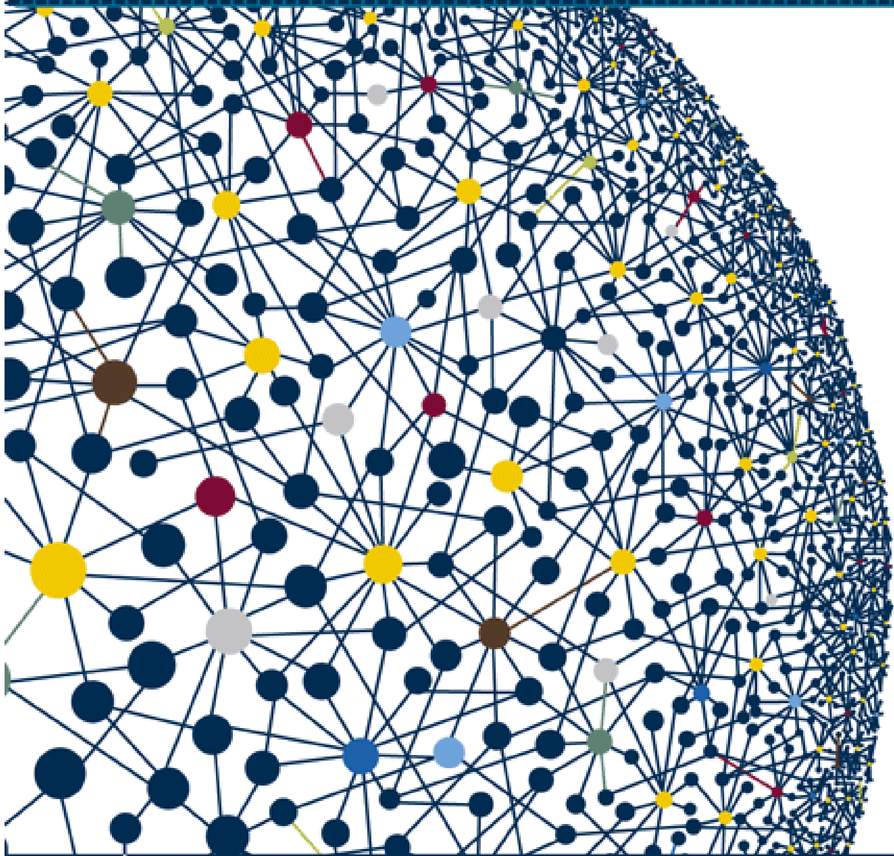

Payment Card Regulation in Australia

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Overview

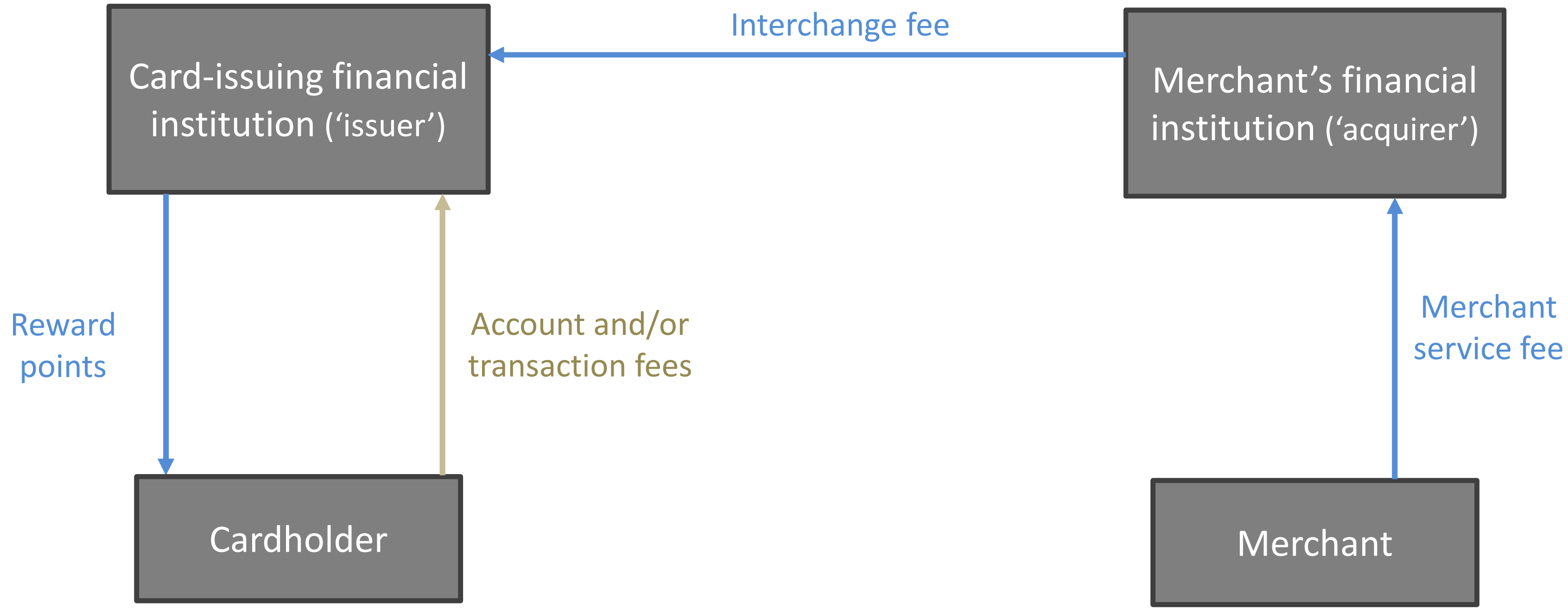
1. RBA card payment reforms and rationale
2. Effects of the reforms
3. Current Review of regulation

Background 1: View of Efficiency

The regulation of card payments on efficiency grounds comes not from examining the efficiency of individual systems, but from considering the efficiency of the payments system as a whole.

