MONASH University

AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

Direct Charging of Card Fees

Working Paper
May 2017

Authors:
Stephen King and Rodney Maddock

MONASH BUSINESS SCHOOL

Thought Leadership in the Financial Sector

Direct Charging of Card Fees

May 2017

Abstract

Australia's payment card regulations are similar to those used in a variety of countries around the world.[1] However, as we argue below, they are complex, open to gaming and have failed to win support from consumers.

In this paper, we present an alternative approach to regulation involving direct charging for card fees. This approach is technically feasible, improves transparency, meets the objective of efficiency of the payment's system, and is simpler than current regulation.

Introduction

All non-cash payments for retail transactions involve multiple parties. While the goods are simply handed over the counter, the payment is more complex. Money has to move from the customer's account to the merchant's account so the transaction involves at least four parties – customer, customer's financial institution, merchant and merchant's institution. Information has to flow between the various parties to establish and authorise the transfer of funds.

Payments is a very big business. The total value of credit and charge card transactions in Australia is about $26b per month. The total value of debit card transactions is about $22b per month.[2] The return for getting the incentives right is thus very large. This has led authorities to impose regulations at multiple stages in pursuit of efficient outcomes.

At the retail level, merchants can 'surcharge' customers for card transactions but these surcharges can only be up to levels set by the Reserve Bank of Australia (RBA).[3] The

[1] "Following the Wallis Inquiry, Australia was one of the first countries to implement interchange fee caps. Interchange fee caps have since become more common and are currently applied in 38 jurisdictions" Commonwealth of Australia 2014, *Financial system inquiry: Final report* (Canberra), p171. See also Hayashi, F and Maniff, J 2014, *Interchange fees and network rules: a shift from antitrust litigation to regulatory measures in various countries* (Federal Reserve Bank of Kansas City, Kansas City), p1.

2 See tables available "*Payments Data*". RBA. http://www.rba.gov.au/payments-and-infrastructure/resources/statistics/ (accessed on 21 December 2016).

[3] "A payment surcharge is an additional amount charged by a business when you pay for goods or services by one form of payment (e.g. a credit card) rather than another (e.g. cash)." "*Credit, debit & prepaid card surcharges*". Australian Competition and Consumer Commission. https://www.accc.gov.au/consumers/prices-surcharges-receipts/credit-debit-prepaid-card-surcharges (accessed November 15, 2016).

Australian Competition and Consumer Commission (ACCC) can prosecute ‘overcharging’ merchants.[4]

At the interbank level, the card holder’s bank can charge the merchant’s bank an interchange fee.[5] This fee is also regulated by the RBA.

Interchange fee regulation and surcharging regulation were introduced in Australia from 2003, and the regulation has been modified and expanded since then.[6]

The stated objective of the regulation is to “improve the efficiency of the payments system”.[7] For example, the RBA notes that merchant surcharging “provide[s] price signals that encourage consumers to use less expensive payment methods”. It argues that regulation is needed to prevent excessive surcharging that “diminishes the effectiveness of these price signals”.[8] Similarly, the RBA argues that competition is ineffective in holding interchange fees to an appropriate level in “mature card systems”.[9] Regulation is needed to overcome this market failure and prevent excessively high fees.

In this paper we argue for a much simpler system, what we call direct charging. Under this model, each merchant sets prices for goods and services that do not depend on the payment instrument proffered by the customer. There is no surcharging (so we can eliminate one level of regulation).

---

[4] “On 25 February 2016 the *Competition and Consumer Amendment (Payment Surcharges) Act 2016* became law. It inserted a new part into the CCA [*Competition and Consumer Act* 2010] banning excessive payment surcharges and provided new powers for the ACCC.” The ban covers credit, debit and prepaid card transactions involving Visa, MasterCard and American Express companion cards, but not cards directly issued by American Express. It also covers the EFTPOS system operated by the Australian banks. “*Credit, debit & prepaid card surcharges*”. Australian Competition and Consumer Commission. https://www.accc.gov.au/consumers/prices-surcharges-receipts/credit-debit-prepaid-card-surcharges (accessed November 15, 2016).

