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Head of Payments Policy Department,
Reserve Bank of Australia
GPO Box 3947,
SYDNEY NSW 2001

Submission by email: pysubmissions@rba.gov.au

Dear Sir/Madam,

We are pleased to provide our comments based on current commercial experience with the payments system. We have provided our overall comments and opinions in this letter with our detailed comments in attachment 1 and our response to the specific issues raised in the paper in attachment 2.

Overall Comments

Economically efficient payment systems are fundamental to Australia’s financial infrastructure and financial health, requiring (among other things) a regulatory framework that:

- Provides non-discriminatory access to all merchants and system participants
- Removes inbuilt economic cross subsidisation between categories of participants within a payment mechanism
- Delivers transparent transaction and system pricing, real time to all participants, in efficient ways with charges that are representative of the cost of resources to provide the payment mechanism
- Minimises the support for anti-competitive business structures and structural barriers to system competition.

Credit card payments play an important role in Australian payments, including in the Business-to-Business sector, growing from a relatively small portion of aggregate payments around 40 years ago. The Bank has recognised that today, credit cards are a “must take” payment mechanism, and that there are no practical alternatives in many situations.

The regulatory framework that underpins this payment mechanism and its industry structure is out-dated and does not reflect its mainstream role in commerce today. It entrenches anti-competitive practices at the system level, facilitates cross-subsidisation from merchants to other system participants, and limits economic efficiency through lack of timely transparency of pricing and costs. The RBA issues paper canvasses this in great detail, acknowledging that card payment systems are a critical part of the Australian payments infrastructure.



In our view, the recognition of card payments systems as critical financial infrastructure by the RBA needs to be similarly extended to the regulatory structure governing merchant and interchange fees, scheme mechanisms, timely transparent scheme pricing, and terms & conditions, recognising the inherently anti-competitive industry structure, and high levels of cross subsidisation provided by merchants to the other four beneficiaries of card payment system.

We recommend that all necessary steps be taken to ensure the card payments systems become economically efficient and competitive through the following:

- Remove obstacles to a competitive payments system environment, by eliminating regulations which support and enforce cross subsidisation
- Apply the same standards to economic financial infrastructure that are applied to other forms of infrastructure: focus the objectives of the card payment system on delivery of payment services, forced and transparent unbundling of costs and correct economic allocation. In Australia's highly mature card payments system, this is best achieved by the elimination of interchange fees and proxy charges entirely over a three to five year period, building to a model of recovery of economic cost from all system participants as incurred by those participants, and as an interim measure, by capping the level of interchange fees for credit and debit cards at no higher than 0.30% and 0.20% (respectively), subject to a maximum charge of \$2.
- Remove institutionalised distinctions between merchants with immediate effect and remove the rights of Schemes to arbitrarily provide price privileges, particularly between strategic and other privilege granted merchants, and all other merchants to remove anti-competitive structures
- Require real time card specific merchant and interchange fee data to be made available to the merchant and cardholder at the time of a transaction as a matter of high priority.
- Implement all necessary steps to facilitate 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.

We would welcome the opportunity to discuss our submission.

Yours sincerely,

Marion Johnstone
Group Treasurer

Attachment 1- Detailed Comments

With only two widely accepted card schemes, there is no evident competition between schemes, or evident mechanism to drive competition, only evidence that current regulations entrench the status quo and inadvertently drive a proliferation of high cost cards.

