Chapter 6

Interchange fees, surcharges and competitive neutrality in the payments system

6.1 This chapter considers the related issues of interchange fees, credit card surcharges and whether current regulatory settings in relation to the payments system are competitively neutral.

6.2 Interchange fees are fees charged by financial institutions when credit cards are used in a purchase. They are often not directly seen by the person who uses a credit card to purchase an item but some merchants attach a 'credit card surcharge' to credit card purchases or to specific credit cards. The credit card surcharge represents the cost to the merchant of the interchange fee charged by the purchaser's credit card issuing financial institution against the merchant's financial institution. Interchange fees and credit card surcharges are not necessarily directly related to the cost of making a financial transaction or selling a product or service.

6.3 It has been argued that interchange fees ultimately result in higher costs for all consumers and should be subject to more stringent regulatory limits than currently imposed. Critics of interchange regulation claim that merchants are not passing on any savings from lower interchange fees to consumers, and argue that regulation has only served to increase the costs of credit cards in the form of higher fees and interest charges. Interchange fees in the MasterCard and Visa systems are regulated; the interchange-like fees in the American Express companion card system are not, though the RBA has recently taken steps to bring the American Express companion card into the regulatory environment.

6.4 It is claimed that some merchants are imposing surcharges in excess of their actual payment costs. In particular, evidence regarding credit card surcharges imposed by Australian airlines has been considered in this inquiry. Interchange fees, credit card surcharges and relevant regulations have been subject to recent governmental inquiries and reviews. In particular, the Financial Systems Inquiry (FSI) Final Report provided commentary and recommendations in relation to interchange fees and surcharging, and, in response, the RBA commenced an ongoing review of the regulatory framework for card payments in March 2015. The government has also issued its response to the FSI final report, and recently introduced legislation directed at banning excessive surcharging. These processes, and their relationship to the matters considered by the committee have been noted and have informed this inquiry.

Overview of interchange fees, merchant fees and surcharges

6.5 Interchange fees are one of three sources of revenue for credit card providers. Credit card fees and interest charges make up the other two. The RBA explained how interchange fees work in its submission. Put simply, an interchange fee is charged by the financial institution on one side of a payment transaction to the financial institution on the other side of the transaction. Typically, a credit card transaction will involve four parties: the cardholder, the card-issuing financial institution ('issuer'), the merchant's financial institution ('acquirer'), and the merchant. In most cases, the interchange fee is paid by the acquirer to the issuer.[1]

6.6 While interchange fees are collected by banks, they are set by credit card issuing institutions (Visa and MasterCard) according to categories of transaction within a schedule of interchange rates.[2] For card schemes subject to RBA regulation, interchange rates cannot exceed a weighted average of 0.5 per cent. However, the specific rates applying to each transaction will depend on factors including: the type of merchant (with larger 'strategic' merchants often receiving discounts); the type of card (with premium, high-feature rewards cards typically attracting higher interchange fees); the nature of the transaction (whether it is SecureCode, contactless, and so on); and the value of the transaction. Individual interchange rates can range from around 0.2 per cent for transactions with large 'strategic' merchants to 2 per cent for transactions using the highest level of premium card. Transactions with 'strategic' merchants will typically attract relatively low interchange fees regardless of the type of card used, whereas for transactions with merchants not deemed 'strategic' (usually smaller merchants) the use of premium cards will generally attract higher interchange fees.[3]

6.7 MasterCard told the committee that the interchange fee 'pays for fraud losses and fraud preventions; it pays for the 55-day interest-free period immediately after the cardholder makes a purchase; and, importantly, it pays for the credit loss when a transaction goes bad'.[4] The RBA noted that interchange fees are also used to finance rewards programs.[5]

6.8 There is a direct relationship between interchange fees and surcharging on credit card transactions. To cover interchange fees paid to a cardholder's financial institution by the merchant's financial institution, the merchant's financial institution will impose a fee on the merchant. The merchant is then able to recoup the cost of the merchant fee by imposing a surcharge on customers who use a credit card.

6.9 Rather than impose a surcharge, a majority of merchants prefer to 'absorb' the cost of merchant fees, although this cost is arguably passed on to all customers in the

1 Reserve Bank of Australia, *Submission 20*, p. 11. For a more detailed explanation, see Reserve Bank of Australia, *Review of Card Payments Regulation: Issues Paper* (March 2015), pp. 6-8.

2 Reserve Bank of Australia, *Submission 20*, p. 12. As explained later in this chapter, while interchange fees are not applied in three-party card schemes such as American Express and Diner's Club, interchange-like fees do apply for American Express companion cards, but these fees are not currently regulated by the RBA.