[5] “Interchange fees are wholesale fees set by card schemes such as MasterCard, Visa and eftpos that require payments from the merchant's bank to the cardholder's bank on every transaction.” “*Questions & Answers: Card payments regulation”.* RBA. http://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/q-and-a/card-payments-regulation-qa-conclusions-paper.html (accessed 15 November 2016)

[6] For an excellent summary of the payments system reforms prior to 2010, see Bullcock, M 2010, *A guide to the Card Payment System Reforms* (Reserve Bank of Australia Bulletin, September Quarter), pp51-60. For a more recent overview of changes to payment card regulation see Reserve Bank of Australia 2016, *Review of Card Payments Regulation: Conclusions Paper*.

[7] “Financial system inquiry: Final report” November 2014, Commonwealth of Australia, Canberra at p.171

[8] See “*Questions & Answers: Card payments regulation”.* RBA. http://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/q-and-a/card-payments-regulation-qa-conclusions-paper.html (accessed 21 December 2016).

[9] *Ibid*.

The customer will be (or may be) charged a fee directly by her financial institution. As with automatic teller machine (ATM) withdrawals, this will be presented as an electronic message and give the customer the option of aborting the payment. The essential point of the direct charging concept is that the customer can see the fee that she will be charged for using that particular payment method. The customer can then choose to accept or decline that payment method and move to an alternative. This will impose a market discipline on the fee structure.

This direct charge may (will) reflect the cost of using that form of payment. It may have embedded in it various interchange fees and other charges institutions charge each other. Excessive interchange fees will show up in higher charges to customers. This will allow customers rather than regulators to impose the necessary cost disciplines on the payments market.

Direct charging removes the need for any surcharging (or surcharging regulations). It removes the need to regulate interchange fees. If there is a per transaction interchange fee, it cannot be passed through to the merchant. So direct charging greatly simplifies the regulation. It increases transparency and intensifies interbank competition. Consumers often hold multiple payment cards and if one charges excessive fees then consumers will quickly switch to another. Further, direct charging is technically feasible and already occurs for ATMs.

Thus, we see direct charging as a simple practical approach that better meets regulatory objectives than the current rules.

The problems with current payment card regulation

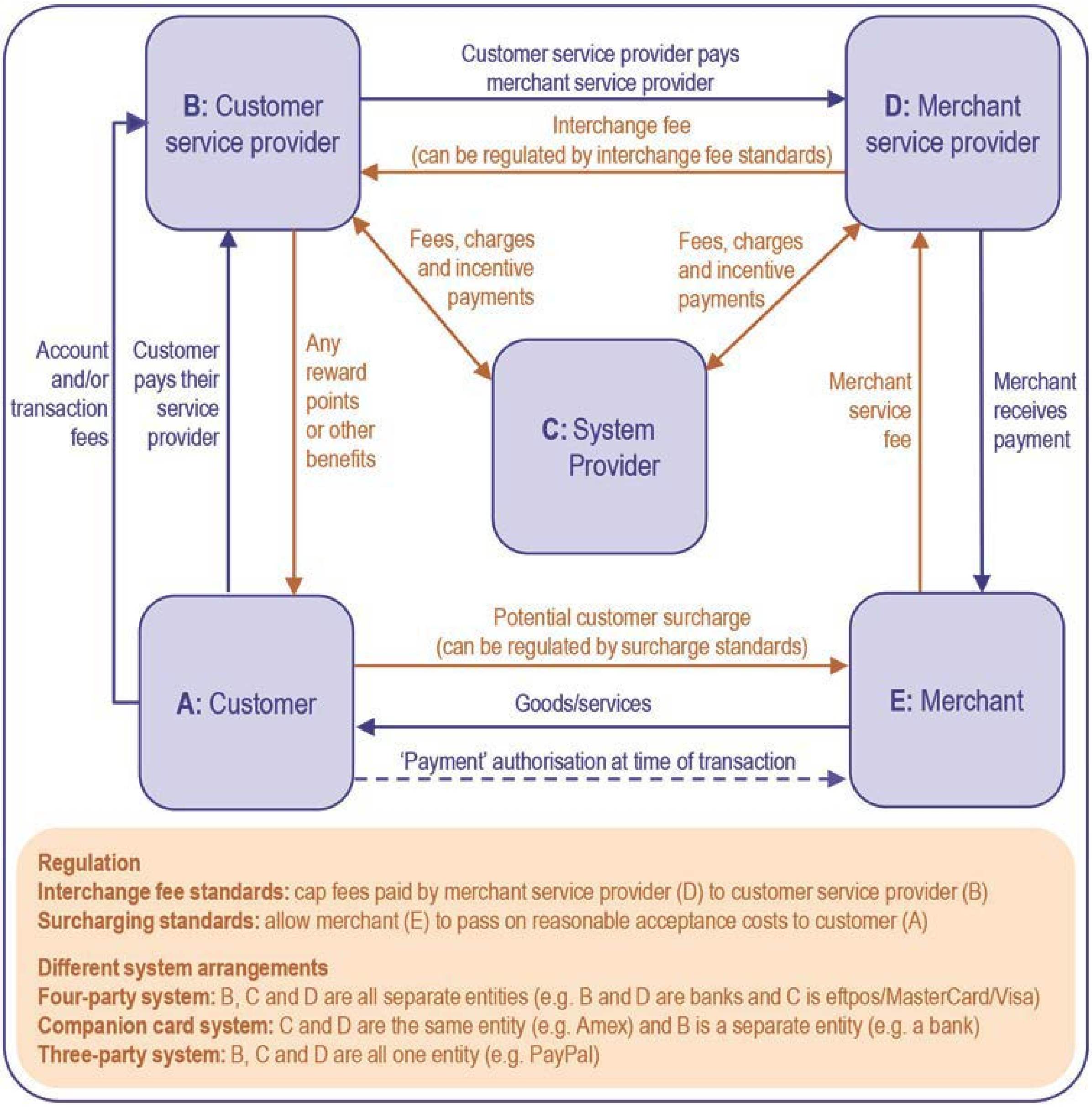
A payment card involves up to five different parties: the customer, the merchant, the two financial institutions (service providers), such as banks, that service the customer and the merchant, and often a system provider (such as Visa and MasterCard) who operate the card system. Figure 1 summarises the range of parties and flows involved in a payment's card transaction.

