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Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By on-line submission

Email: fsi@treasury.gov.au

Dear Sir/Madam,

Response to Financial System Inquiry Final Report – Recommendation 17 & Interchange fees & customer surcharging

Thank you for considering this response concerning the impact of Australian regulation of credit card payments and systems on our business, and for the opportunity to address the issues raised in the Inquiry's interim report in relation to improving the economic efficiency of the credit card system as described in Recommendation 17.

Our response is contained in Appendix 1. We have included Appendix 2 which re-iterates the principles and issues highlighted in our original submission. This provides additional context for response.
We would welcome the opportunity to discuss our submission.

Yours sincerely

Marion Johnstone

Marion Johnstone
Group Treasurer

Appendix 1

Response to Final Report
Recommendation 17

Our responses to questions and issues raised in the Interchange fees & customer surcharging section of the final reports are consistent with the principles and issue raised in our submission and included in Appendix 2:

1. **We agree that interchange fee caps should be broadened to cover the cost of companion cards**

2. **We agree that the PSB should replace the 3 year weighted average cap with a hard cap on fees, so that every interchange fee falls below an interchange fee cap, and we further agree that a lower of a fixed amount or fixed percentage rule should apply. In combination with this measure, the distinction between strategic and non-strategic merchants should be removed.**

   The credit card payment system is critical business infrastructure. The cost of processing a payment is not related to the size of the payment.

   It is important that the interchange fee cap should be substantially lower than the 3 year system average that applies today. It should reflect the low and falling cost of electronic processing, evidenced for example, by the costs of other form of electronic payment, such as EFT or EFTPOS, and be consistent with the levels in train for approval by European authorities, which following their exhaustive review, is set at a cap of 30 basis points, and in some states the lower of a 30bp cap and a fixed charge.

   Until this is done, with parity between non-strategic merchants and strategic merchants, non-strategic merchants will continue to cross subsidise strategic merchants and their customers, and suffer competitive disadvantage across an uneven playing field. As the Murray report acknowledged, the current system causes the transfer of value from non-strategic to strategic merchants due to the immense distinction in fees, and between cardholder categories (essentially, from non-reward cardholders to reward cardholders).

   We note that since the advent of the current regulatory 3 year weighted average cap, the range of interchange fees from highest to lowest and the number of cards categories has grown considerably. The small number of strategic merchants benefit from the system average cap due to their applicable fee table being so much lower than the average cap and therefore substantially lower than the aggregate and percentage fees paid by other merchants.

   The report also notes there is considerable cross subsidisation between cardholders, between the beneficiaries of high fee reward based cards and low fee cards. There is also cross subsidisation between credit card users and other payment mechanisms, such as EFTPOS and EFT. The imposition of an overall cap consistent with the cost of payment processing will promote economic efficiency by removing this area of cross subsidisation.

Noting some payment systems have no interchange fees applied at all, there is no conclusive case for the imposition of interchange fees, but rather, the case for a substantial reduction, if not elimination, is very strong on payment efficiency grounds.

It would be of no benefit to impose an overall limit on interchange fees, only to see that a range of other fees are imposed on merchants, typically non-strategic merchants. Accordingly, the cap must apply in totality across all fees charged to the merchant.

The three tier proposal in our view would be a fall-back position from a combination of a points charge and fixed fee, if for some reason that could not be implemented. However if the three tier approach is adopted it must allow transparency for the high fee cards to allow merchants to fully and appropriately cost recover the merchant charges from customers.

3. **We concur that there should be complete transparency of interchange and other fees for both merchants and cardholders. We also support ease and visibility in re-charging of fees to merchants.**

The card payment system providers should provide the merchant with the applicable interchange fee data in real time immediately prior to a customer payment, and provide the means for the applicable interchange & merchant fees to be directly recharged to the cardholder at the time of payment.

This would facilitate the levying of charges to the cardholder that reflect the charges incurred by the merchant, and provide full transparency to both merchant and cardholder.

At the present time, merchants have no mechanism to determine the cost of a card prior to its acceptance (noting this is relevant only to non-strategic merchants given the privileged below average rates applied on strategic merchant transactions). A merchant should have full visibility of card costs, as should cardholders.

Schemes and card issuers should be obliged to educate cardholders about the specific costs associated a cardholder's particular card so that cardholders will be made aware of the charges they can expect to be recharged to their card.

4. **Any constraints imposed on the recharging of reasonable costs by merchants to cardholders should be subject to implementation of the changes recommended in 1. to 3. above.**

It would be economically inequitable and unreasonable to constrain merchants from recharging their costs of accepting cards unless the system provides real time transparency and a mechanism to charge the actual cost to the particular cardholder. We oppose limits on the recharge of interchange and merchant fees on the basis that inappropriate cost recovery by certain categories of merchant is best dealt with by the recovery mechanisms proposed above.

It would be entirely inappropriate to place regulatory oversight in the hands of Schemes without implementation of the changes outlined in 1. to 3. above.

