About CMSPI

CMSPI is a global leader in retail payments consulting. Our expert team works to empower the retail community with insights, expertise, benchmarking, and analysis to drive value in their payments supply chain. This consultation response was constructed by CMSPI's market-leading '***Insights Team***', which is made up of economists, data and statistical experts, and experienced payments professionals. We have structured our response to reflect the key areas of the consultation document in which CMSPI can offer unique insights.

CMSPI Response to the Reserve Bank of Australia

CMSPI welcomes the Reserve Bank of Australia Payment Systems Board's Review of Retail Payments Regulation and recognizes the RBA's role as a market-leading regulator within payments. CMSPI also appreciates the support the RBA has provided to the merchant community through proactive regulation and incorporating merchant feedback into their proposals.

CMSPI's response to the RBA's consultation focuses firstly on Least-Cost Routing (LCR), with particular attention given to the proposals surrounding online and digital wallet transactions, before addressing surcharging, interchange and scheme fees, and the market for merchant acquiring. It then draws on international experience of similar issues within payments and summarizes key findings.

Card Routing

As the Review notes, limiting the ability of Australian merchants to take advantage of Contactless Routing – and the resulting restriction of competition – can impose significant costs on the payments ecosystem.. RBA data suggests that the average fee for a debit card transaction via the two largest international networks was 72.68% higher than for the equivalent transaction via Eftpos in 2020.[1] It is therefore imperative that merchants are able to access the Eftpos network and competitive pressures allowed to reduce this differential in the long-run.

One key barrier to the benefits of Contactless Routing, as noted in the Review, is the issuance of Single Network Debit Cards (SNDCs). SNDCs remove merchant and consumer choice with respect to routing. A significant cost differential already exists where this practice is effectively in place, with each scheme:

- Visa's "Tokenized Contactless – purchase amount > AUD15" interchange attracting a fee of $0.15 per transaction compared to their "Card Present – Standard Debit Products" fee of $0.04. [2]

[1] CMSPI estimates and analysis from Reserve Bank of Australia data. See C3 Average Merchant Fees for Debit, Credit and Charge Cards. Available at: https://www.rba.gov.au/payments-and-infrastructure/resources/payments-data.html

[2] https://www.visa.com.au/about-visa/interchange.html#2

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- Mastercard's "Tokenised Contactless – Other (> AUD 15)" item commands a fee of $0.15 compared to "Other Card Present – Standard" at $0.04.[3]
- EFTPOS proprietary cards command interchange of $0.11 for "Other Categories – In Store" compared to the priority 2 card with a $0.04 fee.[4]

CMSPI therefore welcomes the Board's efforts to discourage the issuance of SNDCs by reducing their associated interchange fees.

Although the proposal is a positive step in securing competition for a portion of card transactions, there are a number of additional measures that would ensure widespread adoption of Contactless Routing. One such measure would be a regulatory mandate requiring that all debit cards are DNDCs. This step has already been taken by regulators in the U.S., where the 2011 Durbin Amendment required that all debit cards be badged with at least two unaffiliated networks. Although there are concerns around the unique pressures faced by smaller issuers, in CMSPI's experience the relative cost of supporting two networks on each card has not been a significant concern in other jurisdictions.

Another measure to guarantee the competitive benefits of a local card network in the long-run would be to extend Routing to other, currently non-routable transaction types. As it stands, merchant routing choice in Australia is typically only available for domestic, in-store, contactless debit transactions on DNDCs that do not sit within a digital wallet. According to CMSPI estimates, that limits LCR potential to around 7.32% of the total value of domestic card transactions. Figure 1 illustrates the proportion of routable transactions once each additional limitation is added. Although contactless transactions make up a relatively large share of transaction volume (around 77% of in-store card transactions in 2019, according to the Consumer Payments Survey[5]), the Figure illustrates that contactless payments are estimated to be responsible for a smaller share of the market in value terms.[6]

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[3] https://www.mastercard.com.au/en-au/about-mastercard/what-we-do/interchange.html
[4] https://www.eftposaustralia.com.au/interchange-fees-and-principles
[5] See Caddy, Delaney and Fisher (2020). Consumer Payment Behaviour in Australia: Evidence from the 2019 Consumer Payments Survey. https://www.rba.gov.au/publications/rdp/2020/2020-06/full.html
[6] Note: these figures do not include the temporary increase in the contactless limit by some retailers to $200.