- what happens in one system may affect how other systems are used

Background 2: Interchange Fees



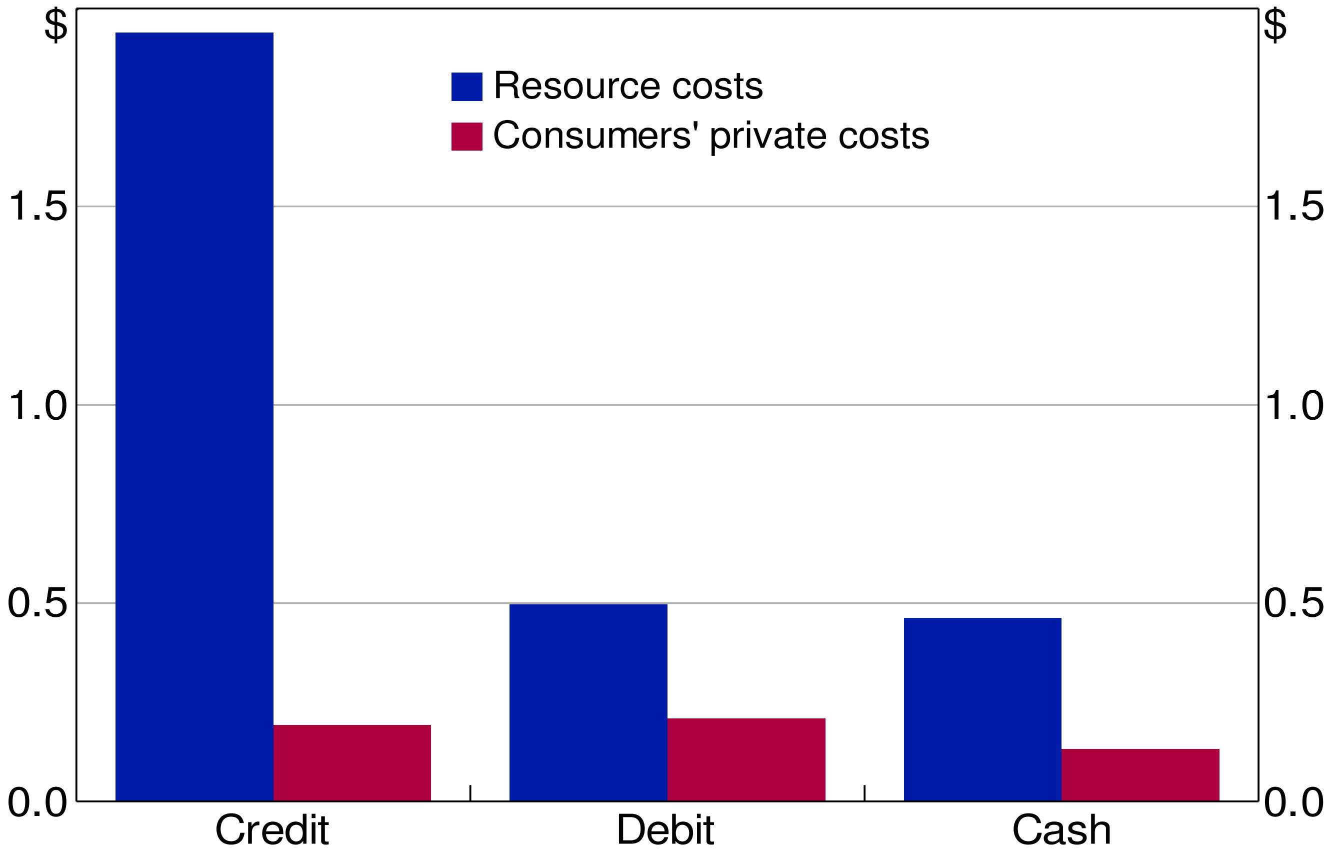
1. Australia’s Card Reforms

Why Be Concerned with Interchange Fees?

- Competition between payment systems drives interchange fees higher, not lower
  - higher interchange encourages issuance and provides more reward points for cardholders
  - seemed likely that interchange fees would rise to the levels that we see now in other jurisdictions
- Those who pay their card off on time receive a subsidy from reward points and interest free periods. Those who use other payment methods help to pay for this
  - typically less well-off subsidise better off consumers
- Differences in interchange fees distort payment choices by consumers

