RESERVE BANK OF AUSTRALIA

65 Martin Place
Sydney NSW 2000

GPO Box 3947
Sydney NSW 2001

Michele Bullock
ASSISTANT GOVERNOR – FINANCIAL SYSTEM GROUP

9 July 2021

Tom Leuner
Executive General Manager, Mergers, Exemptions and Digital Division
Australian Competition and Consumer Commission

By Email – tom.leuner@accc.gov.au

Dear Mr Leuner

Re: Proposed amalgamation of BPAY, eftpos and NPPA

We understand that the Commission would like some further information regarding the Bank's policies on competition in the debit card market to assist the Commission in its consideration of the application for the proposed amalgamation of BPAY, eftpos and NPPA. In particular, the Commission is interested in the Bank's views regarding the role of eftpos in the Australian debit card market and potential policy responses in the event that eftpos's ability to exert competitive pressure in this market were to weaken.

The Bank is currently undertaking its Review of Retail Payments Regulation. On 28 May it released a Consultation Paper with preliminary conclusions to the Review, together with draft variations to the Bank's standards for card payment systems. The Bank has invited stakeholder comments on this document, with submissions due 9 July. The staff will be meeting with stakeholders, before bringing recommendations to the Payments System Board at its meeting on 20 August. The Board will then make a decision about whether to implement the draft standards as published or whether additional changes to those standards would be desirable in the interests of competition and efficiency. An update on the Review will be provided immediately following the August meeting. For the time being, I cannot provide any indication of whether the conclusions to the Review will be published within a few weeks of the August meeting or significantly later in the year. This will depend partly on whether the process of consultation suggests a need for significant changes to the proposals.

The Review has had to consider some complex issues regarding competition in the debit card market, and I cannot foreshadow what decisions the Board may ultimately take. However, I can make some observations on behalf of the staff and the Board that may help the Commission's considerations. As noted in the Bank's 16 April submission to the Commission, the Bank is not taking a position regarding the merits of the particular proposal that is now before the Commission and we note that the Commission will take account of a wide range of issues in deciding if the amalgamation of the three schemes would be in the public interest.

On the competitive position of eftpos, the Bank noted in its 16 April submission that it expects that consolidation of the three schemes would be likely to result in a stronger eftpos that would be able to compete more effectively against the two international debit schemes. We expect that a consolidated entity would be better able to deal with coordination issues and the challenges that the three schemes currently face in getting industry participants to take decisions to support new products or build new infrastructure. We expect that the directors appointed to the board of the consolidated entity by its shareholders would be more senior than the directors appointed by those shareholders to the current boards of eftpos and the other two companies. We expect that eftpos in particular would benefit from more strategic decision-making involving more senior bank representatives who have greater ability to support eftpos initiatives within their own organisations.

The issues that the Bank has been considering in the current Review regarding dual-network debit cards (DNDCs) and least-cost routing (LCR) and their role in facilitating competition in the debit card market are very challenging ones. The Bank has been strongly supportive of the role of DNDCs and LCR in promoting competition and holding down payment costs for merchants. As LCR functionality has been gradually rolled out over the past few years, schemes have responded to the increase in competitive pressure with lower interchange and scheme fees on transactions that could be subject to routing to another network. The weighted-average interchange rates for Visa and Mastercard debit payments have declined and since late 2019 have been comfortably below the 8 cents weighted average cap imposed by the Bank. Industry participants have also reported that the international schemes have significantly decreased scheme fees on some routable debit transactions. This has translated into a reduction in the average cost of accepting debit card transactions through the international schemes over the past couple of years; these aggregate data are published quarterly on the Bank's website.

However, as noted in our recent Consultation Paper, there are a number of emerging challenges to the viability of LCR. First, several smaller and mid-sized issuers have begun moving away from DNDCs towards single-network debit cards (SNDCs) which allow payments to be processed through only one (international) debit network. Second, technological changes have driven a significant shift away from the use of physical (plastic) cards at the point-of-sale to the use of new 'form factors', such as mobile wallets, through which LCR is not currently possible. In addition, the shift towards online transactions has reduced the share of transactions that can be routed because eftpos is still in the process of rolling out its online payments functionality. Third, merchants report that the international schemes have sought to leverage their market power in the credit card market to dis-incentivise the take-up of LCR in the debit card market.

As detailed in the Consultation Paper, the Bank is proposing to take a number of actions to safeguard the role of DNDCs and LCR in promoting competition in the debit card market:

- The Bank would state an explicit expectation that the major banks will continue to issue DNDCs, with both schemes to be provisioned in all relevant form factors offered by the issuer (such as in mobile wallets as well as physical cards). The Bank's understanding is that the major banks intend to continue issuance of DNDCs, and that more generally they remain supportive of the domestic eftpos system. The Board has weighed up the economy-wide benefits from greater DNDC issuance against the incremental costs to issuers of supporting a second debit network. On the basis of the evidence and feedback the Bank has received to date, the Board is not convinced that the benefits of extending any requirement to issue DNDCs beyond the major banks would outweigh the additional costs imposed on those smaller issuers. These additional costs could have the effect of reducing competition between ADIs more broadly.
- This is not, however, a straightforward conclusion. The veracity of the evidence is challenged by some stakeholders and it involves weighing up potentially contrasting impacts on competition in the banking and merchant services sectors. The Bank has therefore invited stakeholder views on an alternative option of mandating broader issuance of DNDCs.