3 Reserve Bank of Australia, *Submission 20*, p. 7.

4 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, p. 46.

5 Reserve Bank of Australia, *Submission 20*, p. 12.

form of higher prices, regardless of whether they use a credit card or not. In this sense, while interchange fees are interbank fees, the cost is passed through the system to the merchant and may in turn be passed on to the consumer, either in the form of surcharges or higher prices.

Designated and regulated payment systems

6.10 The RBA is empowered to 'designate' and regulate payment schemes under the *Payment Systems (Regulation) Act 1998*, and has a mandate to 'promote efficiency and competition in payments systems consistent with the overall stability of the financial system'. Consistent with this mandate, the RBA's Payment Systems Board (PSB) regulates card payment schemes in relation to matters such as interchange fees, surcharging and scheme access.[6]

6.11 The RBA designated the MasterCard and Visa payment schemes in April 2001, and, as explained in the next section, both schemes have been subject to interchange and other regulations since 2003. Three-party systems—most notably American Express and Diners' Club, but also China UnionPay, JCB and PayPal—are not designated (although, as noted below, American Express companion cards have recently been designated).

6.12 The committee heard testimony that the inconsistency in the regulatory treatment of the systems has undermined the competitive neutrality of Australia's payments system. This inconsistency is in part due to historical factors. When first regulated, Visa and MasterCard were both operated as member associations of banks, and the RBA was concerned that access arrangements 'were more restrictive than necessary to ensure the stability of those systems'.[7] However, as the RBA explained in a 2014 paper on payment card Access Regimes:

> The environment has now changed significantly. Most importantly, MasterCard and Visa have now both changed corporate structure to become publicly listed companies rather than member associations of banks. This suggests that the schemes are likely to be more open to new types of participation, while the emergence of new business models is creating stronger interest in direct membership.[8]

6.13 On 15 October 2015, the RBA designated the American Express companion card system. As the RBA explained in its accompanying media release, designation does not impose regulation, but rather is 'the first of a number of steps the Bank must take to exercise any of its regulatory powers'.[9]

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6 Dr Malcolm Edey, Assistant Governor, Financial System, Reserve Bank of Australia, *Proof Committee Hansard*, 27 August 2015, p. 10.

7 Reserve Bank of Australia, *Submission 20*, p. 7.

8 Reserve Bank of Australia, *Payment Card Access Regimes: Conclusions* (March 2014), p. 1.

9 Reserve Bank of Australia, ' Review of Card Payments Regulation: Designation of Payment Systems', 15 October 2015, http://www.rba.gov.au/media-releases/2015/mr-15-19.html.

6.14 The question of competitive neutrality in the regulation of the payments system, specifically as it applies to interchange fee regulation, is considered later in this chapter.

Payment systems reform in the early 2000s

6.15 Starting in 2003, the RBA introduced a series of reforms aimed at improving the efficiency and competition in the Australian card payments system. These reforms included the regulation of interchange fees for designated card schemes. In order to reduce interchange fees on these schemes, the RBA set the abovementioned standard which provides that interchange fees cannot exceed a weighted average of 50 basis points. The reforms also enabled merchants to apply surcharges on card transactions 'so that cardholders were more likely to face prices that reflected the cost of the card they were using'.[10] The RBA also took steps to improve access to the scheme by entities wishing to issue cards or provide card payment services to merchants.[11] In a submission to a 2007–08 Payment Systems Board review of the reforms, the RBA concluded that the reforms had improved transparency and led to more appropriate price signals to consumers.[12]

6.16 CHOICE noted in its submission that as a result of the 2003 reforms, average interchange fees for MasterCard and Visa were reduced from an average of 0.95 per cent to 0.5 per cent. According to CHOICE, this has 'had a predictable flow-on effect to merchant service fees which have reduced, on average, from 1.44% for MasterCard or Visa transactions in March 2003 to 0.84% now'.[13]

6.17 As discussed below, a number of witnesses argued that the 2003 reforms had only served to increase the costs and decrease the benefits of credit cards, without any corresponding decline in consumer prices.

Views on interchange fees

6.18 In its submission, the RBA argued that interchange payments, along with the loyalty programs they finance, ultimately 'increase the costs of payments for merchants and accordingly drive up the final prices of goods and services for all consumers, including for consumers who do not use credit cards'.[14] The RBA pointed out that competition in payment card networks can actually have the effect of driving interchange fees higher:

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10 Reserve Bank of Australia, *Submission 20*, p. 12.

11 Reserve Bank of Australia, *Submission 20*, p. 2; Reserve Bank of Australia, *Review of Card Payments Regulation: Issues Paper* (March 2015), p. 5.