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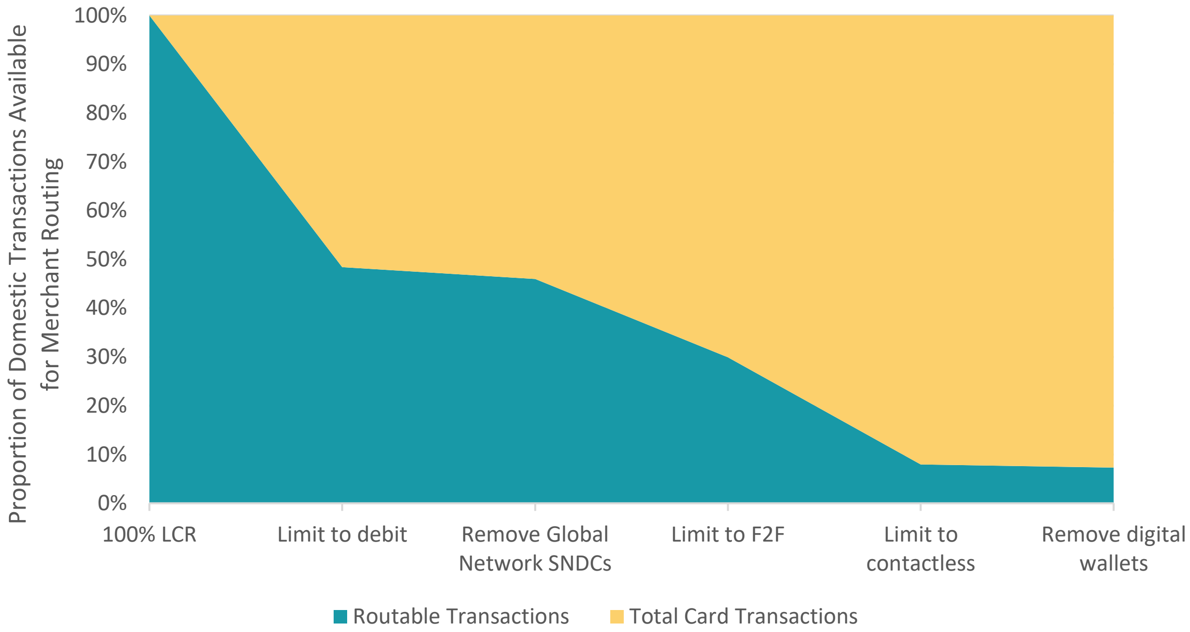

Figure 1. Limitations to the proportion of transactions available for merchant routing in Australia by value.[7]

Restrictions on the availability of Routing have a significant cost impact on Australian merchants. Comparing the average merchant fees of the Eftpos and global card networks (as published by the RBA), CMSPI estimates that extending Routing to all aforementioned transaction types could save Australian merchants around $2.3 billion annually. This figure assumes a best-case scenario whereby all transactions for which Routing is available are routed optimally. In CMSPI's experience, however, this is unlikely to be the case; even for in-store contactless transactions, merchants are often unable to access Routing or lack awareness of the benefits available.

Figure 2 illustrates how the average merchant cost is affected by limitations to Routing. For context, the estimated impact of a lack of Routing for other transaction types amounts to approximately 0.36% of the value of all domestic card transactions in Australia.[8] Reducing the issuance of SNDCs is therefore a positive step in reducing costs and protecting the local Eftpos network. If the local network were lost, even assuming that average global network fees remained at their current rate, CMSPI estimates that merchants could stand to lose a routing opportunity of $180 million annually. This is even with current routing restrictions in place. As such, to ensure a significant impact on merchant

[7] CMSPI estimates and analysis
[8] CMSPI estimates and analysis based on Euromonitor International (2021) data

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costs, the RBA should consider three additional provisions: extending Routing to other transaction types, implementing an explicit co-badging mandate, and ensuring that all merchants have access to Routing on those transactions for which it is available on an opt-out basis.

