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Head of Payments Policy Department

Reserve Bank of Australia

GPO Box 3947

Sydney NSW 2001

24 April 2015

Dear Madam/Sir,

RE: Review of Card Payments Regulation

Please find attached a submission from Pebble Payments Pty Ltd, in response to the Issues Paper released by the Bank in March 2015.

I would welcome the opportunity to discuss or clarify any of the points raised in our paper.

Yours sincerely,



Dominic White
Managing Director

Pebble Payments Pty Ltd

Submission by Pebble Payments

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Introduction

Pebble Payments Pty Ltd

Pebble Payments provides strategic and tactical advice to organisations involved in the payments industry, with a particular focus on accepting card payments. Pebble has provided advice to banks, card companies, retailers, payment processors and software organisations worldwide.

The organisation was established in 2010 by Dominic White, who over the last 25 years has held senior executive roles in the payments, card acceptance and ATM businesses within major Australian banks (NAB, Commonwealth Bank and ANZ) while contributing at industry level as Director of EFTPOS Payments Australia Limited and a member of Visa's Asia-Pacific Advisors Groups for Chip, Ecommerce and Card Acceptance.

Our clients have included Macquarie Group, Visa International, NAB, First Data Resources, Keycorp, Wesfarmers, Touchcorp Ltd, ANZ, Verifone, Ingenico and a number of others.

In recent months we have worked increasingly with retailers, assisting them in attempting to understand the complexity of their card acceptance costs and the options available to them in managing these.

Why we are making a submission

We believe that there continue to be inequities in the card payments system in Australia. These often tend to affect organisations on the "acceptance" side of the industry more than on the "issuing" side.

In our experience, there has historically been less representation of this side of the industry, and hence we felt it was worth putting forward our views for the Payment Systems Board to consider in its deliberations.

While based on considerable experience with Retailers and Acquirers, the submission in large part represents the views of Dominic White, and is not intended to represent any other parties.

Format of our submission

After a general overview, we will address each of the Issues raised in Sections 4 and 5 of the *Review of Card Payments Regulation Issues Paper* ("the Paper") in four parts, within which we will then highlight our views on the Specific Issues for Consultation.

Overview

The Payments System Board (the Board) of the Reserve Bank (the Bank) should be congratulated on bringing a greater degree of transparency and equity to Australia's card payments system since the early 2000s.

We encourage the Board to continue on this path, recognising that there is still a level of inequity and a lack of transparency existing in the system, in particular on the “acceptance” side of payments. We believe that market forces will not address this inequity.

To illustrate this continued inequity, consider two points. Firstly, data from the Bank's Research Discussion Paper, “The Evolution of Payment Costs in Australia” (published December 2014) highlighted the inequity in payment methods when looking at each method using the “private net costs” to each party. As a comparison, we have summarised this in the table below:

	Visa/ MasterCard Credit	Visa/ MasterCard Debit	EFTPOS Debit	Cash
Cost to consumers	\$0.19 (0.15%)	\$0.21 (0.3%)	\$0.21 (0.4%)	\$0.13 (0.5%)
Cost to merchants	\$1.25 (0.98%)	\$0.63 (0.91%)	\$0.36 (0.69%)	\$0.25 (0.96%)
Net cost to system	\$1.34 (1.05%)	\$0.94 (1.36%)	\$0.70 (1.35%)	\$0.51 (1.96%)
Average transaction size	\$128	\$69	\$52	\$26

Source: Pebble Payments analysis of data from “The Evolution of Payment Costs in Australia”, published December 2014

There are numerous factors affecting a consumer's choice of payment method, not least their financial preferences for debit versus credit. From a purely economic perspective, the data would suggest that consumers should be ambivalent as to which payment method they use. On the other hand, the cost to merchants varies significantly and yet it is consumers that predominantly drive the decision as to which channel/method is used at the point of sale.

The second point is the resulting financial effect on the merchant. Typically, although EFTPOS is the most utilised electronic payment method (usually at least 30-50% of card transactions), the cost of EFTPOS makes up less than 20% of the merchant's total card payment costs. The opposite is true where merchants accept high cost cards such as American Express. In other words the volume does not drive the total cost.

Merchants have no direct relationship with the parties determining their payment costs (i.e. the Card Schemes). Competitive forces are not aligned with effective system outcomes, and hence the need for continued intervention. For example, while it is the role of the Card Schemes to set interchange rates, they are not directly affected financially by interchange – they simply pass the value through their system. They also do not deal directly with end users and so are removed from direct competitive tension with regard to interchange rates. Hence for these and other reasons set out in the Paper, we encourage the Board to continue to intervene.