Provision of the applicable interchange and other fee data in real time immediately prior to a payment would ensure transparency to both merchant and cardholder. Application of fee caps which reflect system benefits and costs would promote payment efficiency.

This would provide more economically efficient price signalling to cardholders, remove cross subsidisation between the cardholders, and eliminate the question of over-recovery of costs by merchants.

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

Of course, if the approach to system fees was made consistent with that in train in Europe, being the lower of total percentage cap on fees or a dollar amount, the level of transparency of fees would be automatically increased.

Other matters

5. **There should be no distinction between "strategic" and "non-strategic" merchants in interchange fees.**

The distinction between "strategic" and "non-strategic" categories of merchant is anti-competitive, is a substantial value transfer from "non-strategic" merchants, and provides a very uneven playing field. The present system wide cap on interchange fees results in "non-strategic" merchants bearing the cost of cards over and above the interchange fee system level cap. A lower total cap will also have the impact of eliminating the cost impact of this distinction.

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

This would provide all participants with greater clarity on costs of this important payment mechanism. Importantly, it would also provide information on the level of cross subsidisation taking place across the system, and contribute some transparency while other regulatory charges are in implementation.

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7. **It is important that the RBA do everything in its power to encourage, prompt, and facilitate the development of alternatives other than credit card for consumer payments (both consumer present and online) which would enable the merchant to receive *immediate* cleared value regardless of the amount, including of amounts (say $2500) larger than those currently facilitated via EFTPOS, as a matter of urgency.**

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

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Appendix 2

Background to CSR Response

To achieve economically efficient payment systems, it is important that the regulatory framework:

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

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

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

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

- Interchange fees on many card categories are set at levels multiple times higher than the cost of processing transactions to enable card issuers to incentivise those categories of card holders with reward points.

- Merchants designated as 'strategic' receive highly preferential treatment, being charged interchange fees that are many times lower than interchange fees charged to other merchants, and that are much lower than the interchange fee cap (refer Scheme websites[2]). The Schemes and card issuers ensure they charge fees at the aggregate system level equivalent to the system "cap". To achieve this, interchange fees charged to 'non-strategic' merchants are charged at levels many times higher than the system "cap", which by default becomes the system average (as adjusted over time). The direct result is that 'non-strategic' merchants subsidise both strategic merchants, and shoppers at strategic merchants. This is both anti-competitive and economically inefficient.

- Strategic merchants are accordingly incentivised to accept cards that provide reward benefits to their card holder customers, given doing so is at the relative expense of their competitors. To remain in the competitive race with strategic merchants, non-strategic merchants must also accept cards. However, as strategic merchants effectively set the competitive tone, there is little potential for merchants operating in the industries dominated by strategic merchants to recover the disproportionate interchange fees.
- The claim that a system cap has reduced overall fees paid reflects the relative shift in sales among merchant categories in the economy, distortions in the calculation of the average, and the transfer in costs from strategic to non-strategic merchants; it does not mean that the system has become more economically efficient and lower cost.
- For those merchants seeking to recover interchange and merchant fees from cardholders, they can only do so at their average cost of accepting all cards. Merchants receive no information on the interchange cost of the particular card being presented, and Schemes and card acquirers and issuers provide no mechanism for merchants to recharge the specific cost of use to the presented card. This subsidises the rewards holders of expensive, rewards rich cards.
- Card issuing organisations are highly incentivised to issue cards to which reward mechanisms are attached. This incentivises their cardholder base to maintain loyalty to the card issuer at the economic cost of other participants in the system. We also understand that there is a significant delay between the accumulation of and claiming of rewards by card holders, providing further value transfer to card issuers.

- In relation to competitiveness between Schemes and payment alternatives:

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

The current "locks" on the system provide significant barriers to competition in this area. Barriers are evidenced by the 80%+ market share held by two Schemes, the parallels in pricing between Schemes for particular categories of cards, the lack of alternative mechanisms, and the lack of transparency to the merchant on the cost of accepting a card at the time of the card transaction takes place.

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

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

- Remove obstacles to a competitive payments system environment by eliminating regulations and Scheme rules that support and enforce cross subsidisation
- Apply the same standards to economic infrastructure as other forms of infrastructure; force unbundling of costs, and correct economic allocation by capping the level of interchange fees at no higher than 0.30%, with a maximum charge of less than $10, more reflective of transaction costs
- Remove distinctions between strategic and other merchants to remove anti-competitive structures
- Implement all necessary steps to ensure Schemes and card issuers provide automated differential fee recharging by merchants directly to the cardholder at the time of the transaction
- Roll out principles of open transparent pricing in real time, a level playing field for system users, remove regulation and system 'rules' which protect anti-competitive structures, and apply these principles to all payment systems and mechanisms
- Open and transparent publication and availability to the public of transaction data (including by merchant category, by Scheme, detailed fee data by merchant category, interchange fees paid to card issuers & retained by card acquirers).