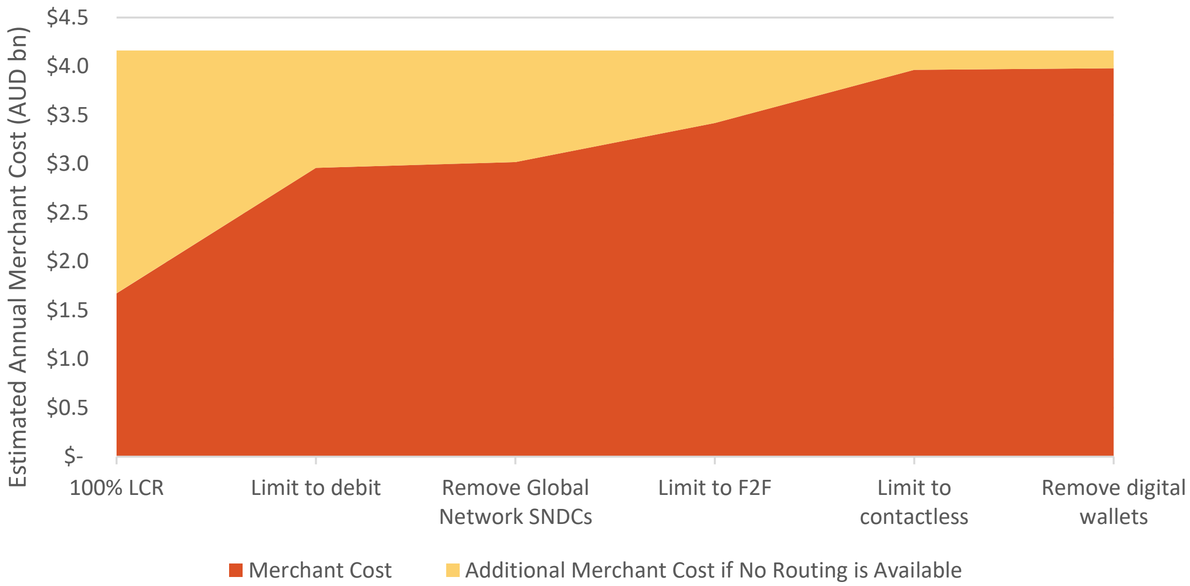

Figure 2. Estimated annual merchant cost of limitations to Routing in Australia.[9]

Digital Wallets

By focusing on the average merchant service charge, the $2.3 billion figure underestimates the impact of digital wallet transactions, whose interchange fees are often significantly above the average, as detailed previously. Although acknowledged in the Review, the Board's current proposals do not allow merchants choice over the routing of these transactions. This is on the grounds that merchants would be overriding an implicit consumer choice. However, the extent of customer participation in said choice is limited; card-backed digital wallets such as Apple and Google Pay typically route via the global card network by default, requiring the consumer to take multiple steps within the app to alter their network choice.[10]

[9] CMSPI estimates and analysis
[10] See the steps required to change the default network to Eftpos within the Apple Pay wallet: https://support.apple.com/en-bn/HT209137

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With digital wallets forecasted to take up a growing share of the payments mix and the Covid-19 pandemic having quickened their adoption,[11] leaving routing restrictions unaddressed could generate a serious barrier to competition in the long-run. This is particularly so given that Apple currently does not allow third parties to access its NFC technology – a development that is under scrutiny from the European Commission.[12] Furthermore, there is a concern that these transactions could be used to cross-subsidise strategic rates with the global networks, similar to the 'tying conduct' referenced in the case of credit cards. As a result, extending the requirements of Routing to digital wallet transactions – by mandating that dual tokenization be enabled by their providers - is necessary to safeguard competition in the long term.

Online Transactions

Another area in which Routing remains in its infancy, as noted by the Review, is online commerce. CMSPI estimates suggest that a lack of LCR in the card-not-present space could cost Australian merchants around $0.4 billion every year. Based on 2019 ecommerce usage, this figure is likely to have increased with the Covid-19 pandemic. CMSPI therefore welcomes the Board's measures to encourage competition in the ecommerce environment. However, the proposals still lead to a form of Routing that is more limited for merchants than in the face-to-face environment. This is partly due to claims over security. In its work, CMSPI has not observed material differences in the security afforded to users by global and domestic card networks online. In 2018, for example, the Nilson Report's review into global card fraud found a fraud loss of 7.37 cents per US$100 with the global card brands compared to just 2.01 cents with domestic networks.[13] CMSPI therefore believes that merchant routing choice should be protected online.