Part One: Transparency of Card Payments

General Comments

We agree with the analysis presented in the paper referring to the lack of transparency for merchants accepting card payments. In our experience, there is some ability for merchants to identify debit versus credit in a physical environment, however little ability to identify various card products within the credit range, and virtually no ability to identify card costs in an online environment. We also are not aware of any Acquirers offering merchants the ability then to act on such information in real time at the point of sale.

Our organisation works with merchants to help them understand their card acceptance costs, and as such we have access to a wide range of pricing models provided by Acquirers in the market today. In our view, it is increasingly difficult, and in some cases actually not possible for merchants to compare and predict the costs of accepting payments from International Card Scheme products. For example, as well as the “blended”, single merchant service fee (MSF) traditionally offered, and the fully transparent “interchange plus” model, some Acquirers offer a hybrid model, whereby several interchange categories are bundled into a smaller number, say 5-7 categories, presumably with the view of simplifying and providing some level of transparency to merchants. While this is, to an extent, a commendable direction, unless the specific higher-level categories are published by the Acquirer, showing which specific interchange rates are bundled into which category, then there is in fact no transparency for the merchant and it is not possible to compare one Acquirer offering with another.

In addition to the points raised in the Paper, we are also aware of at least one Acquirer in the market charging merchants of all sizes for “Scheme Fees” in addition to interchange. These additional fees are the fees charged by the Card Scheme to the Acquirer, and may range from <0.01% to >0.50%, depending on the card accepted. On average, we estimate the Scheme fees charged by the International Card Schemes (i.e. Visa and MasterCard) to be in the order of 0.07-0.09%. These fees are not published and in fact are subject to commercial confidentiality between the Schemes and the Acquirers. As a consequence it is not possible for merchants to verify the scheme fee charged by the Acquirer.

Why does this matter? It is our belief, based on a number of years' experience, that the cost of a business's merchant facility is only one of several factors determining their choice of Acquirer. Typically in Australia, a merchant's Acquirer will be their transaction Bank, and in the majority of cases the merchant will have other products with that Bank, such as lending or deposit facilities. As a consequence, the merchant is less likely to switch Acquirers and so the competitive pressures deriving from transparency are lessened. In the end, merchants typically prefer to consider the total cost of the facility each month and compare on that basis. The issue with transparency is that this comparison with a new provider becomes almost impossible until the merchant actually shifts its business. It is, in effect, a barrier to competition.

Specific Issues for Consultation

Strengthened transparency

We agree that systems should be updated to enable real-time physical and electronic identification of card types, especially credit and debit, but also within each category. This will not be easy, and will require providers to upgrade their processing systems to enable this, at significant cost. Consideration should be given to implementing this over a period of time.

This is a core element in improving the system. Having been closely involved with many merchants who have moved to an interchange-plus pricing model, the consistent feedback has always been that they need greater ability to identify the card type.

A core issue becomes then, what will the merchant do with this information? In our view, the most relevant use of the information is to assist them in understanding their costs, and taking action based on that knowledge. Their options could range from something as simple as training their staff to suggest customers “push CHQ or SAV” in a physical environment and use lower-cost EFTPOS, to potentially setting up an automatic surcharge for categories of high-cost cards (see section on surcharging).

Hand-in-hand with this is the requirement for Acquirers to offer full interchange-plus pricing (not the hybrid model) to all customers. Our understanding is that all the main Acquirers now have this system capability and this should not be difficult to implement. We do, however, feel it is important for merchants to still have the option of a single blended rate where required. In our view the offering is similar to fixed or variable home loans. Where a client for example wants more certainty, they are able to opt for a fixed rate (single MSF) rather than variable, however they should be aware that this may be at a higher cost and have the option always of accepting a variable (interchange-plus) option.

Further easing the “honour-all-cards” rules

Supported. While adding complexity, depending on the outcomes of the interchange regimes, in principle merchants need to be allowed to make decisions on card acceptance and/or surcharging for high-cost cards within a card scheme. Surcharging of higher-cost Amex transactions is relatively prevalent today, however some Visa and MasterCard products now have similar or even higher costs for the merchant. Should these higher-rate cards continue, then we believe merchants need to have the ability to decide on acceptance or at a minimum be able to surcharge for these.