Consumers' Private Costs and Resource Costs

Per average-sized transaction



Source: RBA

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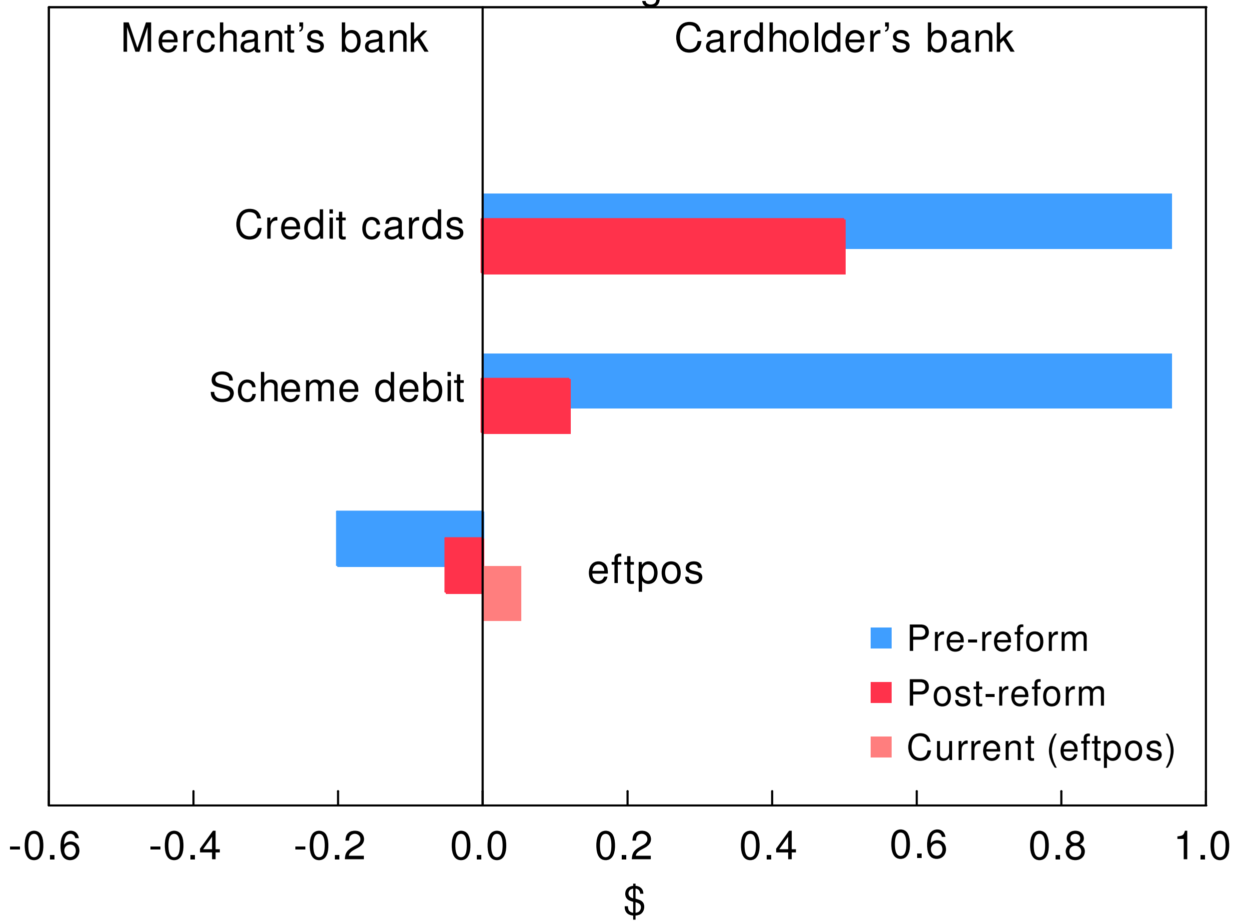
- Differences in interchange fees distort payment choices by consumers.
- Established systems with high interchange fees make entry by new systems difficult
  - diffiicult to persuade issuers and consumers without matching interchange fees

Regulation of Interchange Fees

- RBA was given power to set standards for payment systems in 1998
- Following joint work with competition regulator, the RBA set caps on credit card interchange fees in 2003 and on debit cards in 2006
- Focus was to bring rates on different card systems closer together and closer to zero

Interchange Fees on a $100 Payment

Excluding GST



Source: RBA

Removal of ‘No Surcharge’ Rules

- ‘Perfect’ surcharging by merchants would remove the need for interchange regulation
  - cardholder could decide whether the benefits of using that card justified the cost
  - competitive pressure would be placed on interchange fees

But

- It was understood that surcharging would take time to gain acceptance amongst merchants and cosumers
- Surcharging was seen as very important, but could not be relied upon alone
  - both surcharging and interchange regulation were used

Access to Card Schemes

- A third element of the reforms (unrelated to interchange fees) was access
- Card schemes at the time were associations of banks and only banks could be members
- RBA considered that other entities were capable of participating without bringing undue risk

Regulatory response:

- New category of Authorised Deposit Taking Institution (ADI) created, for those solely issuing or acquiring credit card transactions – Specialist Credit Card Institutions (SCCIs)
- RBA Access Regime required that SCCIs be made eligible for membership