The system fee structure distorts the allocation of economic resources

- **It strongly incentivises the issue of expensive cards by card issuers**
 - **It strongly incentivises the use of expensive cards by cardholders**
 - **It distorts consumer decision making, as those who benefit from reward products are subsidised by other users of the system, including other consumers**
 - **Without transparency of fees at the time of the transaction, merchants cannot pass on the correct cost of the cardholder;**
 - **Schemes and card issuers withhold information which would provide transparency of cost and equity, and appropriate allocation of economic cost.**
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- Although card acquirers act as intermediaries with no contract in place between the merchant and each scheme, the card schemes determine the pricing, and terms and conditions under which merchants can access a scheme's payment mechanisms. Interchange fees charged by each scheme to merchants not deemed strategic or requiring privileges are fixed by card category. Both schemes charge the same or very similar fee levels for aligned card categories.
 - **Under the present regulatory & system structure, merchants economically underwrite the card payment systems and system participants through the high levels of interchange & merchant fees**, even though merchants are only one of the five participants in scheme arrangements (including the schemes, card acquirers, card issuers, and high cost cardholders).
 - Merchants bear the cost of the substantial economic "rents" or benefits that are extracted by others in the cards value chain, notably providers of reward arrangements, card issuers and acquirers, the schemes themselves, and cardholders, because it is a "must take" mechanism.
 - Australia's card system is mature and well established. There is no longer any justification for an interchange fee structure and no justification for high ad valorem fees. As a "must take" financial payment product, charges that are relative to economic resources used should be paid by all users of the system.
 - **The current regulatory structure (including the 3 year weighted average interchange benchmark regulatory system) has led to an increasing proliferation of high cost cards, a growing gap between the interchange fee benchmark and high cost card fees, and an even greater gap between privileged and non-privileged merchants.** Merchants designated as "strategic" and other privileged merchants receive highly preferential treatment, being charged interchange fees at rates lower than the interchange benchmark and many times lower than those paid by other merchants. The strategic and other privileged merchants gain a competitive advantage over the non-strategic merchant that is unrelated to their true business costs. In CSR's case, it competitively sells identical products to identical markets against

competitors with a privileged merchant fee. In effect, it is non-strategic merchants who are bearing the cost of the rewards component of card products across the system.

- The lack of transparency combined with the business model employed by card issuers, acquirers, and schemes creates a privileged economic structure, strongly incentivising rent seeking behaviour. **Most of the costs imposed on merchants are to cross subsidise the reward features of card product that are entirely unrelated to the provision of a payments mechanism.** This is not a market based outcome, but occurs because regulations licence a privileged market position and industry structure.
- Strategic merchants are incentivised to accept cards that provide reward benefits to their cardholder customers, with the added attraction that this is at the expense of their competitors. To remain competitive, non-strategic merchants must also accept these cards. However there is little potential for merchants operating in the industries dominated by strategic merchants to recover the disproportionate interchange fees.
- There is **no economic justification to charge interchange fees as a percentage of the transaction.** The cost of processing a transaction is not dependent on the size of the transaction. This charging method is entrenched by current regulations.

It is a significant concern that banks are replacing EFTPOS cards with scheme debit cards when customers' EFTPOS cards expire. Under the existing system of caps, this has the impact of lifting costs for merchants and starving the low fee EFTPOS system of revenue and therefore reducing investment in that system. The EFTPOS system is the only practical alternative for "real time" payments to merchants in many situations.

The RBA recognises that the efficiency of the card payment systems would be better met if merchants applied differential pricing to the recharging of interchange fees to cardholders, but the mechanisms to facilitate this are not provided by Schemes.

- **Differential pricing (ie cardholders would pay a recharge in accord with their card type) within a scheme cannot be implemented due to roadblocks on information at the card issuer and scheme level.** Our experience is that **schemes refuse to make the fee data on the particular card's interchange fee available at the time of presentation, despite in our view having the technology to do so, preventing differential pricing.**

This creates the unique and absurd circumstance of a buyer of a service, in this case the merchant, being obliged to pay for the service without its cost being available. By **preventing merchants from recharging costs to cardholders that are specific to the particular card, the system of cross subsidisation from merchants to other system participants is entrenched** (whether or not merchants seek to recover an average of fees from cardholders). It leaves merchants no alternative but to charge an estimate of average cost of accepting cards.

- **Regulations should require transparency of merchant and interchange fees applying to particular cards in real time.** We believe that regulations should also provide a mechanism for the interchange fee to be charged directly to the cardholder in real time, provided the cardholder is given prior notice of the cost.

Open and transparent system pricing combined with differential pricing in real time would also provide transparency on recharges of interchange and merchant fees by merchants. This would shine a light on what is a reasonable in a recharge and disrupt attempts by merchants to pass on excessive charges.

