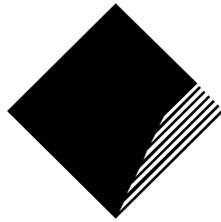


INTRODUCTORY COMMENTS
ON
INTERCHANGE FEES



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The Commonwealth Bank appreciates the opportunity to offer these introductory comments on interchange fees at the Reserve Bank of Australia's Payments System Review Conference.

Our recent submission to the Reserve Bank made the following key points in relation to interchange fees:

- Interchange fees should be transparent, simple, and relatively stable;
- Interchange fees may change over time to maintain or further develop a market;
- Direct pricing in end markets is a key complement to interchange fees;
- Network owners and participants should be able to self-manage, with transparency in approach and review;
- While costs are an important consideration, a focus only on costs for setting interchange fees is an unduly narrow approach; and
- Regulatory intervention should only occur when there has been a demonstrated, or there is a perceived risk of, market failure.

The introductory comments presented below discuss these, and related, issues. In addressing the suggested scope for these comments and questions posed by Professor Harper, we offer the opinion that the opportunity now exists for the Reserve Bank to step back from regulation of interchange fees in favour of a principles-based approach to self-regulation.

THE ROLE FOR INTERCHANGE FEES

Interchange fees play an important role in developing, maintaining, operating and enhancing many networks, including payment systems. That role can go beyond the role of "encourag[ing] the growth of payment networks by redistributing revenues between participants to induce them to join"¹. Interchange fees also provide an effective mechanism to maximise the benefit to each group of customers in many two-sided markets.

There may be some markets where zero interchange is the right answer. This is not the case for credit cards, nor for many other payment systems. To arbitrarily set interchange fees at zero for all payment systems would be to ignore a useful tool for facilitating efficient use of resources to meet the needs of business and personal consumers.

Interchange fees should be *simple* and *relatively stable* over time. They can (but may not need to) change over time to maintain/further develop a network or in response to competitive pressures in light of changes to the market.

¹ "Debit and Credit Card Schemes in Australia", RBA and ACCC Joint Study, October 2000.

QUESTIONS FOR DISCUSSION

In suggesting the scope of the discussion regarding interchange fees, Professor Harper reported that he's received feedback which suggested "particular interest in a number of issues relevant to interchange fees, including:

1. whether changes such as removal of the no-surcharge rule and honour-all-cards rule have themselves adequately addressed concerns about competition;
2. the prospects of self-regulation of interchange fees; and
3. to the extent that competitive issues remain, how should they be addressed?"

I will return to those issues shortly, but to help set the context for those questions, it is worth recalling the reasons behind the current regulatory regime, as stated by the Payments System Board at the time of their decision to designate card systems. The Board's concerns were set out in the Payment System Board's Media Release of 12th April 2001, quoting from the previous RBA/ACCC Joint Study:

- A. "interchange fees are not reviewed regularly by system members on the basis of any formal methodologies;
- B. interchange fees are higher than can be justified by costs, and system members lack clear incentives to bring these fees into line with costs;
- C. price signals are encouraging the growth of credit card usage at the expense of other payment instruments, particularly debit cards and direct debits, that consume fewer resources; and
- D. restrictions by credit card systems on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed."

If these concerns were the reason for the Payments System Board imposing regulation of interchange fees, the corollary is that interchange regulation is no longer required once these concerns have been resolved. I will address these concerns in order.

A. REGULAR REVIEWS

The first concern is perhaps the easiest to address, because it can be entirely within the control of the industry, or of each scheme or payment system operator. If it was true that interchange fee regulation was required because of the lack of regular review based on formal methodologies, then that reason for regulation is removed once the relevant scheme or payment system operator commits to regular reviews on the basis of formal methodologies.

B. COSTS

The second concern was that interchange fees were higher than can be justified by costs, and system members lacked clear incentives to bring these fees into line with costs. We

should be very clear about what it means for interchange fees to be justified on the basis of costs. To focus *solely* on costs as the basis for interchange is too narrow.