2. Effects of the Reforms

Summary of Effects

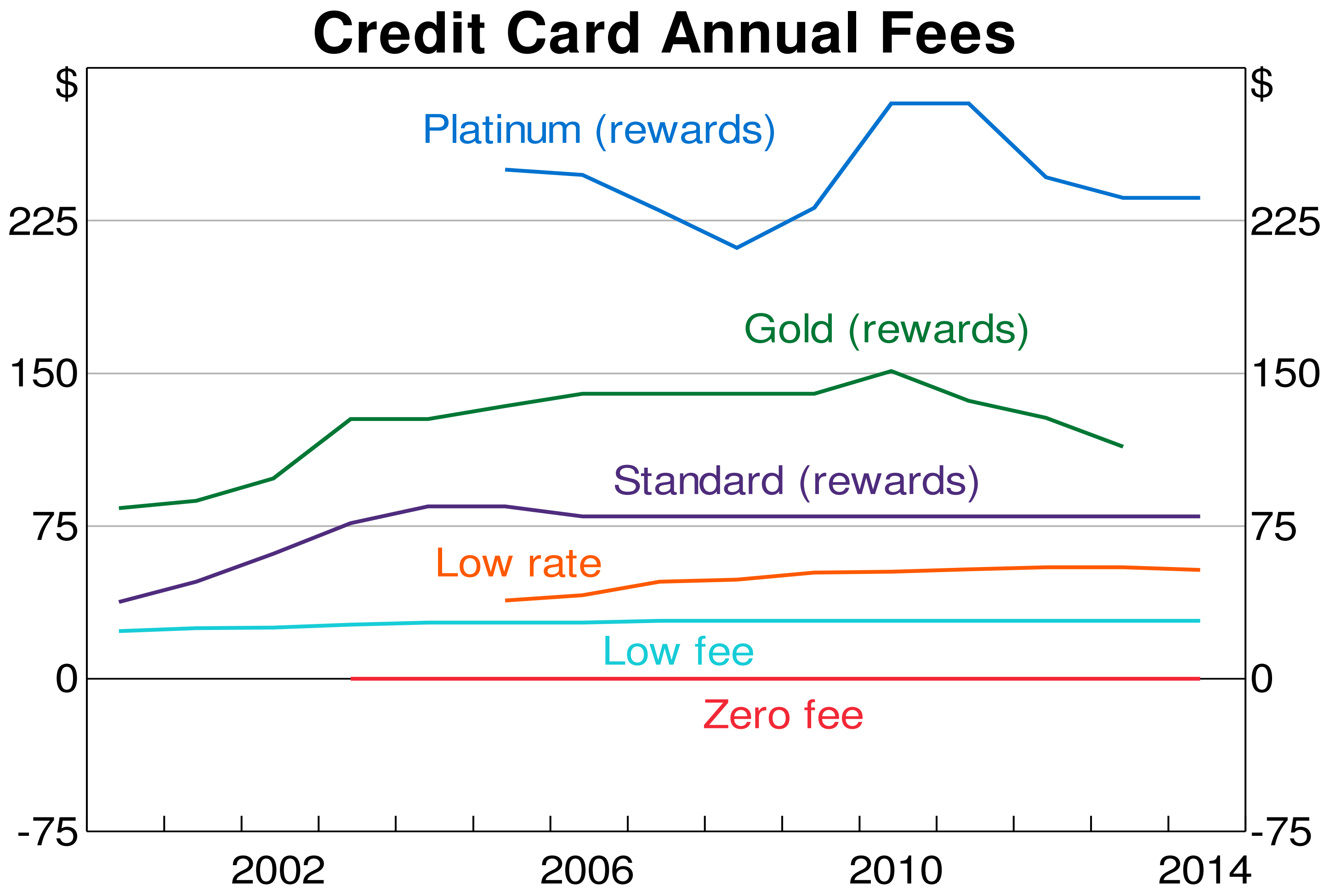
i. Price signals to cardholders from issuers improved