12 Reserve Bank of Australia, *Submission 20*, p. 8.

13 CHOICE, *Submission 10* (supplementary), p. 2.

14 Reserve Bank of Australia, *Submission 20*, p. 12.

> Where the market structure is such that there are two payment networks whose cards are accepted very widely (i.e. merchants accept cards from both networks), and where consumers may hold one network's card but not necessarily both, competition tends to involve offering incentives for a consumer to hold and use a particular network's cards (loyalty or rewards programs, typically). A network that increases the interchange fee paid by the merchant's bank to the cardholder's bank enables the cardholder's bank to pay more generous incentives, and can increase use of its cards. However, the competitive response from the other network is to increase the interchange rates applicable to its cards.[15]

6.19 CHOICE claimed that this dynamic is the reason card schemes have been pushing for higher interchange fees. It explained:

> There is pressure for interchange fees to increase as card schemes compete for banks to issue their brand of card. The higher the interchange rate, the more attractive it is for a bank to issue a certain scheme's card.[16]

6.20 CHOICE argued that lower interchange fees would result in lower merchant fees, and ultimately lower costs to the consumers, even if these cost reductions were too small to directly observe.[17] In summarising its position, CHOICE wrote:

> The interchange debate is about who pays for our payments system. Do we want a high-cost payment system with some of the funds going towards 'special' features like rewards points that only high-spending customers can benefit from? Or do we want a lower-cost system that will reduce costs for all merchants and should lead to lower costs for consumers across the economy?[18]

6.21 CHOICE acknowledged that reduced interchange fees would likely result in a reduction in the value of rewards programs. However, CHOICE suggested that this was not in itself a bad thing: rewards programs, although overwhelmingly operating to benefit higher income earners, were in effect paid for by all consumers because the costs of higher interchange were passed through the system to the consumer.[19]

6.22 Both MasterCard and Visa were critical of the current limits on interchange fees, and argued strongly against any further lowering of those limits on the basis this would increase costs to credit card customers in the form of higher fees and interest

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15 Reserve Bank of Australia, *Submission 20*, pp. 11–12.

16 CHOICE, *Submission 10* (supplementary), p. 1.

17 CHOICE, *Submission 10* (supplementary), p. 4.

18 CHOICE, *Submission 10* (supplementary), p. 8.

19 CHOICE, *Submission 10* (supplementary), p. 6.

charges.[20] It is important to emphasise here that while Visa and MasterCard set interchange fees (in reference to the RBA's weighted average standard) they advise that they do not earn revenue on the fees. However, both companies have a strong interest in how the fees are set because they have a bearing on the extent to which their schemes are used. MasterCard explained:

> If interchange is set too low, as it is in Australia frankly, the economics of the system are broken and issuers find other ways to recover the costs of issuing cards. If it is set too high, retailers and businesses simply would not accept our products. So our interest is in getting the level right so that it is not too high and not too low, but is set at the correct level so that the payment system here in Australia can operate as efficiently as others around the world, and do so in a way that ensures consumers are protected from increased fees—and effectively paying for the value that merchants receive.[21]

6.23 MasterCard contended that the RBA's regulatory intervention in 2003 had broken 'what was until then an efficient value chain'. MasterCard added that this had created economic pressure through the system, including on interest rates, and had not reduced consumer prices as the RBA and others had claimed.[22] It argued for the removal of interchange regulation, or failing that, redefining the RBA's remit so that it was required to 'look at any future regulation through the lens of the consumer, which it is not required to do in its remit today'. As discussed further below, MasterCard also suggested that if interchange regulation was not removed, then it should at least apply equally to all card schemes, including American Express.[23]

6.24 Mr Zinn argued that there was no evidence or research 'to show that the merchants have passed on any benefit from having a lower interchange fee where that has been regulated'.[24] The Australian Taxpayers' Alliance (ATA) pointed to three reasons the lower merchant service fees resulting from lower interchange fees were not passed through to consumers:

> Firstly, there might be resale markets which are just not very competitive. Secondly, the amounts we are talking about here might be so small that they do not shift the pricepoints. If something is priced at $9.99, a very marginal reduction in the cost might not be enough to justify shifting to another pricepoint. Finally, for a large and increasing share of transactions, cards

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20 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, pp. 49, 54; Mr Stephen Karpin, Group Country Manager, Australia, New Zealand and South Pacific, Visa Inc, *Proof Committee Hansard*, 16 October 2015, p. 71.

21 CHOICE, *Submission 10* (supplementary), p. 47.

22 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, p. 47.

23 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, p. 47.

