

OPTIONS FOR INTERCHANGE REFORM

Response to the EFTPOS Industry Working Group
“Options for EFTPOS Interchange Fee Reform” discussion paper

Westpac Banking Corporation
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Executive Summary

- Westpac is committed to ensuring the success of industry reform of EFTPOS Interchange in Australia.
- We believe the current EFTPOS Interchange system has two main flaws:
 - (a) the flow of payment from issuers to acquirers is incorrect, in that it does not reflect value derived or costs created in utilization of an efficient payment tool, and
 - (b) the current arrangement has shown inflexibility in its ability to allow parties to move to sustainable and/or more transparent outcomes. Over the past 15 years, Westpac has seen almost no movement in EFTPOS interchange pricing, despite our repeated bilateral attempts to negotiate amendment.
- Credit cards are a direct substitute for debit cards. Westpac supports the underlying view that as in the case of credit cards¹ only issuer costs should be considered in interchange fee calculations, and this ought to apply equally and consistently to debit cards.
- The RBA has announced a timetable for credit card interchange reform and we believe simultaneous reform of EFTPOS Interchange arrangements with credit card reform is imperative to ensure ease of implementation across stakeholders and to minimize industry and business disruption.
- Without EFTPOS Interchange reforms occurring, Westpac believes there is a significant risk that the EFTPOS network will not be invested in, and alternatives will attract new investment (scheme based debit, stored value cards, credit cards). Westpac believes that EFTPOS serves the needs of Australia well, but without reform, it will be overtaken by substitutes.
- Westpac believes that the growth in credit card transactions versus debit card transactions is a result of merchant value being created and consumer acceptance driving the use of credit cards. Merchants and consumers have shown that credit cards and debit cards are payment substitutes. If there remains a significant gap in the issuers' recompense for credit and debit cards, debit cards will not receive the investment from issuers that will allow them to compete with credit cards.
- Westpac stands ready to proceed immediately with urgent reform of the EFTPOS Interchange system.

¹ See Reserve Bank of Australia, *Reform of Credit Card Schemes in Australia: A Consultation Document*, December 2001.

Background

Westpac has participated in the EFTPOS system in Australia for over 15 years and believes that it offers a secure, reliable and valuable service to Merchants. In addition, consumers gain the convenience and flexibility of being able to purchase using a debit card in a wide variety of stores across Australia.

On numerous occasions Westpac has attempted to renegotiate its bilateral contracts to produce a more sustainable outcome, but has not successfully achieved any significant movement over the life of EFTPOS. Indeed, with all other things being equal, the current arrangements act against changes occurring bilaterally, because it results in a win-lose situation.

Westpac has advocated the need for industry wide reform of EFTPOS for some time, has participated openly in the current working group deliberations and offers the following comments in relation to the questions posed in the “Options for EFTPOS Interchange Fee Reform” discussion paper dated July 2002.

Issues for consideration

- 1. Are the objectives for assessing options for reform appropriately defined? Are there other considerations that should be included in assessing the merits of any interchange fee options?**

Westpac agrees with the objectives as stated. Additionally, Westpac supports the principle of consistency of methodologies between credit cards and debit cards in relation to interchange fees and believes simultaneous reform of credit and debit interchange is desirable from a public policy standpoint.

- 2. Are the three general interchange fee options clearly and appropriately defined? Are there other options that should be considered?**

We agree that the three general interchange fee options cover the attainable options. On each of the options we have the following comments.

Option 1 – retain the bilaterally negotiated structure.

We agree that the current system of bilaterally negotiated outcomes can be seen to result in uneven bargaining and potentially unfair outcomes for different participants². For this reason we cannot support either sub-option which considers retaining the bilaterally set fees. Given changes proposed by the credit card interchange fee amendments, we believe that keeping the current bilaterally negotiated regime will result in issuing banks opting out of EFTPOS for different approaches. Among others, these approaches may include variants on existing proprietary schemes (eg American Express, Diners Club), or open schemes (Visa or MasterCard scheme based debit) or other substitute payment methodologies.