- The Bank's interchange standards would be amended to set a lower cents-based interchange cap for SNDC transactions than for DNDC transactions. This would limit the possibility of schemes using interchange rates to incentivise SNDC issuance, which could accelerate the shift towards SNDCs.
- The Bank would state an expectation that all acquirers and payment facilitators (which provide card acceptance services to merchants) will offer and promote LCR functionality to merchants in the device-present (in-person) environment, with regular reporting to the Bank of LCR offerings and merchant take-up. The Board does not see a need for explicit regulatory requirements regarding the provision of LCR at this stage. This reflects the progress that has already been made by acquirers and payment facilitators on developing this functionality and the other policy actions being taken to address specific threats to the viability of LCR. That said, if expectations for the provision of LCR are not met, the Board has said that it will consider formal regulation.
- The Bank would state an expectation that the industry will follow a set of principles regarding the implementation of LCR in the device-not-present (or online) environment. While the Board supports the provision of LCR online, it seems too early for formal intervention in this area as eftpos' online functionality is still being rolled out, including its security capabilities. However, the Board also has some concerns that online LCR could be hindered by scheme rules regarding its implementation. The Board has therefore set out some principles to ensure that the provision of LCR online appropriately balances the interests of merchants, consumers and the card schemes. The Bank would monitor whether the principles are being observed.
- The Bank would explicitly prohibit schemes from engaging in 'tying conduct' involving their debit and credit card products. This would supplement the implied prohibitions in competition law, helping to ensure that the debit schemes compete solely on the basis of their debit card offerings, thereby supporting competition in the debit card market.

Based on stakeholder submissions and consultation discussions over coming weeks, the Board will consider whether the proposed measures outlined above would be in the public interest and consistent with the Bank's mandate to promote competition and efficiency in the payments system. Based on consultation, the Board will make any appropriate changes in concluding the Review.

The Commission has expressed interest in what steps the Bank might take in the event that eftpos' competitive position in the debit card market were to weaken, with LCR and DNDCs playing less of a role in holding down payment costs for merchants.

First, I want to make the general point that in its regulation of the debit card market, the Bank is not looking to protect or promote particular schemes. Rather, regulation is designed to promote competition more broadly by targeting behaviours or practices that have the effect of limiting competitive pressure.

In that context, the Bank has indicated the types of responses it might consider if competitive pressure in the debit card system were to weaken. In particular, the Consultation Paper stated explicitly that if the Board's expectation regarding ongoing issuance of DNDCs by the four major banks was not met, the Board could consider imposing formal regulation in response. This could include an explicit requirement that two networks must be enabled on all debit cards issued by those banks (and potentially by a broader range of banks). It is likely that any such regulation would be agnostic as to which two debit networks were included by issuers; various combinations of domestic and international schemes might be feasible.

More broadly, if the cost of payments were to rise because LCR was no longer a viable option for many merchants and interchange fees or scheme fees were rising, the Board could consider if any other policy actions might be in the public interest. The cost of debit payments to merchants includes three components:

1. Interchange fees: these are wholesale fees set by payment schemes that are paid to issuers by acquirers, and passed on either directly or indirectly to merchants. The current regulatory framework includes a benchmark that effectively prevents weighted-average interchange fees for each of the schemes from rising above 8 cents per transaction. As noted above, the introduction of LCR has prompted reductions in some interchange fees by the two international schemes, so that their weighted-average fees are now materially below the benchmark.
2. Scheme fees: these are wholesale processing and branding fees levied by schemes on acquirers (and separately on issuers) that are also passed on either directly or indirectly to merchants. As noted above, the introduction of LCR has also prompted reductions in some scheme fees charged by the two international schemes.
3. Acquirer mark-ups: this is an additional element that makes up the merchant service fee charged to merchants and reflects both the internal cost to the acquirer of providing acceptance services as well as its profit margin.

The Consultation Paper sets out the Bank's proposals for subjecting components 2 and 3 to greater competitive pressures. For example, the Bank is proposing to require that all regulated schemes disclose their scheme fee schedules to the Bank and also provide quarterly data on overall average fees charged to issuers and acquirers. The Bank will consider publishing some of the aggregate data, to provide stakeholders with greater visibility over the average levels and growth rates of these fees across schemes. The Bank is also proposing initiatives to further improve the transparency of payment costs for merchants, to help reduce some impediments to competition in the acquiring market for smaller merchants. To the extent that developments in the debit card market suggest that implementing additional measures along these lines would be in the public interest, the Bank would consider doing so.

As regards interchange fees, the Bank sets a benchmark for weighted-average interchange fees for the debit card (and credit card) systems and it would be open to the Bank to consider a reduction in this benchmark if there was upward pressure on interchange fees due to a reduction in competition. The Bank could initiate such action at any time, and would not have to wait for a scheduled review of the broader regulatory framework.

In summary, the Bank is already proposing a number of measures to safeguard competition in the debit card market and there would be a number of additional regulatory responses that the Bank could consider in the event that there was some reduction in competition, including due to a weakening in eftpos' position.

I hope this information is helpful to the Commission in its decision-making process. The Bank would be happy to provide any other data or information to support the Commission.

Yours sincerely

Michele Bullock
Assistant Governor FI
Financial System Group