ii. Merchant service fees fell

iii. There was no ‘death spiral’ in card systems

iv. Surcharging is now common, but not ubiquitous

Annual fees rose as interchange fees were capped



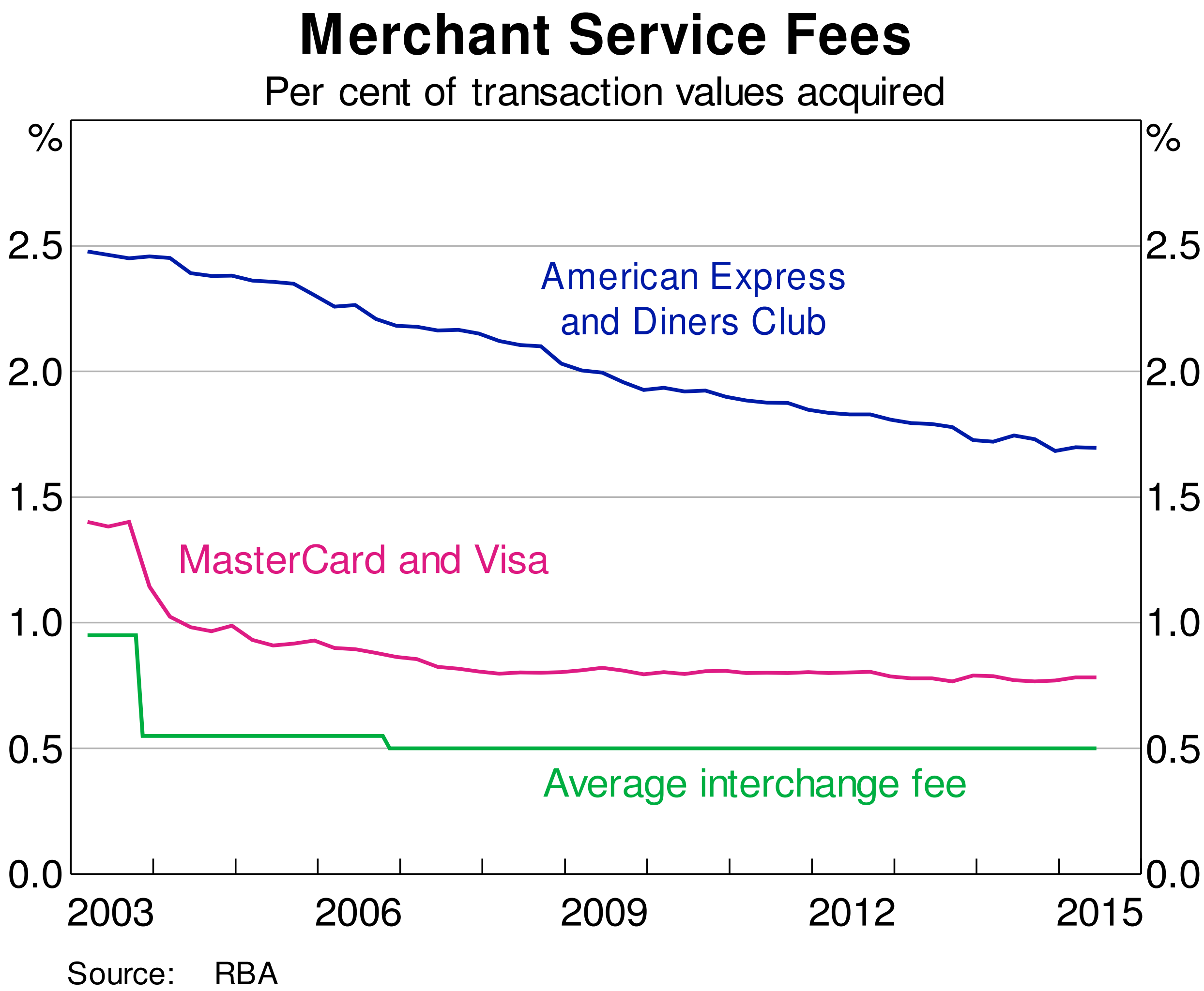
Source: RBA

The value of credit card rewards declined

Value of Credit Card Rewards		
Year	Average spending required for $100 voucher	Benefit to cardholder as a proportion of spending (%)
2003	$12,400	0.81
2004	$14,400	0.69
2005	$15,100	0.66
2006	$16,000	0.63

Source: Banks' websites, Canstar Cannex

Lower interchange fees reflected in merchant discounts



Pass-through to Consumers?

No concrete evidence has been presented to the Board regarding the pass-through of these savings

Payments System Board, 2008

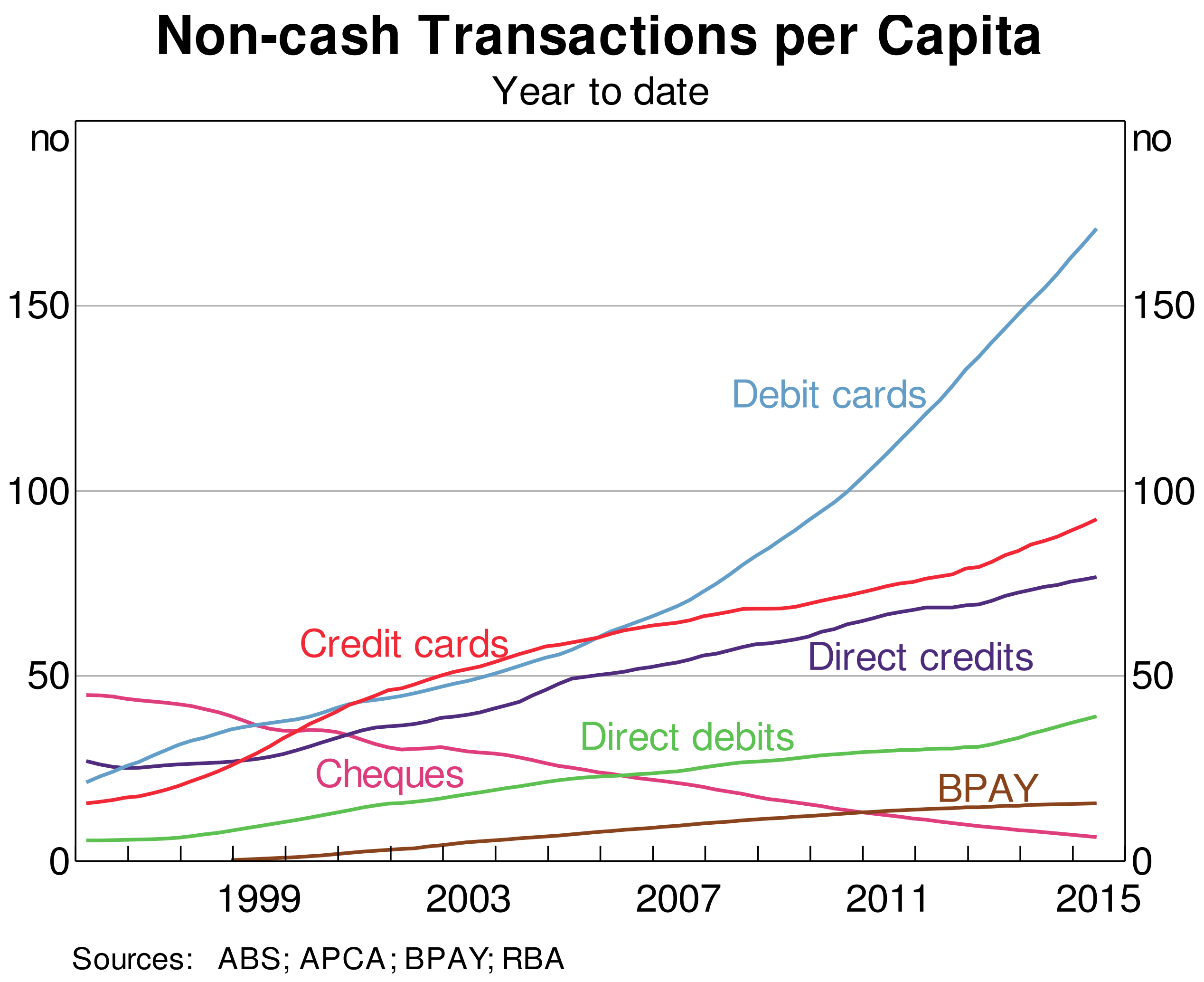
Pass-through to Consumers?