24 Mr Christopher Zinn, private capacity, *Proof Committee Hansard*, 27 August 2015, p. 49.

> are cheaper than cash. Given that there is a regulatory—or, often, a customary—requirement to take cash, the pricing, in order to avoid a loss for retailers, may be to the cash cost rather than the card cost. Therefore, changes in the card cost do not lead to reductions in prices.[25]

6.25 Visa argued that if interchange regulation was maintained, then the weighted average approach—which allows for a range of interchange rates to be set—should be maintained, rather than any move toward a flat rate. It added that the weighted average should not be set any lower. The flexibility of the current rate model, Visa argued:

> …provides for a greater range of product choice for cardholders and it also presents the flexibility to foster better merchant acceptance, expanding electronic payment acceptance, enhancing security of payments and accepting credit from those who might otherwise not get access to it in the event that interchange were lower.[26]

6.26 The Australian Payments Clearing Association (APCA) also argued against reducing the overall level of interchange fees:

> Australia has low interchange fees compared to other developed credit card markets, such as those in North America. Further, APCA believes the Australian payments industry is exhibiting high levels of competition and innovation, with the rapid uptake of contactless payments and the introduction of new mobile-based and online payment offerings. Drastic change to the economics of retail payments runs the risk of disrupting existing market dynamics and innovation, with costs ultimately borne by cardholders and merchants.[27]

6.27 A joint submission from ATA and the International Alliance for Electronic Payments (IAEP) suggested that the interchange fees are 'the subject of increasingly stringent regulation that is restricting the development of the credit card market and harming consumer welfare'. The ATA and IAEP claimed that interchange fees deliver significant benefits to merchants, in the form of increased sales, a guarantee of payment, and a shifting of credit risk to financial institutions. These benefits, they argued, are reduced by regulation. The ATA and IAEP characterised the RBA's regulation of interchange fees as an unjustifiable 'interference in a functioning market'. If interchange fees were subject to lower limits, the ATA and IAEP argued, this would lead to increased interest rates and fees, and reduced interest-free periods. Smaller card providers would also have 'reduced capacity to offer low-cost cards'.[28]

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25 Mr Matthew Sinclair, Advisor, Australian Taxpayers' Alliance, *Proof Committee Hansard*, 16 October 2015, pp. 36-37.

26 Mr Stephen Karpin, Group Country Manager, Australia, New Zealand and South Pacific, Visa Inc, *Proof Committee Hansard*, 16 October 2015, p. 69.

27 Australian Payments Clearing Association, *Submission 22*, p. 1.

28 Australian Taxpayers' Alliance & the International Alliance for Electronic Payments, *Submission 8*, p. 2.

6.28 COBA argued against any changes that would lower the limit on interchange fees, and asserted this would reduce the capacity of smaller card issuers to offer low-rate cards. In the event interchange limits were lowered, COBA wrote that card issuers would 'be forced to absorb the reduction in income or recover it from card holders in the form of higher rates or higher fees'.[29]

6.29 CHOICE conceded that it was 'difficult to accurately assess the claims that fees will rise and that low interest cards will not be able to be provided if interchange is lowered'. However, it observed that low-rate cards remained available in foreign markets where interchange fees had been lowered. More broadly, CHOICE concluded that it was 'spurious to suggest that reducing interchange is somehow going to create new costs for consumers; the costs already exist, they are simply submerged in business-to-business transactions over which consumers have little visibility or opportunity to respond'.[30]

Competitive neutrality and interchange fees

6.30 While interchange fees in designated four-party schemes (MasterCard and Visa) are subject to regulation by the RBA, three-party schemes (most notably American Express and Diners Club) are not subject to interchange regulation.[31] The FSI Interim Report explained that in three-party schemes, the scheme takes the role of acquirer and issuer. As 'no interchange fees are involved, these schemes are not covered by interchange regulation'.[32] However, three-party scheme companion cards, which are typically operated through the American Express scheme and issued by banks, operate much like four-party schemes, and the service fees that companion card schemes pay to issuers are economically equivalent to interchange fees in four-party payment schemes.[33] Despite the existence of interchange-like fees, American Express companion cards are not currently subject to interchange regulation, although as noted earlier the system was designated on 15 October 2015.[34]

6.31 The RBA noted in its recent Consultation Paper on card payments regulation (discussed later in this chapter) that critics of current regulatory settings—most notably, Visa and MasterCard—have argued that the different regulatory treatment of three- and four-party schemes has 'contributed to the issuance of American Express companion cards and an increase in the market share of three-party schemes over the

