



Financial System Inquiry

THE AUSTRALIAN RETAILERS ASSOCIATION

SUBMISSION

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Australian Retailers Association

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Australian Retailers Association

- Voice of the Retail Industry

For over 110 years, the Australian Retailers Association (ARA) has been the peak industry body in Australia's \$265 billion retail sector which employs over 1.2 million people. As an incorporated employer body under the Fair Work (Registered Organisations) Act 2009 and with a range of member services including employment relations, policy development, advocacy and education, the ARA promotes and protects over 5500 independent and national retailers throughout Australia.

The ARA provides leadership and solutions to improve the long-term viability, productivity and visibility of the retail industry by proactively dealing with government, media and other regulatory bodies on behalf of our members. ARA members comprise a diversity of sizes and types of retailers reflecting the profile of the retail industry, ranging from large national chain retailers to one-person operators throughout the nation.

OVERVIEW

The ARA welcomes the opportunity to provide a supplementary submission to the Financial System Inquiry following the publication of the Inquiry's Interim Report on the 15 of July 2014.

The Inquiry's interim report covers a broad range of topics and this submission focuses on the observations made and policy options put forward by the Inquiry with respect to the payments sector.

We note that the Inquiry has raised a number of specific questions with respect to the regulation of the payments system and we trust that the additional information in our submission is of assistance to the Inquiry in the preparation of the Final Report.

As outlined in our first submission retailers in Australia are facing a difficult operating environment. In the last ten years, the structure of the retail sector has shifted and evolved as a result of globalisation, advances in the digital economy and changes to business practice policies (such as employment, changes to card payments).

The ARA offers support, information, and representation to around 5500 retailers across the nation, representing approximately 50,000 shop fronts and works closely with Governments, The Reserve Bank of Australia (RBA) and other industry participants to ensure the long-term viability and position of the retail sector as a leading contributor to Australia's economy.

We believe that the ARA membership and retailers in general are well placed to comment on Australia's payments system having direct exposure to its operations and to its cost structures which is particularly important given the level of competition, significant cost pressures, reduced margins, falling growth and wages costs that are well above our international competitors facing retailers today.

The ARA along with the Australian Merchant Payments Forum represents the interests of merchants within the important payments sector of the economy. It is critical that the perspective of merchants is considered in addition to those of schemes, issuers, acquirers and cardholders. Merchants make significant investments in payments infrastructure and are essential components of the payments system.

The Reserve Bank of Australia (RBA) has been a global leader in reform of payments systems, particularly card payments systems, but Australia is now beginning to fall behind other jurisdictions and around the world, both in scope of reforms and in the quantum of some reforms.

The ARA believes that there are a number of issues that have been identified in the Inquiry's Interim Report that need to be addressed to ensure that Australia's payment system remains competitive and to remove the harm of rising costs to retailers from unintended consequences of the reforms. .

EXECUTIVE SUMMARY

ARA POSITION

- The ARA supports the Inquiry's observation that regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.
- The ARA believes that all card participants in the payment system need to be subject to the same regulatory obligations.
- The introduction of high interchange premium cards has significantly increased costs to

merchants who are not in a position to negotiate lower interchange fees directly with the card schemes and this difference in purchasing power reduces small independent SME retailers' ability to compete with large retailers.

- The FSI should further explore the option of Merchants having the choice of routing for all payment transactions including, but not limited to American Express transactions and debit transactions
- In principle the ARA believes surcharging is not a good customer experience. The ARA believes that permitting merchant surcharging on credit and debit cards has been pro-competitive and as such has been a positive regulatory intervention in relation to non regulated payment systems. Where regulated systems are in relatively secure payment environments there is little charge back to merchants. However in less secure web based environments there is still a case for surcharging. An ability should remain to surcharge non regulated payment systems. The ARA also recognises the costs of cash and the regulated systems can be competitive with those cash costs.

THE SUBMISSION

Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.

As outlined in the Interim report the RBA has implemented a number of significant reforms to Australia's card payment systems. As stated in our initial submission we believe that the RBA has been a reluctant regulator and has opted for regulation only as a last resort if it has been unable to encourage industry initiatives to address areas of concern.