No concrete evidence has been presented to the Board regarding the pass-through of these savings, although this is not surprising as the effect is difficult to isolate. The Bank had previously estimated that the cost savings would be likely to lead to the CPI being around 0.1 to 0.2 percentage points lower than would otherwise be the case over the longer term (all else constant). It is very difficult to detect this against a background where other costs are changing by much larger amounts and the CPI is increasing by around 2½ per cent per year on average.

Despite the difficulties of measurement, the Board's judgement remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers. This judgement is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge.

Payments System Board, 2008

No ‘death spiral’ from lower interchange fees

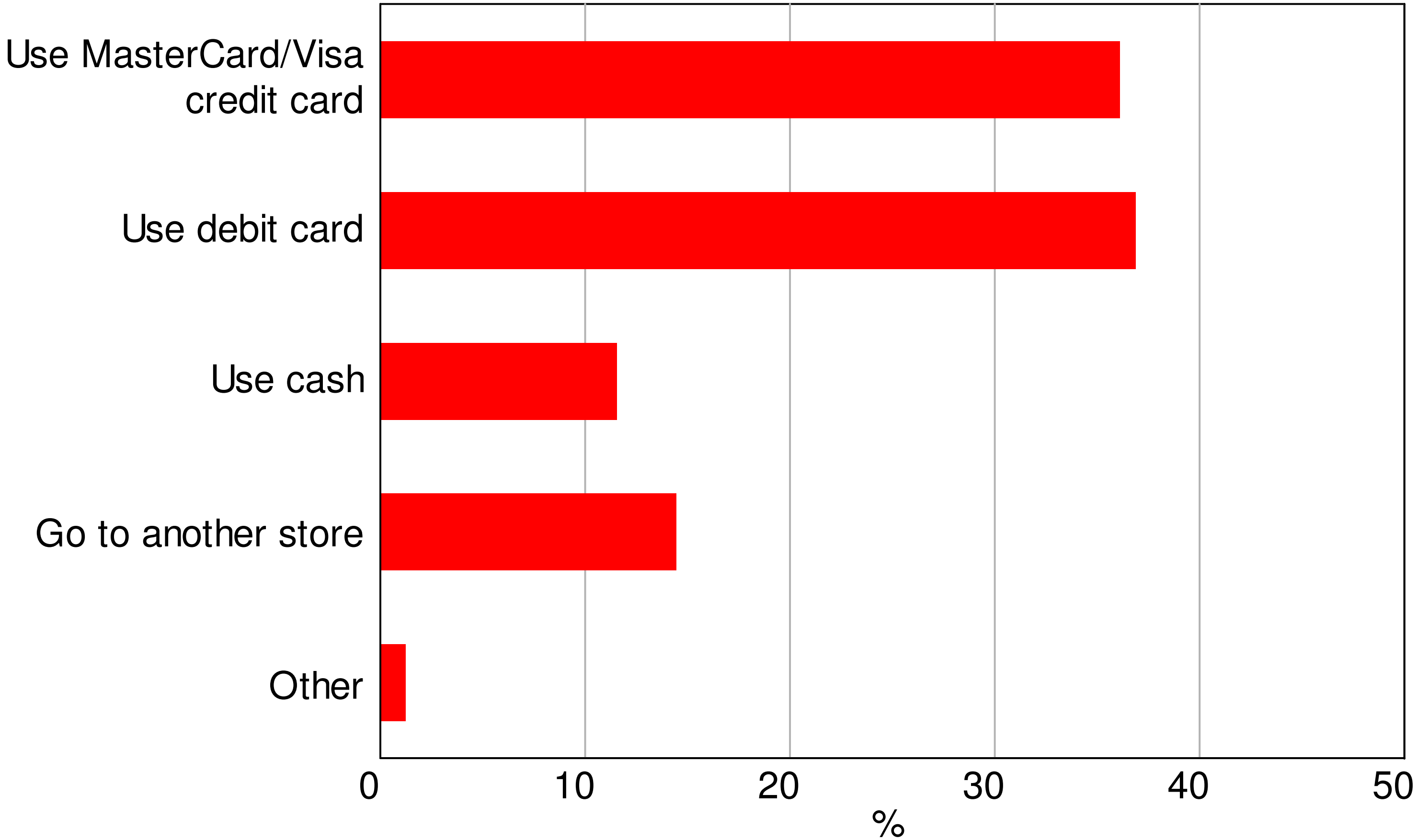


Evolution of Surcharging

- As expected, surcharging was slow to take off, but is now common and accepted
- Consumers clearly respond to surcharging

Response to Surcharging on MasterCard/Visa Credit Cards

Per cent of respondents*



* Respondents with a MasterCard/Visa credit card were asked for their response if faced with a surcharge of 1 per cent for using a MasterCard/Visa credit card to make a $100 transaction at a department store