29 Customer Owned Banking Association, *Submission 19*, p. 10.

30 CHOICE, *Submission 10* (supplementary), p. 8.

31 MasterCard, *Submission 2* (attachment 4), p. 3.

32 The Treasury, *Financial System Inquiry: Interim Report* (July 2014), section 2, p. 26.

33 The Treasury, *Financial System Inquiry: Interim Report* (July 2014), section 2, p. 26.

34 Reserve Bank of Australia, media release, 'Review of Card Payments Regulation: Designation of Payment Systems', 15 October 2015, http://www.rba.gov.au/media-releases/2015/mr-15-19.html.

past decade'.[35] According to the RBA, most merchants also support bringing companion cards into the regulatory system. In contrast, American Express and some companion card issuers:

> …argued that fee arrangements for companion cards were negotiated bilaterally and therefore were of a different nature to multilateral interchange fees, so should remain outside the regulatory framework. More generally, it was argued that concerns about 'competitive neutrality' had been overstated because American Express had a much smaller share of the cards market than the two largest four-party card schemes; and because American Express cards are not considered 'must take' cards by many merchants, and/or are more often subject to a surcharge.[36]

6.32 The views reported in the RBA's recent consultation paper align with the evidence received by the committee on this subject. American Express's 'strong view' was that American Express branded cards should not be subject to interchange fee regulation.[37] In contrast, MasterCard argued that if interchange regulation was not removed (something it argued for) then the regulations should at least apply equally to all schemes, including American Express.[38] Mr David Masters, a representative of MasterCard, explained the company's concerns regarding the apparent lack of neutrality in the application of interchange regulation:

> The great frustration for me is that the absence of American Express being included in the regulation has meant that reward points are higher on those products because their version of interchange within the GNS business [Global Network Services—that is, American Express companion cards] is higher than ours, which effectively means you have this perverse scenario in Australia where the most expensive card for a retailer to accept is the card that a cardholder is virtually incentivised to pay with. That is broken regulation.[39]

6.33 Like MasterCard, Visa argued for a level regulatory playing field:

> As a consequence of American Express sitting outside the current regulatory environment, we are seeing consumers pay more surcharging at

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35 Reserve Bank of Australia, *Review of Card Payments Regulation: Consultation Paper* (December 2015), p. 9.

36 Reserve Bank of Australia, *Review of Card Payments Regulation: Consultation Paper* (December 2015), p. 10.

37 Ms Luisa Megale, Vice President Asia, International Public Affairs and Communications, American Express, *Proof Committee Hansard*, 22 September 2015, p. 41.

38 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, p. 47.

39 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, p. 48.

> the checkout and a substantial growth of Amex market share since the regulatory imbalance in their favour eventuated in 2003.[40]

6.34 Visa added that American Express companion cards were a four-party model analogous to Visa and MasterCard cards. American Express had grown its market share significantly in recent years, and this growth was largely attributable to the current regulatory imbalance in the market.[41]

Views on surcharging

6.35 As noted above, merchants have some ability to recoup the cost of merchant fees through credit card surcharges. The RBA argued that the ability to surcharge 'is important to promote efficiency in the payment system and is also a means by which merchants can exert some downward pressure on the cost of payments'. However, like several other witnesses, the RBA noted its concern that some firms in particular industries may be surcharging excessively, and indicated that the matter was part of its current review of the Card Payments Regulation (which is discussed further below).[42]

6.36 MasterCard called the effect of surcharging on consumers 'abhorrent'.[43] Visa indicated that its preference was for surcharging to be banned. In the event it was not banned, Visa recommended that there should be 'clear limits related to cost recovery only, backed with the enforcement of a government agency'.[44]

6.37 American Express referred to surcharging as a 'tax on payment at point of sale', and contended that surcharges had 'done absolutely nothing to benefit consumer outcomes'.[45] While surcharging is justified as a way for merchants to recoup the cost of accepting a credit card payment, a range of witnesses noted that merchants also enjoyed substantial benefits by being able to use credit cards. Referring to the specific example of the hotel industry, where surcharging is common, American Express observed:

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40 Mr Stephen Karpin, Group Country Manager, Australia, New Zealand and South Pacific, Visa Inc, *Proof Committee Hansard*, 16 October 2015, p. 69.

41 Mr Stephen Karpin, Group Country Manager, Australia, New Zealand and South Pacific, Visa Inc, *Proof Committee Hansard*, 16 October 2015, p. 70.

42 Reserve Bank of Australia, *Submission 20*, p. 14.

43 Mr David Masters, Head of Public Policy, Asia Pacific, MasterCard, *Proof Committee Hansard*, 22 September 2015, p. 48.