Option 2 – move to multilateral interchange fees

A multilateral fee based on the methodology used to calculate credit card interchange fees appears to be the best outcome if EFTPOS is to survive and grow as an option for issuers. A standard fee could be set for all EFTPOS players that maintain links with other EFTPOS players (ie network players), somewhat akin to Tier 1 players in APCS or BECS. Westpac would support this fee being a “default” rate with allowance for bilateral parties to arrive at other arrangements if desired.

For participants for whom it is not cost-effective to maintain links with all of the network players, these participants could contract a bilateral arrangement with a network player to provide a service to them.

Westpac would support the development of a periodic review regime to ensure the fees reflect the latest available data, and understands that Trade Practices consideration (an ACCC authorization) would likely be required to effect this change.

Option 3 – eliminate interchange fees

Westpac believes setting interchange fees to zero risks a migration away from EFTPOS by issuers to structures where a return is received per transaction. Westpac believes that fees should only be set to zero if the likely result of an “issuer costs only” study was an insignificant payment relative to the costs and difficulty in actually calculating a number.

In any event, if option 3 was chosen Westpac would advocate a periodic review of the outcomes of this proposal with a process to amend the zero option if a change to the “issuer costs” occurred.

² RBA and ACCC, *Debit and Credit Card Schemes in Australia, A Study Of Interchange Fees And Access*, October 2000

3. Are there other advantages or disadvantages of the three options that should be taken into account?

Other issues that need to be accounted for are as follows:

- (a) the significant changes occurring in credit card schemes will change behaviours elsewhere in the payments environment. Leaving a significant gap between outcomes in credit card scheme interchange and EFTPOS will lead to significant re-adjustments (such as further migration by issuers away from EFTPOS),
- (b) the impact on the overall payments system efficiency,
- (c) the impact on stakeholders, for example the effect of reducing the benefits received by credit cardholders to the benefit of retailers, and not making compensating adjustments in the EFTPOS environment, and
- (d) the increased attraction to issuers and cardholders of overseas based schemes (eg American Express, Diners Club) over EFTPOS.

4. Are the three cost-based models associated with a multilateral interchange fee appropriately defined? Are there other cost models that should be explored?

We believe that these cost based models are appropriately defined. We agree that "... an explicit and transparent methodology for any multilateral interchange fees would seem desirable", indeed we believe that it is essential given the level of scrutiny in the payments system.

It is our view that unless the "issuer costs" model is adopted in the EFTPOS scheme (in a per transaction or ad valorem model, or some combination of the two) investment in the scheme will be sub-optimal and significant investment will flow to competing payment forms. This outcome will likely result in the ultimate demise of EFTPOS in Australia.

5. Are there other advantages or disadvantages to the cost models that should be taken into account?

Given the similarities in the service provided by the Issuing bank in providing a payment guarantee to the merchant, an important advantage would be the extra transparency and simplicity in having a common methodology for both credit and debit card interchange. Our view is that any divergence from the methodology used in setting the credit card interchange fee would need to be justified. In fact there should be full congruence with the cost collection and inclusions defined by the RBA for credit cards.

We do believe that value based models are theoretically more desirable than cost based models, but concede that measuring merchant and consumer welfare is difficult and thus a cost based model is the next best option.

6. What other issues involving access to the EFTPOS network should be considered? What options should be considered to address these issues?

Westpac is not aware of any major access issues outstanding for the EFTPOS network. However, if access questions are raised by other respondents to the options paper, they could be addressed as part of the reform proposal.

7. Are there other implementation issues that need to be considered?

Yes, Westpac considers the impact and timing of the credit card changes need to be part of the reform timetable.

Westpac understands that there are Trade Practices considerations which need to be considered as part of the implementation of any changes.

Which option is best?

Westpac believes that the most transparent and straightforward option is a multilateral fee calculated by the same methodology used for credit cards. This will enable more transparent price signals between the different payment instruments.

Westpac believes that if this methodology does result in an outcome which results in a very small fee, and the costs of calculation and administration outweigh the actual benefits of setting interchange fees, then setting the fee to zero would not be unreasonable.

In any event, if option 3 was chosen, Westpac would advocate a periodic review of the outcomes of this proposal with a process to amend the zero option if the costs used in the calculations were to change over time.