- Nevertheless, it should be recognised that surcharging as a means of cost recovery is a highly unsatisfactory solution for merchants in most markets. Not unexpectedly, surcharging is resisted and intensively disliked by customers, and adversely impacts customer relationships. Strategic merchants have no imperative to surcharge. It is particularly irksome for a merchant to have to bear and pass on the cost of a bank reward product.
- Regardless of whether the merchant surcharges or not, customers with low cost cards are inherently cross subsidising those with higher cost rewards providing cards.

An efficient and transparent card payment system required to fulfil the RBA’s statutory mandate would:

- provide a card payment system that has charges to users of the system that reflect the economic cost of providing the system, and does not intentionally fund a reward system
- eliminate entrenched cross subsidisation and particularly the very high levels of cross subsidisation structured into current arrangements. Card issuers, acquirers and Schemes would need to compete on the genuine economic benefits that they bring to the payment mechanism. It may encourage competition between payment systems and facilitate innovation. Consumers and businesses would make payment choices based on the economic benefits to them. The economic efficiency of financial system would be improved.
- provide open and transparent real time pricing, and enable differential recharging in real time. This would also provide transparency on what is reasonable in terms of recharges of interchange and merchant fees by merchants. This would shine a light on what attempts by merchants to pass on excessive charges.
- remove anti-competitive privileged fee structures and artificial distinctions between merchants. Structural distinctions between merchants have no place and no justification in a long established payments platform that is critical to the nation’s financial infrastructure.

Interchange fees should be phased out over 3 to 5 years. As a transitional measure, a maximum interchange fee capped at no higher the Standard Card rate of 0.30% for credit cards should apply to all transaction types, with an overall cap of \$2, should apply.

- This would bring card systems more into line with charges made by other payments mechanisms. This would remedy the issues discussed above. We note that the European parliament is currently considering a capped fee of 0.3% that would apply to all charges to all merchants. In July 2013, the European Commissions published various proposals to cap fees, noting the “unjustifiably high levels of these fees.”

The advocated principles outlined above should apply equally to other incumbent payment mechanisms, such as American Express, and all new payment mechanisms.

There may be a case for a large role for the ACCC in regard to monitoring anti-competitive arrangements in the payment systems and associated mechanisms. Consideration should be given to having the RBA focus on economic efficiency, and ACCC to monitoring anti-competitive industry structures.

Attachment 2 - Issues for Consultation

- **Publishing thresholds for which payment system providers will be subject to interchange or related regulation, possibly based on transaction values and/or market shares.**

The RBA and the Payment Systems Board must ensure that information, decisions, and decision making processes are transparent and support a highly competitive playing field. Increased choice and competition is required from alternative providers and alternative payment mechanisms for services to merchants as well as to consumers.

The access regime should recognise that the card system is a mature but essential financial infrastructure, and facilitate high accessibility.

- **Broadening interchange fee caps to include other payments between schemes and issuers.**
- **Making changes to the interchange benchmark system to reduce the upward 'drift' in average interchange rates inherent in the current three-year reset cycle.**
- **Lowering interchange caps.**
- **Replacing weighted-average interchange caps with hard caps.**
- **Applying caps as the lesser of a fixed amount and a fixed percentage of transaction values.**
- **Including prepaid cards within the caps for debit cards.**

There is little justification for retaining the incentive based an interchange fee structure for such a mature and well established system. Interchange fees should be phased out over time (3 years is ample time for business models to adjust) by regulation, with a hard cap on fees until that is achieved. This approach should be broadened to capture all charges.

The three year weighted average cap, as discussed in Attachment One, increases costs for merchants, and is recognised by the Bank as driving greater issuance of higher fee cards. It has only been partially effective from a consumer perspective given the high levels of cross subsidisation in the system.