Note that

(i) The interchange fee regulation covers direct payments between the service providers (parties B and D in figure 1).

(ii) Surcharging regulation covers some of the payments between the merchant and customer (parties A and E in figure 1).

Figure 1: Payments system fees and charges.[10]



Potential problems with both interchange and surcharging regulation are highlighted by this diagram. For example, it is clear from that any regulation of the interchange fee can be circumvented by channelling payments through the system provider (party C). For example, if the current interchange fee is $2 but the regulated fee is $1, then the parties can avoid the regulation by paying $1 as an official interchange fee and then the merchant's service provider passes $1 to the system provider who immediately passes it on to the customer's service provider. The net result is that the merchant service provider pays the customer service

[10] Reproduced from Commonwealth of Australia 2014, Financial system inquiry: Final report (Canberra), p172.

provider $2 with or without the regulation. The only effect of the regulation is to increase the number of electronic transfers.

Because of this problem, 'anti avoidance' regulation is needed. Thus, in 2016, the RBA announced that "to prevent possible circumvention of the debit and credit card interchange standards there will now be limits on any scheme payments to issuers that are not captured with the interchange benchmarks".[11]

Similarly, interchange fees can be avoided by integrating certain parties. As noted in figure 1, in a companion card system, the system provider and the merchant service provider are the same party. Formally there is no 'interchange fee' although there are payments from the combined party to the customer's service provider. These payments were not regulated between 2003 and 2016 and companion card schemes grew significantly in popularity.[12] In 2016 the RBA announced that "Interchange-like payments to issuers in the American Express companion card system will be subject to equivalent regulation as applies to the MasterCard and Visa credit card systems".[13]

Interchange fees can also be avoided by forming a 'three party' payment scheme where the two service providers and the system provider are the one party. Any 'fee' then becomes an internal transfer and the 'fees' of these three-party systems remain unregulated.

As with any price-based regulation, the regulator faces the issue of setting the 'correct' regulated price. It is unclear what this should be. After all, what interchange fee (if any) will lead to an 'efficient' payment card system? Further, what if there is not a single 'best' fee for all transactions?

The RBA dealt with these problems by setting a 'benchmark' interchange fee but allowing for variation around that average benchmark. This has led to an increased variance in interchange fees with 'preferred' merchants benefitting from lower fees than other merchants.[14] As a result, the RBA recently capped credit card interchange fees at 0.80 per cent while retaining the

---

[11] Reserve Bank of Australia 2016, *Review of Card Payments Regulation: Conclusions Paper,* p2.