Part Two: Interchange Fees and Payment System Efficiency

General Comments

There are effectively three core points made in this section: (i) the absolute amount of interchange that should be allowed (i.e. the 0.50% for credit); (ii) the mechanism for setting the amount; and (iii) the specification for caps, i.e. cents per transaction versus “ad valorem”, or percentage of value. We will discuss these one by one.

In the first instance, it is not clear to us why the Board would seek to reduce interchange rates further. The EU has set a hard cap of 0.30%, which seems to have become a target figure discussed in the industry. However we note that when the Board first designated the credit system in Australia and set an initial weighted average target rate (of 0.55% and then 0.50%), this was based on extensive cost studies at the time. We would urge the Board to carefully analyse any cap or benchmark using a similarly rigorous approach as they have used in the past before settling on a figure. In our view, reducing to 0.30% for credit or even zero will have significant consequences for the industry as it functions today, and must be carefully considered. That is not to say it shouldn't be done, however based on the FSI final report and the RBA papers published to date, in our view there is not enough data to set a new rate.

Regarding the second point, however, we believe strongly that there is significant need to reform the way the benchmark is managed. The analysis in the Paper does an excellent job of identifying the issues and we agree with all of the points made. In practice, it is rare that the industry average interchange is at 0.50%, due to the creation of new interchange categories at each reset. In our opinion, Issuers have been (quite rationally) “gaming” the system to maximize returns from existing card portfolios. By this, we refer to the moving of thousands of cardholders from one product (e.g. a “Gold” card) to another (e.g. a “Platinum” card) without the cardholder requesting it. This practice, sometimes known as “BIN flipping” has led to significant increases in profitability of card portfolios without growth in volume of customers or value transacted. This has become like a drug that Issuers are now hooked on, and is at the heart of driving the inequities and inefficiencies in the system.

In our view, the worst method of coping with the interchange creep that has been adopted by the Schemes is the “Strategic Merchant Rate” or SMR. As pointed out in the Paper, these rates, applied to a small number of the largest merchants, distort the weighted average interchange and create a significantly uneven playing field for merchants operating in the same industry. Effectively, several hundred thousand small businesses are subsidizing the costs of less than twenty large institutions. We have heard the argument that it is common business practice to apply volume discounts to large clients in any industry, which is true. However that argument does not hold in this case, as the merchants are not in fact clients of the Schemes (who set the rates), but of the Acquirers. Added to that, interchange rates have no direct financial impact on the Schemes, so they are able to establish these rates without any direct financial impact to them at all.

Should the mechanism of a weighted average benchmark continue, in our view SMRs should not be allowed. Industry-specific rates, most typically used to provide incentives in industries

with low card acceptance (for example Education) could potentially continue, as they do not discriminate between competitors, although these still add complexity to the system.

Finally, the Paper makes a good point that having a "cents-per-transaction" interchange figure can be detrimental to increasing acceptance of small value transactions. We see this in our work with retailers, particularly with very small transaction sizes. The issue with moving to an ad valorem figure is that there is still a genuine fixed cost in processing the transaction. This cost is independent of the value of the payment, and so has to be recovered in some form. Having said that, interchange is somewhat irrelevant to the recovery of that cost. This is a processing cost, which in reality will be determined by Acquirers/Processors where it will be subject to market forces. See our discussion below on dual percentage/value caps.

Specific Issues for Consultation

Broadening fee caps

Supported. This has long been a way that Schemes are able to distort the system by artificially supporting the commercial dynamics of particular products. This is especially prevalent in debit, where from a system point of view, EFTPOS is a more efficient payment method. However due to incentives and rebates, raised from many sources, the International Schemes are able to subsidise their debit products, leading to most Issuers now prioritizing Scheme Debit products over EFTPOS.

We also support bringing companion cards into the mix, to ensure a level playing field.

The core issue with this initiative will be how to enforce it.

Changing the interchange benchmark system

Annual resets in our opinion would go a long way towards lessening the gaming of the system. There would not be enough time for Issuers to move enough customers into new product categories before they were reset. Issuers do incur cost in moving customers between products, even using "Account Level Processing" (ALP) where the card number remains the same, and so each move is scrutinised for its commercial feasibility. A two to three year return is far more attractive than that over a 9-12 month period.

Quarterly resets would certainly remove the "gaming" incentive, however such regularity and the costs incurred may not be necessary.