Broadly the areas of concern have been industry pricing, access to the payments system and restrictions on merchants that have hindered competition.

The ARA via the Australian Merchant Payments Forum, has been an active participant in the payments reform debate over many years and its members have seen firsthand the outcomes of the RBA's reforms to the card payment systems.

As outlined in the RBA's submission to the Inquiry the Bank's reforms, whilst consisting of a series of individual measures, were designed to work as a package as follows:

- a benchmark was established for interchange fees so that prices faced by merchants and consumers more closely reflect relative costs
- transparency of these interchange rates, plus the capacity for merchants to charge for the use of particular cards and the ability to not accept all types of cards, gives merchants negotiating power that can help ensure that lower interchange fees are reflected in lower merchant service fees
- the expansion of eligibility to participate in the card systems promotes competition in providing card acceptance services to merchants
- reductions in interchange rates have reduced the scope for issuers to offer incentives for consumers to use high-interchange, high-cost cards, shifting payments behaviour towards lower resource cost methods.

We agree with the Inquiry's observation that that regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes, however there are issues with the current regulatory framework that need to be addressed which we have outlined in this submission.

THREE PARTY SCHEMES

As outlined in our first submission to the Inquiry another area of concern for retailers has been the increased promotion of American Express cards and in particular the increased issuance of co-branded or companion cards. So called three party schemes like American Express have not been directly affected by the Bank's interchange fee reforms. So whilst traditionally American Express has issued their own cards, following the introduction of interchange regulation on Visa and MasterCard we have seen all four major banks and a number of smaller banks enter into commercial arrangements to offer co-branded or companion cards.

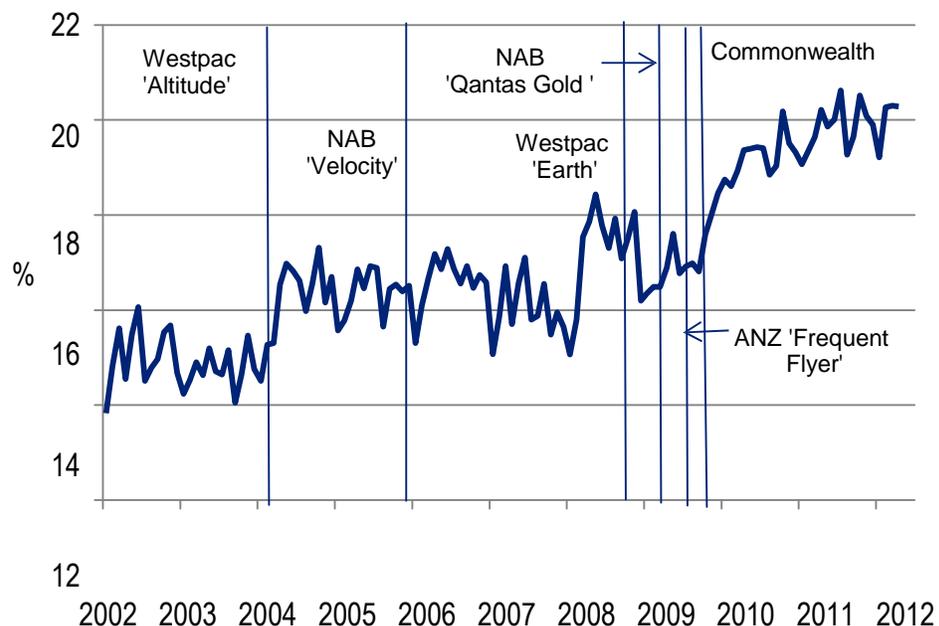
Whilst it is argued that there are no interchange fees in three party schemes, as the RBA points out "there are nonetheless commercial arrangements in place that give financial institutions an incentive to issue companion cards."

As the Interim report also points out, submissions from MasterCard and Visa argue that the service fees companion card schemes pay to issuers are equivalent to interchange fees in four party payment schemes, as they are both payments made to issuers funded by merchant services fees.

