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Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Email: fsi@fsi.gov.au

Dear Sir/Madam

Re: Financial System Inquiry (FSI) - submission

eftpos Payments Australia Limited (**eftpos**) read with interest the Financial System Inquiry (FSI) interim report issued in July 2014, which identified the following priority issues facing the financial system:

- competition and contestability,
- regulatory architecture, and
- technology opportunities and risks.

eftpos is pleased to provide this further submission in response to some of the policy options identified for the payments sector in the interim report and would welcome the opportunity to also discuss these matters further with representatives of the FSI.

1. Price regulation

The Reserve Bank of Australia (**RBA**) can designate a payment system under the *Payment Systems (Regulation) Act 1998 (C'th)* (**PSRA**). Designation of payment systems enables the RBA to regulate certain aspects of the payment system, including access and standards, and then arbitrate disputes and give directions to participants in that payment system. The RBA can optionally accept undertakings, instead of establishing standards for a designated payment system. Public consultation is required before standards are established but is not required for undertakings.

Since designating several payment systems, including eftpos, the RBA has established interchange fee standards or accepted enforceable undertakings to be complied with by participants in each relevant designated payment systems.

The standards and undertakings that relate to interchange fees refer to those fees as being wholesale fees "*payable between [Issuers] and [Acquirers], directly or indirectly, in relation to [a relevant payment system] Transaction*". The standards for debit cards then set benchmarks and require that the weighted average of interchange fees for the relevant payment system do not exceed the benchmark. The interchange fees for credit cards are not taken into consideration in the weighted average interchange fee calculation for debit cards and vice versa.

There are several limiting factors to the current interchange standards and undertakings, specifically those set out below.

- The standards and undertakings apply per specified payment system

  Although payment systems are broadly defined in the PSRA, the narrow application of the definition has effectively meant that each payment *product* is a separate payment system, which is then regulated on an individual basis. Because of this structure, while payment products of a similar kind are subject to similar regulatory regimes, effectively, each product is regulated separately, even if offered by the same entity. For example, each of the credit payment and the debit payment systems of an international payments system are separately designated with separate interchange fee standards applying to each payment product. In competition terms, this creates artificial distinctions between payment products which essentially have a common function, being consumer retail payments, and, in competition terms, are substitutes for one another even though they are different products. This enables price arbitrage and unchecked cross-subsidisation which distorts price signals rather than providing true transparency of pricing for consumers and merchants. See confidential appendix A;

- Regulatory intervention has focussed on narrowly defined "interchange fees" payable between issuers and acquirers

  While there are historical reasons why regulatory attention has focused on interchange fees, the regulation of interchange fees is only part of the whole. Narrow regulation enables other unregulated mechanisms to be utilised to circumvent the intention of the regulation and cause an anticompetitive effect.

  Additionally, where an entity offers more than one product, regulation of each one as a separate "payment system" allows that same entity to:
  - cross-subsidise between separate and unrelated product lines (ie designated payment systems) – such cross-subsidisation can have a very detrimental effect on competition, and effectively be anti-competitive[1], but such impacts are currently left unregulated;
  - set pricing to effectively cause cross-subsidisation between acquirers and issuers of product sub-sets,[2];
  - cross-subsidise between regions in which the payment system operates.

- The lack of consumer and merchant education about cheaper payment options

  Even though interchange fees are regulated, the distinction between payment options and pricing mechanisms is not widely known or understood by consumers and merchants. Specifically, merchants are often not aware of differences in interchange nor are they

[1] http://www.accc.gov.au/media-release/coles-and-woolworths-undertake-to-cease-supermarket-subsidised-fuel-discounts; see also confidential Appendix A

[2] http://www.digitaltransactions.net/news/story/As-Card-Industry-Use-of-Tokens-Increases_-MasterCard-Plans-_Digital-Enablement_-Fees-

aware that they can seek to choose cheaper payment options. This then leads to merchants setting minimum transaction thresholds for all card payments, with the effect that the cheaper payment options subsidise the more expensive payment options. The flow on effect is sometimes a general price increase across goods sold by the merchants or surcharging for some or all card payments.[3]

Submission – Therefore, eftpos submits that:

- interchange fees should be reviewed and either set as certain values or be tightly worded formulae that give rise to truly comparable and transparent pricing. This could be done as aggregate caps or caps for specific value thresholds or transaction types;
- to ensure transparent price signals to consumers and merchants and viable competition in payments, regulations should be introduced that oversee cross-subsidisation and enable payment systems to be able to prohibit surcharging by acquirers' merchants with a goal to deliver a positive competition effect and public benefit;
- the regulator should require acquirers to inform merchants of their right to choose payment systems and have the capacity to technically facilitate that choice; and
- the regulator should have an active role in, as well as an obligation and funding to educate consumers and merchants on the comparative interchange fees applicable between payment systems, the effect of pricing mechanisms and their rights of choice, beyond publication on the regulator's website.

2. Regulatory architecture

The RBA can designate a payment system under the PSRA if the RBA considers there is a public interest to designation. When determining whether there is a public interest for the designation, the RBA must have regard to the desirability for the payment system to be:

"(a) (i) financially safe for use by participants; and
(ii) efficient; and
(iii) competitive; and
(b) not (in its opinion) materially causing or contributing to increased risk to the financial system"

As noted in the interim report, several entity and product specific payment systems have been designated.