For reasons discussed throughout this paper, it is appropriate that the interchange fee be dispensed with and that as an interim measure a hard cap should be in place, similar to the proposed European system should be adopted, whereby total charges are capped at the lesser of a fixed fee (\$2) and a fixed percentage of 30 and 20 basis points (credit and debit cards respectively). The 3 year weighted average cap should be replaced by this mechanism in the immediate term.

Fee caps must include the full range of fees, which must be visible to consumers and merchants at the point of purchase, otherwise fee caps will be ineffectual.

This would bring charges and fees in the card system into line with charges in other payments mechanisms.

The desired outcome of these provisions is to return the payments system to a transparent, pro-competitive model with reduced cross subsidisation.

- **Allowing for 'buying groups' for smaller merchants to group together (subject to any competition law restrictions) to negotiate to receive the lower interchange rates that are accessible to larger merchants.**

Given the large number of merchants who would have to group through one means or another, this is not a realistic solution when more rational changes to the system can provide a universal solution for all merchants. Setting fee caps, and ultimately phasing out interchange fees, as CSR has suggested, that reflect the costs of a vital payments system, as distinct from a loyalty scheme, will obviate the need for buying groups.

- **A tiered surcharging system, perhaps along the lines of the FSI recommendations.**
 - **Allowing low-cost system providers to prevent merchants from surcharging, to encourage consumers to use low-cost payment methods.**
 - **Allowing medium-cost providers to limit surcharges to limits set by the Board.**
 - **Allowing high-cost providers to limit surcharges to the reasonable cost of acceptance.**

The preferred solution is to set fee caps as discussed, while phasing out interchange fees, and providing complete transparency of all fees and charges to consumers and merchants at point of sale. We believe a tiered surcharging system would be complex to implement, and cumbersome to administer. Each merchant is subject to different average interchange costs because of their differing customer bases. Setting a reasonable but across the board surcharge will be extremely difficult: any averaging of costs would be distortionary and would unjustly penalise some merchants without substantial rationalisation of variety in the card base and removal of privileged merchant categories. The better solution will ensure cardholders wishing to experience reward schemes should pay these costs, rather than merchants or other cardholders.

- **Targeted changes to reduce particular cases of excessive surcharging.**
- **Any other changes to enforcement procedures and disclosure practices.**

Setting caps combined with transparency of costs in the transaction will deal with this issue. Returning the system to a vital payments piece of infrastructure will also ensure that such surcharges do not occur.

- **Strengthened transparency over the cost of payments to merchants and cardholders.**
- **Facilitation of differential surcharging by merchants.**

CSR supports transparency of all charges by card/transaction type. Greater transparency of all costs, charges and fees is strongly supported so that merchants have the option to recover them and consumers have a choice as to how they wish to pay for a transaction. It would inherently favour disadvantaged consumers and small businesses using low cost payment mechanisms, and should have the impact of reducing overcharging and reducing system cross subsidisation. CSR supports a system which enables card costs to be distinguished to cardholders based on card type.

Transparency and differential charging would improve market function, and provides merchants and consumer choice (assuming honour all cards provisions are dropped). In itself it does not guarantee the elimination of cross subsidisation between strategic/non-strategic merchants and between cardholders.

Cross subsidy can be eliminated through fee caps and transparent automated pass through or by regulation plus transparent pass through of all charges and fees. Consumers can have access to higher reward cards by issuers charging annual fees.

- **Further easing of ‘honour-all-cards’ rules to allow merchants to decline to accept cards with high interchange fees.**

The credit card system is probably unique in that it forces merchants to accept charges and services for a product without knowing the cost in advance. Unless a hard fee cap applies, the honour all cards rule should be eliminated to allow merchants more freedom to choose which services they wish to use.

- **Ensuring that merchants have the ability to choose to route their transactions via lower-cost networks or processors.**

While merchants pay the transaction costs, it should be the merchant that has the choice of mode of transaction. Schemes should be prevented from hardwiring terminals against choice, which is a feature that prevents competition and transparency in the current system.

- **Clarifying arrangements for competing payment options within a single device or application.**

The right solution will ensure transparency, competitiveness, avoid cross subsidisation, promote conscious choice and minimising rent seeking by system owners.