Lowering interchange caps

As discussed above, we believe significant further work should be undertaken in identifying the impacts of any lowering of interchange caps before a decision is made.

Hard caps

Moving to hard caps would be quite a shift in the Australian industry. In our view it is probably the most comprehensive way to put a stop to interchange “gaming” and ensure a level playing field. However, it has the potential to effectively kill high-end rewards products “overnight”. The question would be how such products could be funded without the ability to have products priced at high interchange. While not our area of expertise, we are aware that there continues to be significant demand for such products.

Instead of a single hard cap, an alternative option could be to have a “collar” type arrangement, limiting the range or spread of rates. For example, there could remain a weighted average target rate of 0.50% for credit, but all interchange rates must be between, say 0.30% and 0.70% (rates to be set subject to consultation and further study). There should be no SMRs and all incentive and other payments must be included. The objective would be to reduce inequities while still allowing the potential for some higher-returning products. The smaller spread and more regular resets should remove incentives for “gaming” and provide a more sustainable long term structure.

Dual percentage/value caps

In our opinion this makes sense and we would support it for debit card transactions. However, as stated above, it may not in itself solve the issue of high costs for low value transactions, due to the fixed nature of some processing costs. Implementation in Acquirer and Issuer systems may be difficult, although presumably global players who own and run these systems are solving for this issue in the EU.

If this system is adopted for debit cards, in order to have some effect on the take-up of electronic small transactions, the Board may need to go further and require Acquirers to charge MSF using the same method. That is, if the interchange is set as a percentage of value, then the MSF (whether a blended or interchange-plus arrangement) must also be a percentage of value. Should this occur, Acquirers would need to recover their processing costs through cross-subsidisation of low value with high value payments.

We do not see value in such a system for credit cards. There is already high take-up of credit at high value, and so no further incentive would seem to be required. There is also increased risk to the system in credit defaults, chargebacks and merchant failures with higher value transactions, and hence there is some justification for the ad valorem nature of interchange for credit cards.

Part Three: Surcharging

General Comments

It is our view that cases of excessive surcharging are not widespread, and in fact are mostly found in the well-publicised airline and taxi industries.

In our view the introduction of surcharging has assisted with more appropriate price signals for users of the system and we would encourage the Board to retain surcharging as a core element in its regulations and an important tool in the merchant's "kit bag" in managing their costs.

An issue to consider however, is the complexity for merchants in their ability to surcharge effectively. Part of this relates to the ability for merchants to identify card types, as discussed above. This also in turn creates the situation whereby it is almost impossible for Acquirers and other providers to be able to automate surcharges on behalf of merchants at the point of sale.

We believe that simplification of the interchange system as proposed will assist the ability to surcharge more effectively. If there is any need to try to regulate "excessive" surcharging, in our view this may best be left to competition regulators in the taxi and airline industries.

Specific Issues for Consultation

Tiered surcharging system

Subject to the implementation of mechanisms discussed above to either reduce the spread of interchange and/or establish a hard cap, we believe there is little reason to further attempt to regulate surcharging. Having said that, the proposal to ban surcharging on debit products should improve the system as a whole.

In our opinion however, it is not surcharging on debit products that is limiting the take-up of electronic payments for low-value transactions, rather it is the common practice of merchants applying a minimum payment amount for EFTPOS transactions in particular. Removing surcharging will have little impact on this. At issue is the fixed-cost nature of the payment processing, and it is difficult to see how this can be overcome, other than through regulating MSF methods as mentioned above in Part Two.

It may be possible to ban minimums from a regulatory point of view, although it is difficult to see how that could be enforced. However this probably would need to be coupled with recognition from merchants that the cost of accepting a debit card payment compares favourably to the cost of accepting a payment with cash. In many cases, small merchants tend to believe there is little or no cost to accept cash and so this argument becomes difficult.

As a final comment, while we would argue that there is no real need to change current surcharging regulation, the proposed three-tiered system has merit, and should enable Acquirers to set up their systems to quite easily automate surcharges for the majority of cards.

For example, a debit card would be set to zero in the system, and a Visa/MasterCard credit card could be set to, say 1% no matter what the card type or BIN (assuming that was the rate set and published by the Board). The simplicity of that system should appeal to all users.

Targeted changes

As described above, we do not believe this is necessary. In our view, such behaviour may be best left to the relevant competition body, in particular because the key organisations in these industries have argued that the fee they charge is not in fact a surcharge, but a fee reflecting other services provided. In our view the Board could end up in endless debates about what is or isn't a surcharge.