The net result is that we have seen a widespread take-up of companion cards which has allowed three party schemes such as American Express to grow market share. The higher merchant service fees costs of these cards directly impacts retailers, and as more consumers switch to companion cards this in turn increases the pressure for retailers to accept these cards or face potential loss of business.

As outlined in our first submission retailers in the middle to upper middle market that the ARA has spoken to have reported an increase in the use of American Express cards from approximately 13% to 18% over the last four years. This is consistent with the market share statistics reported by the RBA, and correlates with the introduction of companion cards issued by the banks as shown in the chart prepared by Deloitte Access Economics in their report accompanying Visa's submission to the Inquiry, which shows that the market share of American Express and Diners Club prior to interchange reforms on average around 15% and increasing to just over 20% in 2013.

Chart 1: Market share of American Express and Diners Club transaction value



Source: RBA, DAE

We believe that similarly to the issue of “premium” interchange rates the growth in unregulated scheme cards is distorting the cards market in Australia and is contrary to the intent of the interchange reforms as articulated by the RBA in their submission to the Inquiry.

We believe that four-party interchange fees and companion card service fees under all schemes are equivalent in economic substance and therefore should be subject to the same regulatory framework.

Submissions from Visa, MasterCard and Eftpos also call for regulatory neutrality and a level playing field, where all payment system providers are treated equally by Australia’s regulatory system. Each propose two options, either all participants bear the same level of regulatory burden or no participants should be subject to regulatory control.

We believe that regulation of credit and debit card payment schemes is required for competition to lead to more efficient outcomes. However uneven application of the regulations is causing a shift towards higher cost payment schemes that fall outside of the regulations and consequently is undermining the core objectives of the regulations.

We believe that whilst three-party schemes like American Express have different operating structures, to that of the regulated payment schemes they do have equivalent analogues to interchange and therefore could be brought into scope of the interchange regulatory regime.

We note the RBA has stated in its submission to the Inquiry that it will be reviewing both the issue of differential interchange fee categories and the issuance of American Express companion cards by financial institutions and considering whether some change to the regulatory treatment of these cards (or those of any other scheme that is not currently designated) might be warranted. We would welcome this review and as outlined in our initial submission would make the same offer to conduct a full survey of our members to provide a more comprehensive view on card use if that was of assistance to the RBA.

MERCHANT ROUTING

The Interim report has sought industry comment on merchant ability to choose which scheme to route transactions through, and requiring acquirers to offer this functionality.

As outlined in our initial submission, the ARA is interested in the concept that merchants through their acquirers could be allowed to decide which schemes or networks consumer’s can decide to route transactions through. As outlined in our initial submission there is strong regulatory support for such a position in both Europe under SEPA and the Payment Services Directive and more recently as part of the European Commission recent proposals for regulation of card based payment systems. There is further support in the United States under the Dodd-Frank Consumer Protection Act.

With respect to debit cards transactions we note that in the submission from Eftpos, they call for a requirement that two payment networks be available on debit cards, similar to the approach recently adopted in the United States under the Dodd-Frank Consumer Protection Act. Under such an approach merchants or consumers then would have the choice as to which debit network they prefer to process these dual network debit cards. In effect each network would compete for the merchant’s business which it is hoped would drive down prices or acceptance costs. Further to this the ARA would note that at present the current tap and go technology card systems default to the credit card and are routed via Visa or MasterCard, ARA strongly assert that a tap and go card issued on a debit card should allow the consumer to decide if the transaction is to be routed via credit, cheque or savings account, the same as a traditional debit card is currently able to be routed via these same transaction routes.

The ARA is interested in further exploring this approach and to ensure that such an approach is effective and available to retailers of all sizes, acquirers should be required to offer this choice to their merchants allowing consumers to decide

It is important to note that the customer experience should be seamless and previously there have been customer usage problems with forced routing.

Similarly with respect to credit cards as we outlined in our first submission merchants should have the option of routing American Express companion cards issued by banks directly to the issuing bank or acquiring bank and not just American Express. For all practical purposes these companion cards are the same as the original Visa or MasterCard and linked to the same account. There is no technical reason that these cards need to be processed via the American Express network and incurring additional payment processing costs.