44 Mr Stephen Karpin, Group Country Manager, Australia, New Zealand and South Pacific, Visa Inc, *Proof Committee Hansard*, 16 October 2015, p. 69.

45 Ms Luisa Megale, Vice President Asia, International Public Affairs and Communications, American Express, *Proof Committee Hansard*, 22 September 2015, p. 40.

> Hotels would not survive without taking that swipe [on a credit card] up-front as a security against you trashing their room or skipping out in the middle of the night. So they get a huge benefit from a credit card.[46]

Airline credit card surcharges and fees

6.38 Critics of surcharges often focus on surcharging in specific industries, and the Australian airline industry has been the subject of particularly strong criticism in this regard. Qantas imposes a flat credit card surcharge 'as a means of recovering a substantial part of its cost of card acceptance'. According to Qantas, Jetstar does not levy credit card surcharges, but rather a 'Booking and Service Fee' which is 'not linked to the cost of card acceptance'.[47] Virgin Australia charges a 'Booking and Service Fee' for bookings made using a credit card, debit card or PayPal. It claims the fee 'covers a range of costs, activities, fees and charges in relation to the booking, including (among other things) the reasonable costs of accepting card payments'.[48]

6.39 Mr Klaus Bartosch, who has led an online campaign and petition against airline credit card surcharges, presented evidence to the committee that he claimed showed the airlines were 'profiteering' on credit card surcharges. He argued for an outright ban rather than a legislated cap on surcharges.[49]

6.40 Qantas claimed that it recovers only 81 per cent of its reasonable cost of card acceptance, as defined by the RBA, through its card surcharges. Qantas stressed that the costs of accepting credit cards went 'beyond merchant service fees, which vary between card types, and include people costs, processing costs, infrastructure, equipment, fraud, fraud prevention and other measures'. Qantas also noted that it offers passengers a range of other booking options that enable them to avoid paying the surcharge.[50]

6.41 Qantas advised that it charged a flat credit card surcharge, as opposed to a percentage of the purchase price, because of the administrative simplicity of the approach and the increased transparency it provider to customers. Qantas also indicated that while merchant service fees were percentage based, other costs involved in processing credit card payments were fixed.[51]

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46 Ms Luisa Megale, Vice President Asia, International Public Affairs and Communications, American Express, *Proof Committee Hansard*, 22 September 2015, p. 45.

47 Qantas, *Submission 32*, p. 2. For fees, see http://www.qantas.com.au/travel/airlines/schedule-of-fees/au/en.

48 For fees, see Virgin Australia, http://www.virginaustralia.com/au/en/plan/fees-surcharges/.

49 Mr Michael Michael, private capacity, *Proof Committee Hansard*, 11 September 2015, pp. 1–3.

50 Mr Andrew James Parker, Group Executive, Government and International Affairs, Qantas Airways Ltd, *Proof Committee Hansard*, 11 September 2015, pp. 8–9.

51 Mr Andrew James Parker, Group Executive, Government and International Affairs, Qantas Airways Ltd, *Proof Committee Hansard*, 11 September 2015, p. 9.

6.42 Similarly, Virgin Australia maintained that its use of a flat fee reflected the fact that its card processing costs were both fixed and variable, and, moreover, that a flat fee is the 'simplest and easiest mechanism for consumers to understand and also for the company to administer'. Virgin Australia also advised the committee that the revenue collected through its 'Booking and Service Fee' was less than the cost of accepting card payments.[52]

Financial System Inquiry and government response

6.43 Interchange fees and surcharging were addressed in the FSI, and as discussed further below, the government has accepted the recommendation made in the FSI Final Report on these matters. Specifically, the FSI Final Report made the following recommendation (recommendation 17) in relation to interchange fees and customer surcharging:

> Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.
>
> Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.[53]

6.44 On the issue of surcharging limits, the FSI Final Report suggested that:

> …the current reasonable cost surcharge rules are difficult for system providers to enforce, potentially complex for merchants to comply with and can cause frustration for consumers, as evidenced by the more than 5,000 submissions the Inquiry received on the matter. The rules are complex because each merchant needs to calculate its acceptance costs, which can involve subjective judgements about a number of factors. The rules are difficult to enforce because system providers have limited visibility of these calculations.[54]

6.45 On 20 October 2015, the government released its response to the FSI Final Report. In relation to the recommendation on interchange fees and surcharging, it stated:

> We will increase the efficiency of the payments system and ensure it achieves fairer outcomes for consumers, merchants and system providers by phasing in a legislated ban on excessive card surcharges. The ACCC will be responsible for enforcing these rules.
>
> The Payments System Board will pursue policies to address problems with interchange fees and provide clarity around what constitutes excessive

52 Mr Adam Thatcher, General Counsel, Group Executive Corporate Risk, Virgin Australia Airlines Pty Ltd, *Proof Committee Hansard*, 11 September 2015, p. 18.