Since designating several payment systems, the RBA has imposed access regimes and established standards dealing with interchange pricing to be complied with by participants in the designated payment systems.

However, designating individual payment systems has not enabled the RBA to deal with cross-payment system disputes nor has it enabled competition and payments efficiency matters to be addressed in an effective manner. For example, an undertaking regime between the RBA and each of 3 designated payment systems manages certain competition matters that arose between those payment systems dealing with a common product set.[4] Those undertakings are between each

[3] See chart 2.3 FSI Interim Report
[4] See confidential Appendix B.1 – B.5

relevant payment system and the RBA and require the RBA to monitor compliance and take further lengthy and expensive action to enforce the undertakings if they are not adhered to, rather than arbitrate or give directions to any of the payment systems operators relating to the common product set. This is because the operators of each designated payment system are not participants in each other designated payment system. If it were possible for the RBA to have designated the functionality or product type or behaviour, then the RBA could have set standards for required functionality or behaviour that applied between operators of the payment systems that provide the common product set, ie consumer retail payments, (whether they were separately designated payment systems or not) and arbitrated disputes or given directions to those not meeting the required level of behaviour[5]. This would enable the RBA to deal more effectively with the risk of loss of competition in payments.[6]

Additionally, designating for technology type, e.g. card payments, has not allowed the regulation to keep up with technology and will not enable it to adequately deal with convergence in products, such as mobile and online payment methods, used to purchase goods and services, that are not dependent on a card but which are still consumer retail payments. While this potentially enables disruption and innovation in the short term, it can do so at the perceived expense of security, integrity and reliability of payments or be based on monopoly protections that are contrary to the open access aim of the PSRA and which support technology lockout, eventually leading to a loss of competition and efficiency.[7] Regulating some payment types and not others means disparate compliance cost, access to technology, pricing approaches and standards of functionality, all of which can inhibit or constrain the ability of both existing and new participants to compete and lead to inefficiencies.[8] It also creates new opportunities for participants to cross-subsidise new product types with other product types to influence use.

Clarification of the role of the RBA in regulating competition in payments and provision of appropriate resources and funding to enable this to occur would ensure more consistent application of competition regulation between the RBA and the Australian Competition and Consumer Commission (ACCC) for similar conduct. For example, the approach taken by the RBA in requiring enforceable undertakings from payment system participants and the subsequent ability to monitor and enforce those undertakings differs markedly from the approach and powers available to the ACCC.[9]

In the Interim Report, there is reference to conduct regulation, potentially encompassing a requirement for large scale technology service providers to obtain an Australian Financial Services Licence (**AFSL**) and be regulated by the Australian Securities and Investments Commission (**ASIC**).

Currently, Authorised Deposit-taking Institutions (**ADIs**) generally require their outsourced service providers of key services to enter contracts that reflect the provisions of the outsourcing and risk management prudential guidelines issued by the Australian Prudential Regulatory Authority (**APRA**). APRA prudentially supervises ADIs and requires them to identify and manage potential systemic risks that impact them, including their technology service provider arrangements. The Corporations Act requires that entities that deal in "financial services" hold AFSLs and adhere to

[5] See Code of Conduct for Debit and Credit Payments in Canada http://www.interac.ca/en/payments-in-canada#Code
[6] See footnote 2
[7] See confidential Appendix C
[8] See confidential Appendix D
[9] http://www.accc.gov.au/media-release/coles-and-woolworths-undertake-to-cease-supermarket-subsidised-fuel-discounts;

certain disclosure regulation. Currently, the switching and processing of payment transactions is not regulated under the Corporations Act through specific exemptions.

It is unclear from the Interim Report:

- what is sought to be regulated or what failure of regulation is sought to be cured by requiring large scale technology service providers to obtain an AFSL. If it is due to a concern over the financial standing of technology providers or the service standards provided by them, then requiring an AFSL would seem to be a disproportionate regulatory response to matters which are currently adequately addressed through commercial contracts achieved by payment industry participants with significant bargaining power; and
- what would constitute "scale" for the purpose or why service providers of scale which are likely to have achieved scale through experience, capability and capacity should be required to adhere to onerous and expensive regulation while small scale participants, who may introduce more stability, security, integrity and reliability risk to payment systems, should not be so regulated.

Submission – Therefore, eftpos submits that:

- payment system regulation requires review to support technical neutrality, access to technology and to anticipate convergence of payment products in future as well as to allow innovation to occur in a way that does not undermine competition or the security, stability, reliability and integrity of payments;
- the regulatory architecture should be revised with additional designation capability for payment functions, to enable cross payment system regulation, in addition to per payment system regulation;
- the PSRA and patent regulation should be reviewed for consistent regulation across products and across systems and to ensure it does not enable technology lockout for payments technology;
- the powers and authority of the RBA to regulate and enforce regulation that prevents anti-competitive conduct should be clarified with appropriate funding being provided for enforcement;
- the regulatory framework should be reviewed so that the RBA, when exercising its power to promote the efficiency in payments, must consider existing commercially available network infrastructure for delivery of new innovations to avoid duplication of investment and effort and facilitate cost effective and efficient implementation of the innovation; and
- there is no need to prudentially supervise or regulate to set minimum standards and for regulator monitoring for large scale payment technology providers who are not themselves "dealing" in "financial products" (as those terms are defined in the Chapter 7 of the Corporations Act).

eftpos would welcome the opportunity to meet and discuss our comments further with FSI representatives.

Yours faithfully,

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Managing Director

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