exchange of payment messages between participants in a payment system.
Three-party card scheme	American Express and Diners Club are known as 'three-party' schemes. These schemes generally (although not always) act as sole issuers and acquirers, therefore the three parties involved in the payment process are the cardholder, the merchant and the scheme.
Transactors	Credit card holders who pay the full outstanding balance on their account by the end of the interest-free period.