53 The Treasury, *Financial System Inquiry: Final Report* (November 2014), p. xxiv.

54 The Treasury, *Financial System Inquiry: Final Report* (November 2014), p. 175.

> customer surcharges on card payments. The Payments System Board released a consultation paper on these issues in March.[55]

6.46 The government further indicated that it expected the Payment Systems Board to complete its work on interchange fees and customer surcharging by mid-2016 (the Payment System Board's review is outlined below).[56]

Competition and Consumer Amendment (Payment Surcharges) Bill 2015

6.47 On 3 December 2015, the government introduced the *Competition and Consumer Amendment (Payment Surcharges) Bill 2015* into the Parliament. Consistent with the commitment given by the government in its response to the FSI Final Report, the bill will:

> …establish a legislative and regulatory framework to ban surcharges imposed in respect of particular payment methods that exceed the cost of acceptance for those payment methods. The amendments will apply to excessive surcharges in respect of payments covered by a Reserve Bank standard or by regulations made for this purpose. Surcharges will be excessive where they exceed the permitted amount specified in the Reserve Bank standards or in the regulations.
>
> The amendments also ensure that the Australian Competition and Consumer Commission (ACCC) is the primary enforcement agency for the ban and that it has appropriate powers of enforcement.[57]

6.48 As explained below, the RBA's consultation paper, released on the same day as the bill sets out a draft standard on surcharging.

Reserve Bank of Australia Review of Card Payments Regulation

6.49 In March 2015, the RBA commenced a review of Card Payments Regulation in response to the FSI Final Report's discussion and recommendations regarding the payments system. An Issues Paper was released in March, followed by a consultation process. The review considered:

- the decline in transparency for some end users of the card systems, in part due to the increased complexity and the wider range of interchange fee categories;
- whether there is scope for interchange fees to fall further, consistent with falls in overall resource costs and as was contemplated in the conclusions to the 2007–08 Review; and

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55 Australian Government, *Improving Australia's Financial System: Government response to the Financial System Inquiry* (2015), p. 6.

56 Australian Government, *Improving Australia's Financial System: Government response to the Financial System Inquiry* (2015), p. 16.

57 Explanatory Memorandum, *Competition and Consumer Amendment (Payment Surcharges) Bill 2015*, p. 3.

- widespread perceptions that card surcharges remain excessive in certain industries.[58]

6.50 On 3 December, the RBA released a Consultation Paper, which sets out the preliminary views of the RBA and new draft standards in relation to the regulation of surcharges on card payments and interchange payments in card systems. The RBA has invited written submissions on its Consultation Paper by 3 February 2016, and has indicated that it does not expect the Board will make any formal decision on changes to interchange standards before its May 2016 meeting. However, the RBA suggests it may be a position to make an earlier decision in relation to the surcharging standards.[59] The RBA's preliminary views and the draft standards are summarised below.

Interchange limits

6.51 As noted above, interchange fees vary widely, with transactions with larger 'strategic' merchants often subject to significant discounts. Higher interchange fees have a corresponding effect on fees levied on merchants by their financial institution. As the RBA explained in its submission, 'the cost of the high interchange rates on premium or commercial cards falls entirely on small merchants and other merchants that do not benefit from special rates.[60]

6.52 The RBA has not proposed any change to the current system of weighted-average interchange benchmark of 50 basis points. However, it does propose supplementing the benchmark with caps on individual interchange fees, and proposes that no credit card interchange fee be able to exceed 0.8 per cent. These changes, it suggests, 'are expected to significantly reduce the extent to which small and medium-sized merchants are disadvantaged relative to a group of preferred merchants in the MasterCard and Visa interchange systems'.[61]

Competitive neutrality

6.53 The RBA raised the issue of competitive neutrality in its Issues Paper, and in the subsequent consultation process heard arguments both for and against extending the current regulatory framework to include bank-issued companion cards. In its Consultation Paper, the RBA has proposed modifying the credit card interchange standard so that the issuance of American Express companion cards will be subject to

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58 Reserve Bank of Australia, *Review of Card Payments Regulation – Issues Paper* (March 2015), http://www.rba.gov.au/payments-system/reforms/review-of-card-payments-regulation/review-of-card-payments-regulation-issues-paper.html.