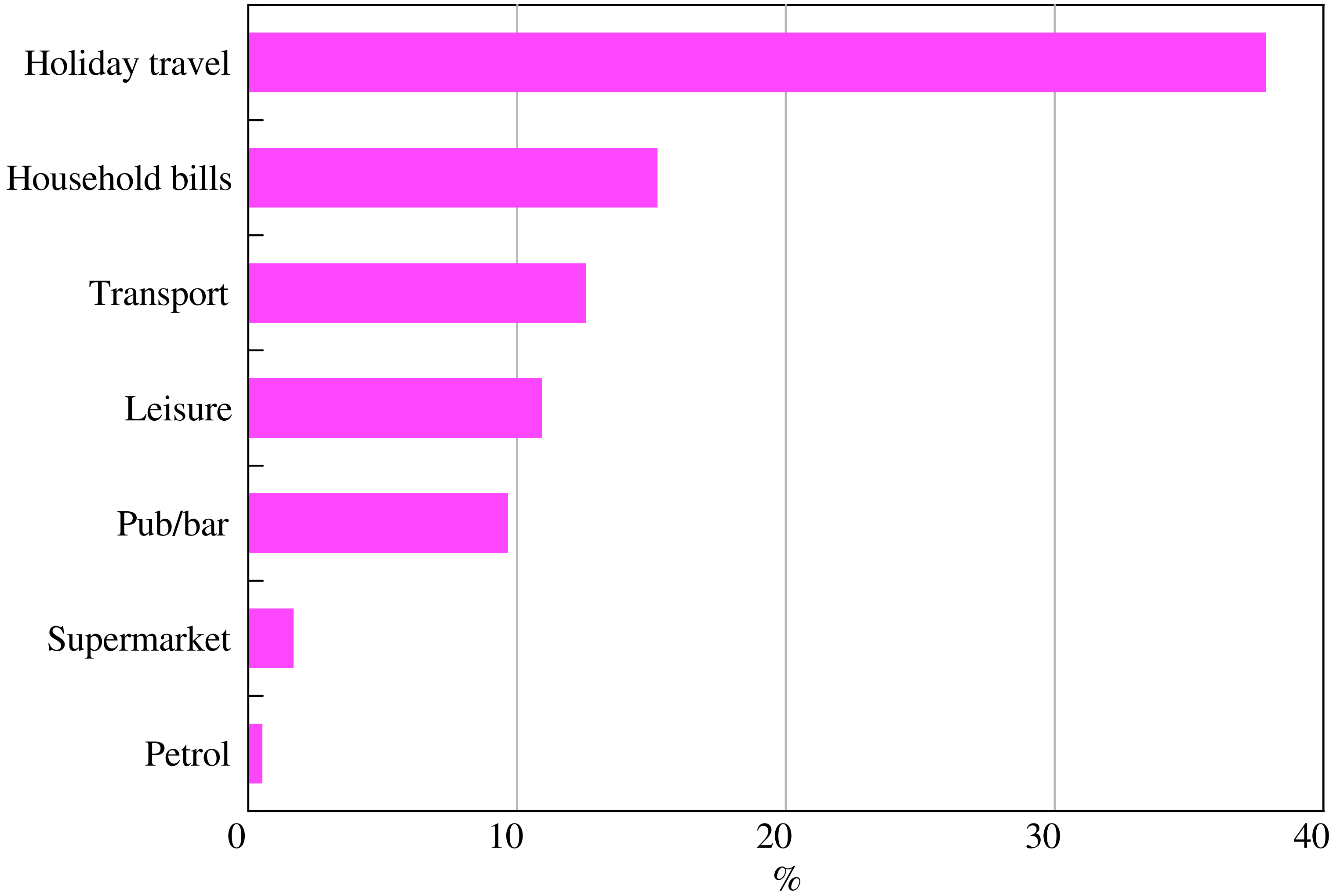
Source: Roy Morgan Research

Evolution of Surcharging

- However, surcharging is not, and will not be, ‘perfect’
- Surcharges are actually paid on 4% of card transactions overall
  - 2% of point of sale payments
  - 13% of online payments
- Surcharges are more likely to be paid in certain merchant categories

Incidence of Surcharges Paid at Merchants

Per cent of number of card payments at selected merchants



Source: Colmar Brunton

Evolution of Surcharging

- Merchants like to keep things simple for customers
  - do not differentiate between standard (low cost) and premium (high cost) cards for the same scheme
- But some surcharge American Express and Diners Club at a higher rate than MasterCard and Visa
  - from RBA diary survey, the median surcharge paid for MasterCard and Visa was 1.5%; for Amercan Express and Diners 2%
  - differentiation is likely to be partly responsible for the fall in Amex and Diners merchant discounts

Access Arrangements

- In a decade, one new acquirer entered the market under the SCCI arrangements
- Potential applicants argued that authorisation as an ADI set too high a hurdle for this type of business
- The card schemes were now listed companies and were more open to new types of members
- Implied that the Access Regime was keeping new entrants out, rather than encouraging competition
- From 2015, schemes are permitted to determine their own eligibility and assessment criteria for participants, subject to:
  - publishing criteria
  - reporting applicants, timelines and outcomes to the RBA
- Several new members have already been admitted

3. Current Review of Card Regulation

Why Review?