[12] The RBA estimates that "the combined share of credit and charge card transactions accounted for by American Express and Diners Club has increased by around three percentage points since the early 2000s and currently stands at around 19 per cent" *Ibid,* p26.

[13] *Ibid, p2..*

[14] Reserve Bank of Australia 2016, *Review of Card Payments Regulation: Conclusions Paper,* pp11-12.

average 'benchmark' at 0.50 per cent.[15] In contrast, the European Union applies "hard caps of 0.20 per cent for debit card transactions and 0.30 per cent for credit card transactions".[16]

Figure 1 shows that the interchange fee is simply one of a complex system of payments between parties. This makes it difficult, if not impossible, to determine the appropriate regulated interchange fee. For example, the RBA's September Bulletin notes that the amount of surcharging by merchants has varied both over time and between different types of merchants.[17] Thus "in June 2010, around 40 per cent of very large merchants imposed a surcharge; for small or very small merchants, the percentage was closer to 20 per cent". The impact of both the amount of merchant surcharging and the level of merchant competition on interchange fee regulation in Australia is unclear.[18]

The variation in surcharging highlights the problem facing the merchant. Different payment instruments involve different fees for the merchant. <u>However, the customer, not the merchant, makes the decision about which payment card to use for a transaction.</u> From the customer's perspective, the merchant is setting an additional charge that is opaque and varies between merchants. To the degree that the customer is aware that the merchant pays different fees for different payment cards, the customer is unlikely to know the size of these fees. Thus, the customer has no way to judge if the surcharge is simply recovering the merchant's costs or represents an attempt at price discrimination.[19]

Consumer concerns with surcharging were reflected in a survey-based report prepared by the consumer organisation Choice for NSW Fair Trading.[20] The report highlights the difficulty for consumers in knowing if a surcharge is "fair and reasonable" and notes that 68 per cent of its survey recipients believe that surcharging for credit cards should not be allowed. Frustration

---

[15] See the RBA standards attached to Reserve Bank of Australia 2016, *Review of Card Payments Regulation: Conclusions Paper,*.

[16] Reserve Bank of Australia 2016, *Review of Card Payments Regulation: Conclusions Paper, p15.*

[17] Bullcock, M 2010, *A guide to the Card Payment System Reforms* (Reserve Bank of Australia Bulletin, September Quarter), p58.

[18] Indeed, Gans and King argue that with either strong merchant competition or perfect merchant surcharging, regulation of interchange fees will result in changes in other prices and fees so that the regulation has no economic effect. Gans, J and King, S 2003, "The Neutrality of Interchange Fees in Payment Systems" *Topics in Economic Analysis & Policy* Vol 3(1): p1069.

[19] The potential for card surcharges to be used for price discrimination has been recognised in the literature. See for example Gans, J and king, S 2003, "A theoretical analysis of credit card reform in Australia" *Economic Record*, vol 79(247), pp462-472.

[20] Choice 2010, *Choice report: Credit card surcharging in Australia* (Report prepared on behalf of NSW Fair Trading).

with surcharging was also reflected in the more than 5000 submissions on the issue received by the 2014 Financial System Inquiry.[21]

In summary, current regulation of interchange fees and surcharging is complex and lacks consumer support. While it has led to a change in consumer behaviour, it has also needed ongoing modification as participants have changed their behaviour to avoid the impact of the regulation. In contrast, direct charging for card fees provides a simple alternative that avoids these problems and can apply to all payment cards, without any surcharging or the need for any regulation of fees.