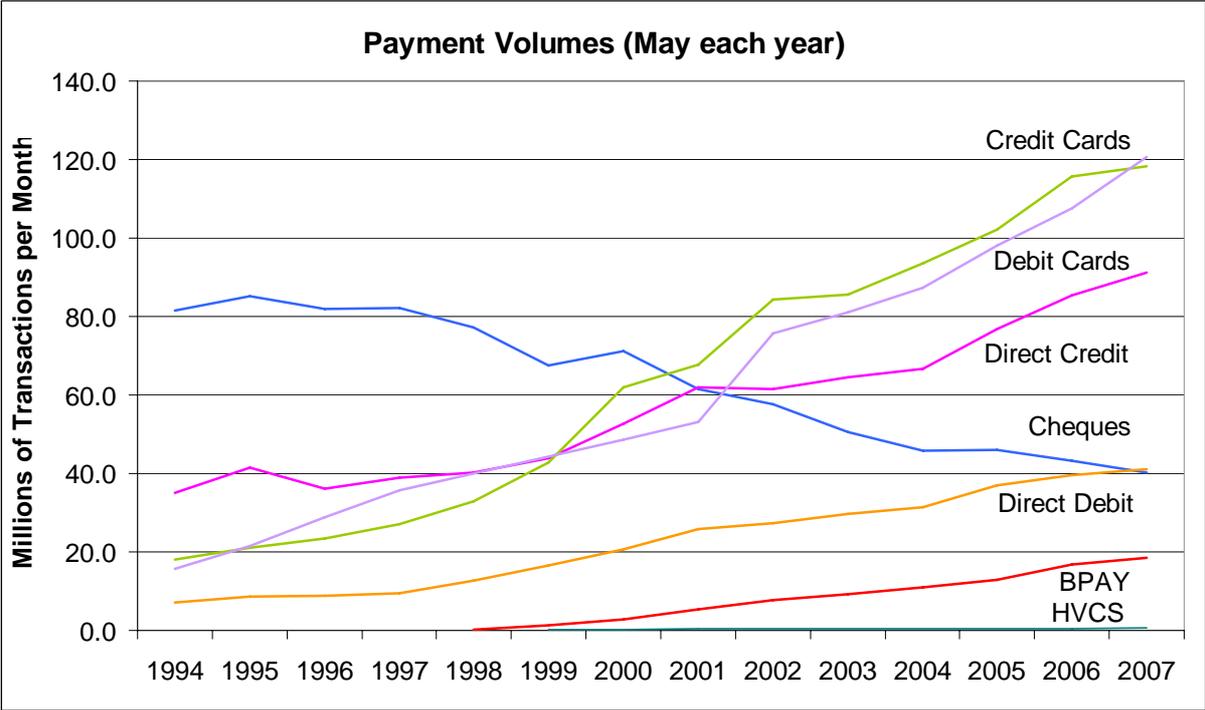
Cost is certainly one necessary factor to consider, but other factors are also very important. These include the competitive environment (payment systems should compete with each other) and the provision of incentives to participants for innovation. The latter is critical if the industry is going to evolve and meet the needs of end users. Restricting interchange to cost alone would impede the ability of the payment system to respond to competitive pressures and to provide important incentives to participants.

C. PRICING SIGNALS AND THE GROWTH OF CREDIT CARD TRANSACTIONS

The third concern was that inappropriate price signals were encouraging the disproportionate growth of credit cards. To evaluate the current state of that concern we need to consider the current growth of EFTPOS and Credit Card transactions, changes to the pricing of EFTPOS and Credit Cards, and the effect of changes to the No Surcharge Rule and the Honour All Cards rule.

Credit Card transactions are no longer growing faster than Debit transactions

Data published by the RBA and APCA (which admittedly includes Scheme Debit with EFTPOS) shows that debit transactions have grown faster than credit transactions. Our own merchant acquiring data indicates that EFTPOS growth (ie, with scheme debit transactions excluded) is higher than the growth of credit card transactions, by a significant multiple. These data indicate that the growth of Credit Card transactions is not disproportionate.



Sources: Australian Payments Clearing Association: www.apca.com.au, Reserve Bank of Australia: www.rba.gov.au

Changes to the consumer price for EFTPOS and Credit Cards

Since the reforms commenced, financial institutions have made substantial changes to the pricing of transaction accounts with EFTPOS capability, to effectively eliminate discrete fees associated with EFTPOS transactions. This, along with devalued loyalty schemes for the use of credit cards, has resulted in the cost of an EFTPOS transaction and a credit card transaction being now much more closely aligned than when the reforms commenced.

While some institutions have acknowledged that those transaction account fee structures were introduced in the expectation of zero EFTPOS interchange, other institutions adopted fixed price accounts well after the current EFTPOS interchange standard had been set, and did so in response to strong forces of competition.

Surcharging and the Honour All Cards Rule

Since the abolition of the No Surcharge rule and the Honour All Cards rule, merchants now have complete freedom to determine which cards they will accept, and the price to the consumer at which the merchant will accept each type of card. While many merchants do not surcharge, data presented by the RBA Discussion Paper in May this year shows a substantial minority of merchants do surcharge, and the number is growing rapidly. There are even examples of merchants charging prices well above the cost of their Merchant Service Fees. In addition to those who explicitly surcharge, many others achieve the same effective result by offering discounts for alternative payment methods such as cash.

By choosing the amount to surcharge, at zero or otherwise, and by alternative pricing signals which achieve the same result, merchants now play an important part in determining the end consumer price of alternative transaction methods. If a large proportion of merchants choose not to surcharge, then clearly the benefit of accepting the cards and absorbing the merchant service fees is of greater value to the merchant than refusing the cards.