59 Reserve Bank of Australia, media release, 3 December 2015, http://www.rba.gov.au/media-releases/2015/mr-15-24.html.

60 Reserve Bank of Australia, *Submission 20*, p. 13.

61 Reserve Bank of Australia, media release, 3 December 2015, http://www.rba.gov.au/media-releases/2015/mr-15-24.html.

the same interchange fee regulation that applies to the MasterCard and Visa schemes.[62]

Surcharging

6.54 The RBA consultation paper reiterated the RBA's view that the ability of merchants to levy surcharges was 'an important mechanism for promoting the efficient allocation of resources in the payments system'. However, it noted that:

> …in a small number of cases in particular industries, surcharge levels on some transactions appear to be well in excess of the merchants' likely acceptance costs. This is particularly evident for certain lower-value transactions on which fixed-rate surcharges are levied, as in the airline industry.[63]

6.55 The RBA's preliminary view, as expressed in the Consultation Paper, was that the system would be improved by:

> …moving away from a limit on surcharges based on 'the reasonable cost of acceptance' to one based on fees paid by a merchant to its acquirer (or payment facilitator), and obliging the provision to merchants of information on average acceptance costs for each system. This will be accompanied by the Government's amendments to the *Competition and Consumer Act 2010*, which will ban excessive surcharging and provide enforcement powers to the ACCC.[64]

6.56 The RBA has further suggested that the information provided by banks to merchants on card acceptance costs should be expressed in percentage terms, unless the cost for a particular payment method was genuinely fixed for all transaction values. This, it argued, 'should eliminate the practice—currently common in the airline industry—of charging the same dollar surcharge on transactions with very different costs to the merchant'.[65]

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62 Reserve Bank of Australia, media release, 3 December 2015, http://www.rba.gov.au/media-releases/2015/mr-15-24.html. As noted earlier, the RBA designated the American Express companion card system on 15 October 2015.

63 Reserve Bank of Australia, *Review of Card Payments Regulation: Consultation Paper* (December 2015), p. 8.

64 Reserve Bank of Australia, *Review of Card Payments Regulation: Consultation Paper* (December 2015), p. 37.

65 Reserve Bank of Australia, *Review of Card Payments Regulation: Consultation Paper* (December 2015), pp. 33-34.

Committee view

6.57 One of the committee's primary concerns in relation to interchange fees is the lack of transparency in how they are levied and, in turn, how the costs are passed through to merchants and consumers. The committee therefore welcomes the RBA's consideration in its current review of the regulatory framework for card payments on 'the decline in transparency for some end users of the card systems'. It is the committee's view that its own inquiry, and in particular the contributions made by witnesses on both sides of the debate, has greatly helped bring the complex subject of interchange fees more clearly into public view. The committee notes that the regulation of interchange fees is a matter that affects almost all Australian merchants and consumers, and it would encourage interested organisations and members of the public to engage with the RBA in its current review process.

6.58 On the more specific question of whether interchange fees are too high, too low, or indeed whether they need to be regulated at all, the committee notes that there are strong arguments on both sides of the debate. This by no means should be taken to suggest that the committee considers all arguments in this debate are of equal merit. The committee considers that the optimal regulatory response is likely to be one which carefully balances the role interchange revenues play in supporting the provision of credit card products, and the need for regulatory limits on those fees to improve efficiency and equity outcomes in the payments system. On a very preliminary reading, the committee considers the draft standards suggested in the RBA's Consultation Paper appear to achieve this balance.

6.59 With regard to the credit card surcharges imposed by Australian airlines, the committee acknowledges that the airlines claim that they under-recover their credit card processing costs through their surcharges and other booking fees. However, the committee does not consider that the surcharge costs are fairly or appropriately shared across the airlines' customer base. In particular, the committee considers the application of a flat surcharge unjustifiably disadvantages consumers purchasing less expensive tickets, and contends that there is no justification for multiplying the surcharge for several tickets when payment is made using a single card transaction. The committee welcomes the government's recent moves to introduce a legislative ban on excessive surcharging. The committee is particularly encouraged by the related proposed changes to the RBA's standards on surcharging, which the RBA has suggested will help ensure airlines and other merchants no longer apply flat credit card surcharges or fees.

6.60 Finally, the committee notes that the RBA is responsible for payments regulation under the *Payments Systems (Regulation) Act 1998*, but given the RBA's independence, legislators do not have a direct influence on its regulatory decisions about the payments system. The committee would appreciate an additional perspective about the value and competitive neutrality of payments regulations, and recommends that the government consider a Productivity Commission inquiry into regulation of the payments system, with a particular focus on interchange fees.

Recommendation 11

6.61 The committee recommends that the government consider a Productivity Commission inquiry into the value and competitive neutrality of payments regulations, with a particular focus on interchange fees.

Senator Chris Ketter

Chair