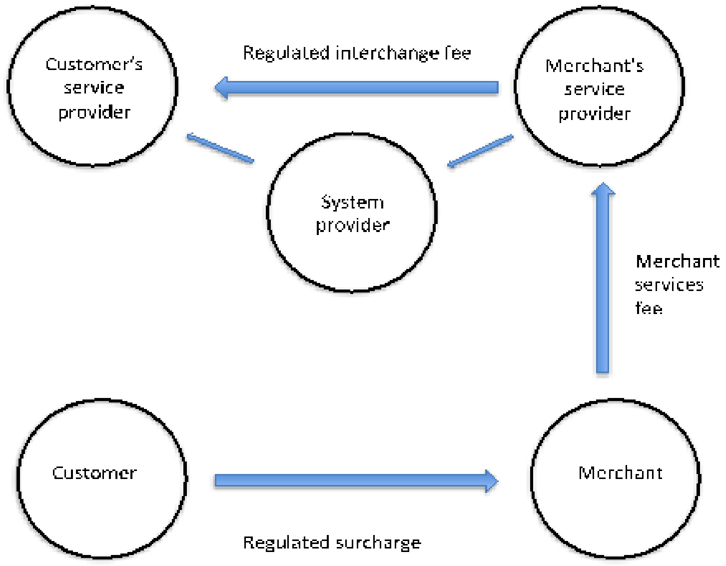
What is direct charging for card fees?

Under current regulation, a customer's service provider can charge fees on a transaction in two ways. First, there can be a charge paid directly by the customer. For example, these charges are common if the customer uses a credit card overseas. The customer may only be notified of such charges when accessing a statement of card transactions.

Second, the customer's service provider can charge the merchant's service provider (directly or through the system provider). The merchant's service provider can then pass on this interchange fee, together with any additional transaction fees it imposes, to the merchant. The merchant can then pass on this merchant service fee to the customer if the merchant surcharges for the relevant payment instrument. This second chain of fees is illustrated in Figure 2.

[21] Commonwealth of Australia 2014, *Financial system inquiry: Final report* (Canberra), p175.

Figure 2: Current transaction payment flows and regulation



Direct charging both shortens this second chain of fees and improves customer information about any fees.

Under direct charging, the merchant sets the same price for a good or service regardless of the payment instrument used. As long as the merchant accepts that payment instrument, then there is no surcharge.

There is no per-transaction merchant services fee. There may be a fixed (say annual or monthly) payment between the merchant and the merchant's service provider for the equipment associated with accepting a transaction (the merchant pays its service provider) or to encourage the merchant to accept the payment instrument (the service provider pays the merchant). However, there is no additional payment associated with an individual transaction.

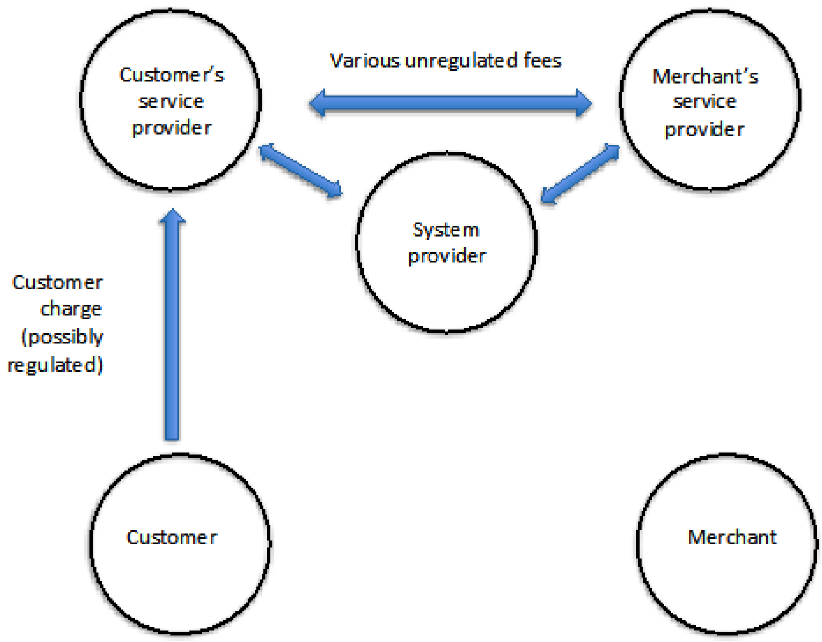
There may be payments between the two service providers and the system provider, such as an interchange fee, which vary on a transaction basis. These are unregulated and, as there is no per-transaction merchant services fee, these payments cannot be 'passed on' to the merchant.

There is, however, a possible/likely direct fee that is paid by the customer when the transaction occurs. When the customer uses an electronic terminal to initiate a payment, the customer's service provider can then inform the customer of any fee that is associated with the transaction. If there is a fee, the customer is given the option of terminating the payment request (and not paying the fee) or continuing with the request (and paying the fee). If the customer terminates the payment then she can use a different payment instrument to complete the transaction.