Without a change along these lines there is serious risk of under investment in the EFTPOS network and a shift to other outcomes which will ultimately result in reduced competition between payment instruments.

Appendix

To support Westpac's view of consistency between credit card and debit card reform we have re-stated the principles by which reform of debit and credit card schemes should take place. These principles were originally stated in Westpac's (November 2000) response to the initial RBA/ACCC study of interchange fees and access. Following some of the principles is brief additional comment on how it should apply to the EFTPOS reforms.

Principles to be followed in interchange fee reform

- 1. An efficient payment system should be acknowledged to exist where pricing of different payment instruments is transparent, so that there are clear price signals to which consumers, merchants, card issuers, card acquirers and other interested parties can respond.**

To ensure transparency, we propose that the same methodology for setting credit card scheme interchange fees be used for EFTPOS interchange. To do otherwise will add unnecessary confusion over the pricing of what are close substitutes. The risks arising from this outcome are covered in this response paper.

- 2. Reform of debit and credit card schemes should be pursued jointly, given the substitutability of the cards for each other for both merchants and cardholders.**

Implementation of the EFTPOS scheme reforms must take place concurrently with the implementation of the credit card scheme reforms.

- 3. Costs and profit associated with the acquiring and issuing of credit and debit cards should continue to be recovered through a combination of merchant fees and fees levied directly on cardholders. Additionally, interchange fees are an appropriate mechanism to enable card issuers to recover costs and share some of the benefits derived by merchants.**

To the extent that issuers incur costs associated with EFTPOS transactions, while the merchant receives a benefit, it is appropriate that issuers receive some payment from merchants, via acquirers.

- 4. To avoid pricing distortions that may favour one payment instrument over another and to ensure competitive neutrality among providers, there should be no prescriptive application of costing or pricing models for interchange.**
- 5. Any interchange model adopted should be designed to ensure that the interchange fee;**
 - **recovers all direct and indirect costs, including the cost of capital where appropriate, incurred by credit and debit card issuers where the benefits flow to merchants; and**
 - **encourages investment in innovation.**

We recognise that the debate over what direct and indirect costs can be included is being resolved in the credit card scheme regime. Once resolved, the same principles need to be applied for EFTPOS.

- 6. Card issuers should be free to price their products in an unfettered manner to cardholders through annual fees, interest rates or other fees levied directly on them. Such fees should be set by issuers unilaterally and be subject to market forces.**

Given the current high level of competition for card issuing, we are not aware of any opposition to card issuers setting fees as determined by market conditions. Of course if the EFTPOS interchange arrangements were left as is while the credit card regime changes, this level of competition is at risk.

- 7. Card issuers should use interchange fees to recover from acquirers, compensation for the benefits which acquirers can offer their merchant customers accepting credit and debit cards compared with other payment instruments. Such fees may have regard to externalities where these exist and would not otherwise be captured.**

Merchants receive benefits from debit card issuance through such factors as immediate settlement of funds, guarantee of payment and delivery of transaction information. Externalities are unlikely to be significant in the case of debit cards.

- 8. Card acquirers should be free to recover all their costs through the merchant service fee. Such fees should be set by acquirers in negotiations with merchants, and thus be subject to market forces.**
- 9. There should be freedom of entry to all areas of the payments system, access being on appropriate commercial terms and subject to the preservation of confidence in, and stability of, the system.**

We believe that setting a standard interchange fee to be used between network players will even allow greater transparency in access negotiations.

10. Appropriate transitional arrangements should be agreed between the industry and the authorities that provide for reform to be agreed and implemented over a reasonable time frame.

This is necessary as the resolution of bilateral arrangements involving debit cards may take considerable time. As well, card issuers, acquirers and merchants will need sufficient notice to prepare for the changes, given the time required for system enhancements, training, etc. The length of time required will be a function of the level of complexity in the new interchange regimes. We believe this timeframe should conform with the now published credit card reform timetables.

11. Acceptance of these principles, and implementation of reform to give effect to them, should be seen as creating credit and debit card arrangements that will meet the Australian community's future needs for efficient consumer transactions in a way which ensures the on-going stability of the payments system.