Surcharging

The Board's proposed caveats towards online and digital wallet Routing rest on the protection of consumer choice. CMSPI recognizes the importance of this choice in driving innovation and improving customer experience. However, there is a concern given the unique structure of the payments market that the maximization of consumer choice could lead to higher fees for merchants and therefore higher prices for consumers. This is because, as the Review notes, surcharging is not a widespread practice in Australia. Consumers are therefore largely indifferent between payment types regardless of the costs they impose on businesses. Given many retailers' low operating margins (particularly relative to the financial services industry), it is more likely that a retailer may have to factor these costs into their overall pricing decisions as average acceptance costs grow. In fact, taking

[11] https://www.finextra.com/newsarticle/38081/digital-wallets-poised-to-overtake-contactless-cards-as-instore-payment-of-choice-in-australia?utm_medium=newsflash&utm_source=2021-5-19&member=86967

[12] See https://www.bloomberg.com/news/articles/2020-09-17/apple-pay-tech-likely-to-be-open-to-rivals-in-rules-mulled-by-eu

[13] Nilson Report No. 1164.

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findings from the EY Interchange Fee Regulation Review[14] and the Shapiro Study[15] (covering the European Union and U.S. regulation, respectively), CMSPI estimates that 71% of any reduction in card fees is typically passed on to consumers in the form of lower prices.[16] It is therefore crucial for both merchants and consumers that the party directly affected by pricing differentials is the one whose free choice is maximized.

In the case of payments, the market failure that occurs when the pricing mechanism fails to reflect underlying costs could theoretically be rectified through surcharging. However, in 2019 the Consumer Payments Survey found that just 4% of transactions in Australia attracted a surcharge.[17] The Review suggests this lack of surcharging may reflect a general belief amongst Australian merchants that card acceptance costs are 'sufficiently low'. However, from CMSPI's experience working with merchants it is likely that this is instead a reflection of a competitive retail environment. The Consumer Payments Survey also found that 1 in 4 respondents surveyed would avoid a merchant altogether if presented with a surcharge on their preferred payment method. Particularly given the turbulence of 2020, this is not a chance that many – especially smaller - merchants can afford to take.

Even if merchants sought to exercise their ability to surcharge, which the Review suggests can generate competition and lower costs, they are often unable to do so for one of the most expensive payment methods available: Buy Now Pay Later (BNPL). Data from Worldpay suggests that 10% of online transactions in Australia were made through BNPL providers in 2020.[18] Many such providers have implemented their own 'no surcharging' rules. The Review states that there are no current proposals to require the removal of these rules on the grounds that such measures can encourage innovation and competition in the short term. However, in the online environment, BNPL has arguably already reached critical mass. Unlike in the case of cards, online BNPL rates are unregulated and typically sit upwards of 3%. In the absence of action on the fees charged by these providers, no surcharging rules give merchants – who are often forced to accept BNPL precisely due to its significant market share – no avenues through which to limit their costs through competition. CMSPI therefore believes that no surcharging rules in the BNPL space warrant urgent intervention.

Interchange Fees

In tackling merchant acceptance costs, one area in which the RBA has been highly proactive is interchange fees. One of the first jurisdictions to explicitly regulate interchange, CMSPI estimates

[14] See European Commission Study on the Application of Interchange Regulation
[15] Shapiro, R.J. (2013). The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees.
[16] CMSPI (2020). Global Review of Interchange Fee Regulation. https://cmspi.com/eur/resources/download-global-interchange-report/
[17] See Caddy, Delaney and Fisher (2020). Consumer Payment Behaviour in Australia: Evidence from the 2019 Consumer Payments Survey. https://www.rba.gov.au/publications/rdp/2020/2020-06/full.html
[18] Worldpay Global Payments Report (2021)

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suggest that Australia's interchange fee regulation could save merchants around $1.48 billion annually.[19] This figure is based on 2019 volumes and therefore does not reflect the relative increase in card usage in 2020. Although total expenditure fell with the Covid-19 pandemic, estimates suggest that the share of transaction value made with cards increased by 2.9% from 2019.[20] In absolute terms, between 2017 and 2020 the estimated total value of card transactions increased by around $54.2 billion.[21] These volumes can translate into substantial economies of scale for issuing banks. With the Covid-19 pandemic often suggested to have generated a long-term shift in consumer behaviour towards greater card usage, CMSPI encourages ensuring that the associated savings are passed onto merchants in the form of revised interchange caps during the next Review.