<u>The customer fees do not require any regulation at all if there is sufficient competition between potential service providers.</u>

The flow of funds for direct charging is illustrated in Figure 3.

Figure 3: Direct charging transaction payment flows and regulation



Why is direct charging a better solution for card fees?

Direct charging is a better way to regulate card fees than the current system that is used in Australia.

Simple

Direct charging simplifies regulation by changing the flow of funds. The indirect flow of funds shown in figure 2 has led to (at least) two separate points of price regulation – the interchange fee and any merchant surcharge. Direct charging eliminates the need for price regulation by making surcharging unnecessary, and making any fees internal to the payment network, with one real-time customer charge. By making any customer fees transparent in real time, direct charging can allow competition, rather than regulation, to determine customer charges.

In contrast to current regulation, direct charging regulation requires only two steps.

First, transaction-based charges (or payments) to a merchant, such as the merchant services fee, are eliminated. There is no surcharging based on the customer's choice of payment instrument and the merchant simply sets a single price for any good and service that it sells.

The merchant's service provider or the system provider may still receive a transaction-based payment. However, these payments would need to be sourced from the customer's service provider.

Second, the customer's service provider may charge a transaction-based fee to the customer. However, this fee must be charged and made clear to the customer at the time of the transaction. The customer must actively accept the fee, with an option available to the customer to cancel the transaction (and use an alternative payment instrument) if she wishes.

<u>Direct charging does not require any regulatory price setting:</u>

- There is no interchange fee regulation, so the regulator does not need to determine what fees are appropriate or excessive. Because there is no price regulation, there is no need for the regulator to consider cost data or to try and block 'loop holes' by regulating fees that are paid to or from the system provider.

- Under direct charging, a merchant cannot surcharge based on the payment instrument chosen by a customer. So, the regulator does not need to determine if a surcharge is 'appropriate' or not. Further, there is no issue of price discrimination based on the mode of payment used by a customer.

The merchant can still choose whether to accept a specific payment card. If a payment card is too costly from the merchant's perspective, either due to the annual fee charged by the merchant's service provider or the costs of using the instrument (such as hardware costs), the merchant can decline to accept that card. However, so long as there is competition between alternative merchant service providers and between alternative retailers, there is no reason for any regulation governing the fixed fees paid between a merchant and its service provider.

Similarly, competition between payment instruments will determine the fees (if any) charged to customers. Regulations need to be in place to ensure that these fees are clear to the customer before they commit to using a payment instrument on any specific transaction. However, there is no need for any price regulation over these fees.

Transparent

It is the customer who chooses the payment instrument in a transaction. While the merchant has a 'menu' of acceptable payment instruments, the customer chooses the specific instrument from that menu, whether cash, credit card, debit card, or something else. The current flow of card payments and charges, however, means that customers often do not see the actual cost of their payment choice. The customer does not know the fees charged to the merchant, and does not know if any surcharge reflects those fees. A customer may be rewarded for using a specific card. But it is often unclear to the customer exactly who is funding these rewards.

In such a situation, customers may choose payment instruments that they would bypass if they had better information.

In contrast, direct charging provides the customer with a clear indication of the cost of using a specific payment card for a transaction. The customer is told that cost as part of the transaction. Further, the customer has the option of continuing to use the card or changing payment instruments after she is told the cost. This transparency will lead to clearer decisions by customers. It will make transparent the costs or benefits of using a specific card to the customer who chooses to use that card.

Fair

The current system of card payments and surcharges leads to opaque cross-subsidies. For example, if a merchant doesn't surcharge, but is charged a merchant services fee, then it will recover this fee from its general operations. The merchant services fees associated with card payments will be part of the merchant's marginal costs, reflected in retail prices. This means that customers who do not choose to pay with a card may be implicitly subsidising customers who use a payment card.

Even if a merchant does surcharge, the merchant services fees associated with one brand of payment card can differ depending on the type of card. For example, merchant fees may be higher on 'premium' cards than on 'standard' cards of the same brand. Often these fee differences are reflected in premium card holders receiving greater 'rewards' for a transaction. A flat surcharge on a brand of payment card that covers the average merchant services fee for that brand will be 'too high' for standard cards and 'too low' for premium cards.

