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The Chairman
Financial System Inquiry
By on-line submission

Dear Sir,

Re: Card Payment Systems in Australia

Thank you for considering this submission to the Financial System Inquiry on the impact of Australian regulation of credit card payments and systems on our business, and to submit our views as to how the credit card systems can be made more economically efficient.

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

- Provides non-discriminatory access to all merchants and system participants
- Minimises 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
- 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 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 has clearly acknowledged that card payment systems are a critical part of the Australian payments infrastructure, evidenced by its decision to regulate the recovery of card fees by merchants from cardholders (among other decisions). It is instructive that the Bank has not accepted arguments that consumers can avoid the imposition of fee recovery by choosing not to pay with a credit card, or not to purchase at all from a particular merchant, although consumers do in fact have these choices.

In our view, this **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 systems.

We believe the following critical issues need to be addressed:

With **only two widely accepted card schemes, there is no evident competition between schemes, or evident mechanism to drive competition, and evidence that current regulations entrench the status quo**.

- 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 are fixed by card category, and 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 paid by most merchants, despite merchants being only one of the five participants in scheme arrangements (including the schemes, card acquirers, card issuers, and cardholders).

- The majority of merchants not deemed "strategic" can only access card payments systems at the very high ad valorem interchange fees, fixed by each scheme. There is **no economic justification to charge merchants interchange fees as a percentage of the transaction**. This could not occur without regulatory support.

- Interchange fees applying to each card are a substantial proportion of the cost faced by merchants (although there are significant additional costs). Although a merchant can switch card acquirers, there is little incentive or reason to do so given fixed rate interchange fees.

- **Most of the costs borne by merchants are to cross subsidise product features unrelated to the provision of a payments mechanism**, notably award/loyalty products, and to some extent a short period of credit. This is not a market based outcome, but occurs because regulations support the current market and industry structure.

  Merchants bear most of the costs that underwrite substantial economic benefits to others in the value chain, notably providers of award arrangements, card issuers and acquirers, the schemes themselves, and cardholders. (We note there are currently law suits between Visa and Walmart (among others) in the United States on this matter).

- **The difference between the extraordinary fees charged to accept more expensive cards when compared to a standard card clearly demonstrates the substantial levels of cross subsidisation underwritten by merchants**. The range of interchange fees is extremely wide, exceeding five times from lowest to highest: Visa's Australian website, quote fees of 'Standard' card at 0.33%, while there are five categories of card with fees exceeding 1.65%, the highest being the 'High Net Worth, Qualified' rate of 2.20%; MasterCard's charges shown on its Australian website are Standard Cards at 0.33% ranging to 'Consumer Elite' at 2.20%.

  Higher interchange fee cards are growing substantially as a percentage of card presentations due to the increasing proportion of these cards on issue, and active marketing of these card categories by other system participants who are incentivised by the system structure to do so.

The RBA recognised that its statutory obligation to promote 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 in place.

- Unfortunately, **differential pricing (ie cardholders would pay a recharge in accord with their card type) within a scheme cannot be implemented at this time.** Our experience is that **schemes decline to make the data on the particular card's interchange fee available at the time of presentation, preventing differential pricing.**

  This creates the relatively unique 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 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.

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

- provide **open and transparent real time pricing, and enable differential pricing 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.**

- contain the very high levels of cross subsidisation structured into current arrangements. Other **participants in the system would be encouraged 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 would make payment choices based on the economic benefits to them. Accordingly, **the economic efficiency of financial system would be improved**.

Distinctions between strategic and other merchants in interchange pricing and other structures are anti-competitive, have no place in vital economic infrastructure, and should be removed.

- **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.** The differences between interchange fees applying to "strategic" and other merchants are highly material. These impact merchants' pricing capacity, and therefore the competitiveness of one business relative to another, including in the same industry category.

- Regulations imposing caps on system averages, when combined with the favourable pricing provided to strategic merchants, incentivise the issue of more expensive cards and imposition of charges to merchants not recognised as strategic. **Although Visa and MasterCard are reported as saying their average transaction fee is 0.82%, this is a system wide average, and the majority of merchants would pay average transactions fees well in excess of this amount.** The pricing on interchange fees quoted above, together with the increasing proliferation of more expensive cards in the cardholder base, have resulted in growing average costs of well above the system average.

A maximum interchange fee capped at no higher the Standard Card rate of 0.33% should apply to all transaction types, with an overall cap of $20, should apply.

- **This would bring card systems more into line with charges made by other small 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.

In summary, 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 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 0.33%, with a maximum charge of $20
- Remove distinctions between strategic and other merchants to remove anti-competitive structures
- Require real time card specific interchange fee data to be made available to the merchant at the time of a transaction

- 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