Scheme Fees

Alongside interchange, scheme fees are an increasingly costly component of merchants' card acceptance costs. Analysis of RBA data suggests that the average scheme fee in Australia rose by around 500% between 2006 and 2013.[22] A similar phenomenon is observable across multiple markets within our data, particularly following interchange regulation. As such, CMSPI strongly welcomes the Board's recognition of scheme fees as a concern for merchants, and its proactive efforts to increase visibility over their composition. In their current format, scheme fees are incredibly complex and genuine expertise is needed to generate meaningful insights from raw scheme fee data. CMSPI works with merchant-level scheme fee data on a daily basis and would therefore welcome the opportunity to collaborate with the Reserve Bank of Australia, as we have with other regulators, to provide quantitative evidence of the impact of scheme fee changes on the merchant community.

Merchant Acquiring

The final element of the RBA's consultation that CMSPI seeks to address is competition in the market for merchant acquiring. Alongside the high costs of change noted in the Review, it is important to note other limitations to competition, as well as how merchant fee data may imply greater competition in the acquiring market than end users experience. In Australia, the largest 4 acquirers hold approximately 90% of the market, according to CMSPI's insights. Their position as both issuers and acquirers can allow them to take advantage of on-us processing, thereby reducing their scheme fee burden and generating the ability to undercut potential competitors. This can lead to additional complexity; on-us transactions may create the appearance of a lower acquirer fee, just as strategic rates between card networks and acquiring banks can serve to obscure underlying rates. As in the scheme fee case, CMSPI would welcome the opportunity to support the RBA's efforts through its data insights.

[19] See CMSPI's Global Interchange Report
[20] CMSPI estimates and analysis based on Euromonitor International (2021) data
[21] Ibid
[22] Reserve Bank of Australia data

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International Comparisons

As a global payments consultancy, CMSPI is able to observe trends in card payment costs and merchant routing choice internationally and draw parallels with the Australian experience. Like Australia, other regions have experienced increases to scheme fees since interchange regulation that have served to increase the cost of card acceptance over time. In Europe, for example, CMSPI estimates that increases to scheme fees since Interchange Fee Regulation in 2015 amount to an additional merchant cost of around €1.46 billion annually across the continent.[23] If the average Australian scheme fee reached the level of its European counterpart, our estimates suggest that this could increase annual costs by around $0.33 billion. It is therefore vital that scheme fees are addressed and considered in relation to global trends.

Similar international comparisons can be drawn when considering local debit networks. Europe has seen the abandonment of multiple local networks over the past decade, including Finland's pankkikortti (ended in 2013), Ireland's Laser (2014), the Netherlands' PIN (2012), and Luxembourg's Bancomat (2011).[24] In those countries where a domestic network remains, merchant routing choice can be pivotal. Figure 3 compares the market shares of local and global card networks in Italy and Germany. Both countries share a local debit network that is available in-store. However, in Italy routing choice lies with the consumer at the POS, whereas merchants in Germany typically have routing choice over their transactions. Between 2015 and 2019, the market share of Italy's Pagobancomat is estimated to have declined by approximately 7 basis points, whereas Germany's Girocard network continues to grow. From CMSPI's experience, ensuring that merchants are able to leverage competition between multiple available networks is crucial in preserving a competitive environment.