- The RBA initiated a review in March 2015
  - likely to conclude in first half of 2016
- The RBA remains confident that its reforms have been beneficial, but
  - after more than a decade, the payments market has evolved and changes may be warranted
- The Government's recent Financial System Inquiry also supported the reforms, but suggested a review of some areas

Review Focus

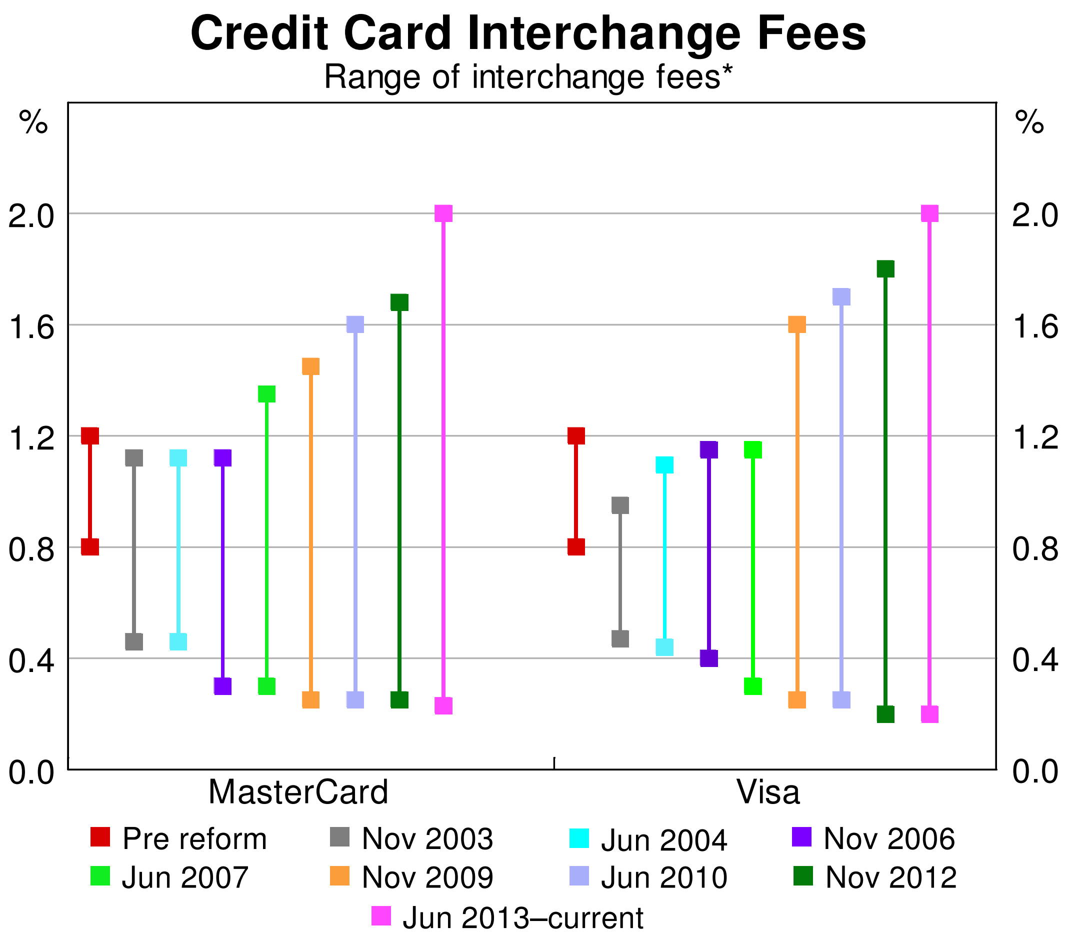
The Review has been wide-ranging, but there are four key areas of focus:

1. The level of interchange fees
2. ‘Companion’ cards
3. Differentials in card costs and transparency
4. Surcharging

Review Focus

1. The level of interchange fees
   - the adverse effects some predicted from interchange regulation did not eventuate. Is there a case for lowering interchange caps from the current levels; e.g. the 30 basis points adopted for credit cards in Europe?
2. 'Companion cards'
   - three party schemes (American Express and Diners) do not have interchange fees and are not regulated, but
   - some banks now issue American Express on the same account as MasterCard and Visa
   - should fees paid to issuing banks be treated in the same way as interchange fees?
3. Differentials in card costs and transparency

The range of interchange fees has widened over time



* Excludes the charity categories (which have an interchange fee of zero) and interchange fee categories with a flat-fee component; excludes GST

Sources: MasterCard; Visa

Review Focus: Differential Costs and Transparency

- Growing complexity of interchange fee schedules is not unique to Australia
- Many merchants do not know whether the card presented is a 0.3% interchange card or a 2% card
- Some cards will cost a 'preferred' merchant 0.2% interchange and a non-preferred merchant 2%
- Should there be a maximum permissible interchange fee in addition to a cap on the weighted average?

Review Focus: Surcharging

- Now surcharging is widely accepted and understood, it is possible that a small number of merchants surcharge more than their card acceptance costs
- These cases have a disporportionate effect on public confidence in surcharging
- Often associated with cases where:
  - there is easy online price comparison across merchants, so an incentive exists to move fees away from the headline price
  - cards are the most convenient or expected form of payment

Review Focus: Surcharging

- The RBA gave schemes the ability to limit surcharges to the 'reasonable cost of acceptence' in 2013
  - the RBA cannot regulate merchants – only payment systems
  - this has had little traction, in part due to lack of scheme/acquirer visibility of merchant costs
- Can we provide a framework that is more readily enforced?
- Public debate about whether a regulator could have powers to enforce limits

Questions?