The ARA believes consumers should have the choice on routing and it is in the best interests of customer service to allow customers that choice. We would ask the FSI further explore this option.

INTERCHANGE RATE DIFFERENTIAL

As well as changing the pricing behaviour of card acquirers and issuers, the reforms have had an effect on the types of credit card products offered by acquiring banks and the way these products are promoted. This has been brought about through changes to the interchange fee schedules set within the bounds of the Reserve Bank's interchange fee standards.

The weighted-average of interchange fees within the MasterCard and Visa credit card schemes needs to comply with a cap on specified dates and whenever interchange fees are altered. Currently this cap stands at 50 basis points or 0.50 per cent.

Because there is still the flexibility to set different interchange fees for different types of transactions, including some that are above the level of the cap in some cases retailers have found the rate can be well above the cap.

The high interchange fees for some categories (such as platinum/premium card transactions), and decrease or introduce low interchange fees for some other categories (such as transactions at 'strategic merchants'), still maintaining the weighted average cap requirements but creating a wide differential of rates applying to transactions.

A number of the interchange fee categories set by the card schemes are directly related to the card type. In late 2006 MasterCard and Visa introduced an interchange category specifically for platinum/premium cards. These cards attract significantly higher interchange fee than for standard cards. In late 2009 both schemes also introduced a new super-premium category with an even higher interchange fee of up to 2.0 per cent, four times the maximum weighted average interchange cap.

The introduction of these cards has seen a significant increase in costs for some retailers as a direct result of the migration to new premium card products. In many cases cardholders are simply issued a new tier of card for no additional charge, and often it is difficult to determine what card tier a particular card attracts as there is no designation of the card tier on the front of the card.

However interchange fees are not applied evenly to all transactions. Instead schemes, must ensure that the weighted-average fees fall below the cap with acquiring banks. Large merchants with more market power have been able to secure lower interchange fees than that which apply to smaller merchants.

What this has meant is that when high interchange premium cards are accepted at large merchants these cards attract interchange as low as 0.20 per cent whereas the same card accepted by a smaller retailer attracts as much as 2.0 per cent or 10 times the cost.

This difference in purchasing power reduces smaller retailers' ability to compete with large retailers.

The Payment System Board 2013 Annual Report noted that as at June 2013 the number of interchange fee categories in the MasterCard and Visa credit card systems combined stands at 42, up from eight in November 2003 driven by acquiring banks platinum and premium cards.

The Board observed that although the benchmark has remained fixed at 0.50 per cent, the range between the minimum and maximum interchange fees has stretched from 0.68 per cent in November 2003 to 1.80 per cent in 2013, and that the cost of the highest fee category is now nearly double the equivalent rate applying in November 2003.

POLICY OPTIONS

We believe that the large interchange fee differentials are undermining the objectives of the RBA's reforms. Accordingly we believe that the interchange fee regulation should be amended to prevent or narrow these differences.

One option that could be considered is to increase the frequency at which the card schemes must report their compliance to the interchange cap and acquirers make the adjustment. As mentioned under the current regulations the weighted-average of interchange fees within the MasterCard and Visa credit card schemes must comply with a cap on specified dates and whenever interchange fees are altered. Currently the specified dates are every three years, with the next date of compliance being November 2015.

Consideration could be given to reduce this period to say annually which may reduce the incentives for the card schemes to deviate too far from the weighted average and hence limit the establishment of high premium interchange rates which may otherwise result in a scheme exceeding the weighted average cap when assessed on an annual basis rather than every three years.

Such an approach would not prevent the establishment of differential interchange rates but would make the management to a weighted average cap harder if this was assessed more frequently. This option could therefore continue to allow flexibility and innovation whilst also addressing the current pricing disparity for retailers.

The second equally workable solution would be to introduce a hard interchange cap.