[23] See the CMSPI & Zephyre Scheme Fee Study (2020)

[24] Centre for European Reform (2021). *Don't imitate – innovate! Why Europe doesn't need a rival to Visa and Mastercard.*

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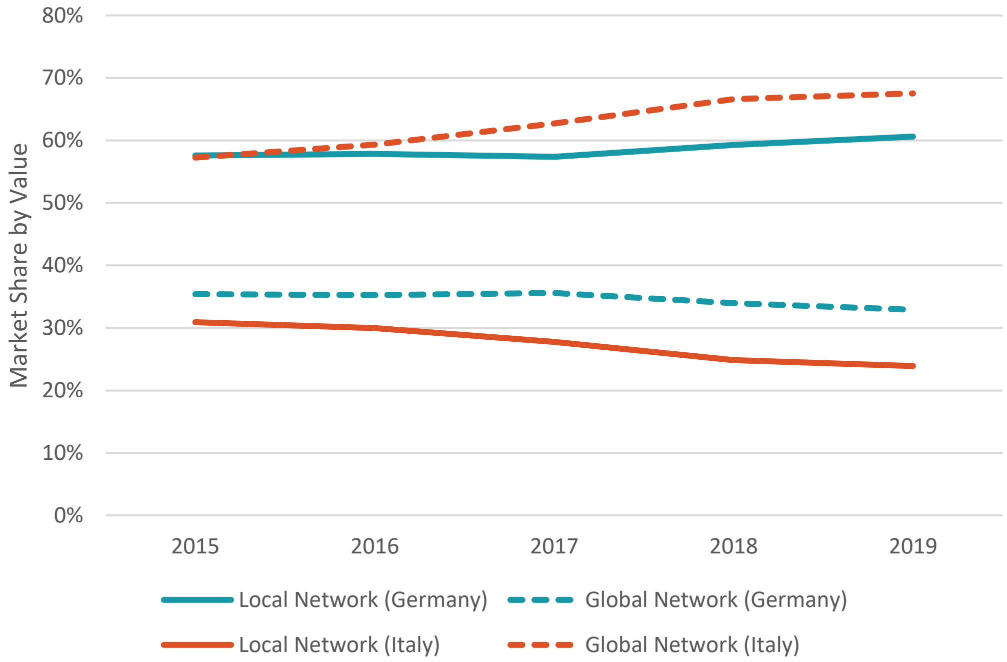

Figure 3. Estimated market share by value for international and global networks in Germany and Italy.[25]

Even in Germany, however, there have been increasing reports of the issuance of SNDCs which bypass the local debit network, generating similar concerns to those expressed in the Review.[26] In the absence of a regulatory mandate around co-badging, this remains an ongoing risk to competition.

In contrast, U.S. regulation requires that all debit cards must be badged with at least two unaffiliated networks. Over the period 2011-2019, analysis of Federal Reserve data suggests that the cost of single-message debit transactions for exempt issuers (to whom interchange caps do not apply) decreased by 5 cents on average.[27] This provides evidence that mandated competition has the ability to exert continuous downward pressure on prices even outside of interchange caps. In contrast, dual-message debit transactions – which do not have mandated merchant routing choice – saw their average price increase by 3 cents over the same period. International experience therefore suggests

[25] CMSPI estimates and analysis based on Euromonitor International (2021) data
[26] See Kirchner (2021). https://finanz-szene.de/payments/girocard-gegen-den-rest-der-welt-die-grosse-analyse-zum-deutschen-kartenmarkt/
[27] CMSPI analysis of Federal Reserve (2021) data. See Federal Reserve (2021). 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions. https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2019.pdf

that regulatory intervention to mandate co-badging is a key method through which competition can be sustained in the long-run.

Summary

CMSPI recognizes the industry-leading work of the Reserve Bank of Australia in its regulation of card payments. The most recent Review of Retail Payments Regulation brings a number of positive developments such as increased attention towards scheme fees - an area in which merchants globally have been advocating for increased regulatory scrutiny. Alongside this, the emphasis on Routing has the potential to protect the domestic card network and promote greater competition in the long-run.

However, we believe there are a number of ways in which the Board's proposals could be strengthened. These include the extension of Routing requirements to currently non-routable transactions, as well as a mandate to ensure that all debit cards are co-branded. In the absence of such measures, it is typically smaller merchants who bear the burden of high prices and opaque charging structures. CMSPI would also like to offer its support to the RBA in providing greater visibility over underlying card acceptance costs and their impact on Australian merchants.

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