Differential surcharging

Supported. To the extent that the wide spread of interchange rates continues, we believe that the merchant needs to have the ability to make acceptance decisions, such as whether to surcharge, based on transparency of cost. Some high-end Visa and MasterCard products are as, or more expensive for merchants to accept than American Express, however they are often reluctant to surcharge due to this having to be applied to all such products.

Part Four: Remaining Issues

Specific Issues for Consultation

Three-party schemes and thresholds

We believe that it is important the Board include all electronic payment schemes in the regulations, to ensure a level playing field. As such the concept of published thresholds for regulating participants makes sense, subject to consultation about the level and make-up.

As for the issue of three party schemes, at issue of course is the fact that by their nature, there is no interchange and hence it is more difficult to regulate without setting prices to end users. We do not believe the Board should regulate the absolute value of merchant service fees. This is not an area of expertise for us. Perhaps focusing on bringing companion cards in under the benchmark/cap, coupled with existing surcharging arrangements will be enough to ensure treatment is equal?

Including prepaid cards in caps for debit cards

Supported. Again, not an area of expertise for us, however in our view a prepaid card is very similar or in fact identical in behaviour to a debit card. We can't see any reason why they would not be treated in the same way from an interchange point of view.

Competing payment options on single device and “merchant routing”

The core role of the Board in this area, as in all others really, is in ensuring there is a transparent, level playing field. To that end, our view is the decision about which payment method to use, or which network should be used needs to be left as far as possible to the users, with wherever possible full information as to the costs and benefits of various options.

From a consumer perspective, our view is that their digital choice should reflect their physical choice: in other words, using a physical wallet, a consumer can take out whatever payment method they choose: cash, EFTPOS, American Express etc. We believe they should be able to choose similarly in a digital environment, and thus any payment scheme rules should not be able to block the consumer’s ability to choose another scheme within their wallet.

Effectively the multi-network cards prevalent in Australia are a pseudo wallet and this debate has been at the fore for some time, resulting in the three-way agreement reached between the Bank, EFTPOS and the International Schemes. We do not see any merit in the Board revisiting that agreement, rather it should focus on the digital space.

As for merchants as end users, we would encourage the Board to continue down the path set in the US for enabling merchants to route transactions through their preferred network. One issue for consideration with this though, is the ability of large international networks to be able to offer incentives to some merchants directly, hence again distorting the economics of the mechanisms. By its nature, EFTPOS, as a low-cost domestic scheme is unable to compete with the larger international schemes and consequently it is possible that smaller merchants may again be subsidising the processing costs of larger competitors. This is something potentially overcome through options identified above to include all incentive payments under the cap.

The rights of the consumer need also to be taken into account. Where a merchant routes a transaction through a network of their choice, consumer benefits and protections must be equal, or else the consumer must have the opportunity to influence the decision. For example there may be additional chargeback protection or rewards points using a Visa Debit product over EFTPOS. Consideration needs to be given to this aspect.

Further Points

Commercial Cards

We note that in the EU regulation, commercial cards are excluded from the interchange benchmark/cap. It is not immediately clear to us why this would need to be the case in Australia. Our concern in doing this is that it then opens a new avenue for “gaming” of the system. If commercial cards or business products are to be excluded here also, we suggest that the Board carefully defines what makes up a commercial card product and ensures that the volume of payments through this method remains within a defined boundary.

Summary

It is our view that the Board should continue to intervene in the card payments system in Australia.

In particular, there is a need to take firm steps to stop the “gaming” of the interchange regimes, which is having the effect of distorting price signals to various end-users, and creating a sub-optimal outcome for the system as a whole.

The key elements that we encourage the Board to consider are:

1. Keep the weighted average credit interchange benchmark at 0.50% until a full cost study can be completed;
2. Implement a “collar” system with smaller spreads for credit and debit cards, which should be determined after industry consultation and study (however, spread should be <0.50% at most);
3. Disallow SMRs (“Strategic Merchant Rates”);
4. Include all incentive and other payments within the benchmarks;
5. Apply the debit benchmark as the lesser of a fixed amount and a fixed percentage of value, and require Acquirers to apply a price reflecting this method; and
6. Make no further change to current surcharging regulations.

Disclaimer

This paper is prepared by Pebble Payments Pty Ltd.

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