This would ensure that no interchange rate would be able to be set above the interchange cap. If for example there was a hard cap set at the current interchange fee standard of 0.50 per cent, the differential between the highest and lowest interchange fee categories applying to all retailers would be narrowed from 1.80 per cent to just 0.30 percent, which is lower than the 0.68 per cent that the PSB reported existed when interchange reforms were introduced in November 2003.

We note that there is strong regulatory support for such an approach with the announcement in July 2013 by the European Commission that current interchange fees set by Visa Europe and MasterCard in the European Union are in violation of European anti-trust laws and would be subject to a hard cap of 0.20 percent of the value of the transaction for debit cards and 0.30 per cent for credit cards.

As highlighted by the RBA in their submission to the Inquiry the reforms announced by the European Commission take a similar regulatory approach to that of the Bank over the past decade and the accompanying documentation to the reforms make a number of references to the Australian payments system reforms to support the European Commissions' proposed actions.

We believe that if a more regular interchange reset was not acceptable to the FSI a similar hard cap could be introduced in Australia and the level of that cap should also be reviewed in light of the European Commission's findings.

SURCHARGING

Another aspect of the RBA's reform package that the Inquiry has sought industry comment is the reforms regarding merchant's ability to recover the costs of merchant services fees by way of surcharge.

In principle the ARA believes surcharging is not a desirable experience for consumers.

However the ARA believes that permitting merchant surcharging on credit and debit cards has been pro-competitive in particular for the non-regulated systems (e.g. AMEX and Dinners). Restricting these unregulated schemes from prohibiting merchants from recovering their costs of accepting cards, has allowed appropriate price signalling to consumers and provides merchants a negotiation tool, albeit generally only larger merchants are in a position to negotiate.

That said in highly competitive markets faced by retailers the ability to pass on high merchant service fees costs is quite limited for fear of losing business.

Whilst there is little quantitative data on the level of surcharging the RBA's own research suggests that the consumer experience of surcharging has remained consistent over recent years and for most of their card transactions consumers do not pay a surcharge. Compared to many other sectors surcharging within the retail sector is not the norm.

The ARA would argue that for the regulated schemes there is no need to undertake surcharging within bricks and mortar transactions where the recent introduction of PIN not sign will further reduce charge back to retailers.

Charge back is a major issue through web based payments. The ARA believes surcharging remains necessary to retrieve costs as security measures remain weak for many payment methods, some newer systems cover charge back costs which could be argued is supported by surcharging. As security for web based payments becomes stronger with less charge backs the issue of surcharging may need to be reviewed.

We understand though that there is concern that in certain industries and payment channels the level of surcharging is considered excessive and inappropriate. We would argue that a further major reworking of the current regime which now has limits on the level of surcharging that is permitted, is not warranted and a disproportionate response given the limited examples of excessive surcharges often cited.

The ARA would recommend that for regulated systems there is no need to surcharge in more secure PIN present traditional transactions however the ability should remain to surcharge the non-regulated systems.

CONCLUSION

The retail industry's initial submission has outlined the difficult trading environment existing for the retail sector. Most small to medium retailers are those that suffer and in most cases, they are charged the highest MSF to compete in the card payments space.

The retail industry:

- Makes a significant contribution to the overall state of the national economy;
- Employs more people in Australia than any other private sector industry;
- Employs more juniors than any other private sector industry;
- There are 141,000 retail merchants in Australia with the majority of those retailers (85% or more) are SME retailers with fewer than ten retail outlets;
- Retailers suffer a higher disproportionate effect in relation to MSF than other industries due to the high volume of use of cards used for payment in the retail industry;
- Retail is on a low to negative growth period during this time of low consumer confidence and low business confidence in the services sector.

The ARA urges the Financial Systems Inquiry to review the cost structure of the payments. We support the view that the regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes however there are issues with the current regulatory framework that are driving up costs for retailers that need to be addressed.

Kind regards,



Russell Zimmerman
Executive Director
Australian Retailers Association

Please note: In 2004 Russell Zimmerman was appointed as Chair of the Australian Merchant Payments System (AMPF). The AMPF works with the major retailers including Coles, Woolworths, Australia Post, BP and Caltex, Reject Shop and the 5,500 members of ARA.