Each of the developments described above have modified the pricing signals to customers, diminishing the extent to which credit card transactions are encouraged in preference to debit transactions. Altered pricing signals have changed the relative rates of growth of credit card and EFTPOS transactions. For each of these reasons, the previous concern that pricing signals were encouraging the growth of credit card usage at the expense of debit transactions is no longer relevant. We maintain that the current arrangements which prevent previous restrictions around surcharging and honouring all cards are sufficient, and that ongoing restrictions on wholesale pricing or interchange fees are unnecessary.

D. ACCESS

Of the four concerns quoted, the first three are core to the question of whether interchange regulation is still required. The fourth issue of “access” will be discussed separately at this conference. For the purpose of this discussion it is sufficient to note that former restrictions on access have been removed, or could be removed if any remain.

Having addressed the original concerns cited by the Payments System Board as their reasons for regulating, I return now to the three questions posed by Professor Harper.

1. HAVE CHANGES SUCH AS REMOVAL OF THE NO-SURCHARGE RULE AND HONOUR-ALL-CARDS RULE THEMSELVES ADEQUATELY ADDRESSED CONCERNS ABOUT COMPETITION?

The abolition of those two rules has definitely addressed the issue of pricing signals to end consumers, but other developments described above have also helped. Most importantly, if interchange fees were deregulated and rose, then the mechanism now exists through which a future pricing change could be immediately passed on to consumers. The existence of that mechanism means that competitive forces do, and will continue to, apply downward pressure on interchange fees.

It also follows from this that there is no fixed “correct” level of surcharging in the market. As in any multiple-variable equilibrium system, the number of merchants who surcharge will rise and fall over time in response to changes to other variables. If interchange fees are relatively low, then the level of surcharging should be expected to be low too. It is important that the public policy objective should be to achieve the *ability* of merchants to surcharge, as the Reserve Bank has already done, and not to achieve any specific *level* of surcharging.

2. WHAT ARE THE PROSPECTS FOR SELF-REGULATION OF INTERCHANGE FEES?

Perhaps an unintended consequence of the current arrangements, whereby the RBA has set a limit on the weighted average interchange fee, and the Schemes have determined individual category interchange fees, is that it fails the key tests of being simple, transparent and stable. While the myriad of individual interchange fees are transparent, the methodology being applied by the Schemes to determine these fees is not transparent. Further, the frequency of change is providing uncertainty to participants, which is not conducive in an environment where participants face major investment decisions to upgrade and re-invest in their technology.

Noting the Reserve Bank's view of itself as a "reluctant regulator", a self-regulatory arrangement which achieves the principles outlined above is clearly preferable to the current situation. Self-regulation exists now in the Australian market, and works well in the BPAY scheme.

In BPAY, interchange fees known as "Capture Reimbursement Fees" are reviewed regularly on the basis of a formal methodology. The methodology includes costs as an important component. BPAY's Capture Reimbursement Fees have been thoroughly investigated by the ACCC and the Reserve Bank, and have withstood scrutiny. Interchange fees are now published by BPAY to achieve the Reserve Bank's objective of transparency.

Self-regulation is already working very well for BPAY, and could work equally well for any scheme or payment system.

3. TO THE EXTENT THAT COMPETITIVE ISSUES REMAIN, HOW SHOULD THEY BE ADDRESSED?

The reforms to date, especially the removal of the No Surcharge Rule and elements of the Honour All Cards Rule, have effectively addressed the issues of competition which were previously identified by the joint study. The only issue remains is that the design of interchange fees is now driven largely by imposed regulation rather than through transparent self-regulation. That issue should be addressed by each scheme or payment system individually demonstrating that it is capable of self-regulation of interchange fees.

THE WAY FORWARD

Moving to a lighter regulatory touch is the preferred way forward. The industry, including the RBA as regulator, now has this opportunity.

Work is already under way within APCA to explore ways in which a principles-based approach to industry self-regulation could be implemented, and we support that work. Alternatively, the card schemes could establish and publish a methodology for self-regulation of their own interchange fees, based on sound principles. They could also commit to have interchange fees reviewed regularly in line with their published methodologies, with reviews conducted in line with published time-frames, and by suitable independent experts.

This process should commence as soon as each scheme, payment system or industry body is ready, and does not require the whole industry to move at the pace of the slowest participant.

CONCLUSION

To sum up, I'd like to reiterate the following key points. Interchange is an important tool for achieving efficient outcomes in many payment systems. The removal of the No Surcharge rule and elements of the Honour All Cards rule has addressed important concerns regarding price signals to consumers, while other factors such as re-pricing of transaction accounts and credit cards have also resulted in closer alignment of consumer prices for credit card and debit transactions. Access issues will be addressed at another point in the conference, but access to issuing and acquiring markets has been liberalised.

The industry, or the operator of any card scheme or payment system should now be able to establish a methodology for self-regulation of their own interchange fees, based on sound principles, and subject to review by an appropriately qualified independent expert. This process should commence as soon as any scheme or payment system is ready, and does not require the whole industry to move at the pace of the slowest participant.