Direct charging for payment card fees removes these implicit cross subsidies. A customer will face the specific fee associated with her card, and can choose to accept or reject that fee. There are no surcharges or transactions-based merchant services fees that lead to inequities between customers.

Efficient

Different payment instruments have different marginal costs and benefits for customers and merchants. They also have different 'system' costs. The customer has an incentive to choose the most efficient payment instrument if she faces the overall costs and benefits of using that instrument.

The issue of 'optimal' fees and incentives has been key in the economic literature on interchange fee regulation.[22] An 'optimal' interchange fee, together with 'optimal' merchant surcharging, can provide incentives for the customer to choose the payment instrument that maximises economic efficiency. Of course, both the literature and practical experience have shown that neither the interchange fee nor any surcharge need be optimal in practice.

When a customer chooses a specific payment instrument, three potential marginal costs or benefits arise. First, the benefits to the customer herself. This may include the convenience and ease of using the payment instrument and the security of the payment. Second, the benefits or costs to the merchant. These may include convenience of recording the transaction, security or the costs of processing the transaction. Third, the service providers and system provider will face marginal costs for creating and processing the transaction.

Direct charging creates strong incentives for the customer to face two of these marginal costs and benefits. The customer will directly face her own costs or benefits. The 'system' costs can also be passed through to the customer. If the merchant's service provider faces a marginal cost of a card transaction then this can be passed back to the customer's service provider through a (negative) interchange fee. The system provider can also pass any marginal costs to the customer's service provider through fees. The customer's service provider can add these transferred costs to its own marginal cost and use the direct charge to pass these on to the customer who makes the choice to use the payment card.

[22] See for example Baxter, WF 1983, "Bank interchange of transactional paper: Legal and economic perspectives", *Journal of Law and Economics*, vol 26,: pp541-588; or Rochet, J-C and Tirole, J 2002, "Cooperation among competitors: Some economics of payment card associations", *RAND Journal of Economics*, vol 33: pp549-570.

The transparency of direct charging means that customer fees are more likely to reflect underlying costs than under the current approach to payment card regulation. Customers will observe any direct charge in real time and before finalising their choice of payment instrument. This will lead to transaction-by-transaction competition between payment cards and their related service providers. If the transaction fee on a payment card is too high, the customer can avoid the fee by switching the transaction to an alternative payment instrument. This competition will temper any market power of service providers or card systems.

In contrast, current regulation means that customers are unlikely to see any specific fees or rewards from different payment instruments until they receive a statement from their service provider, well after the specific transaction.

Under direct charging, the merchant receives the same payment for a sale regardless of the payment instrument chosen by the customer. However, the merchant may not be neutral over payment instruments. Direct charging does not provide any financial mechanism for the merchant to reflect its marginal preference for specific payment instruments.

Nonetheless, any merchant benefits can be reflected by the merchant ‘directing’ customers towards a preferred payment instrument, say through signage (but not price differences). While direction may not fully capture the relative benefits to the merchant, the merchant’s incentives in directing the customer are in line with the costs or benefits to the merchant. The merchant has no monetary benefit from directing the customer to a higher cost payment instrument as there is no surcharging to the customer or marginal fee paid by the merchant.

In summary, direct charging is not a perfect system to ensure that customers choose the most efficient payment instrument for each transaction. It will not perfectly capture merchant costs and benefits. However, it is likely to significantly enhance competition between payment instruments. While imperfect, it is likely to be significantly more efficient than the current system of fee and surcharge regulation.

Feasible

Direct charging is feasible with current payment card technology. Direct charging is used for ATM charges in Australia. These transactions use networks that are also used by payment cards. Payment card transactions currently need to be electronically ‘cleared’ by the customer’s service provider. Direct charging would require that, in addition to clearing the transaction, the customer’s service provider would message any transaction fee back to the card payment terminal, giving the customer the option to accept the fee or abort the transaction.

A payment that is like direct charging already occurs when a merchant offers direct currency conversion (DCC) for an international payment card transaction.

Under DCC, a customer whose 'home' currency is different to the currency used by the merchant, is given the option of paying in either the home or merchant's currency. The 'home currency' amount is displayed to the customer on the merchant's payment terminal. The customer has the option to electronically accept that amount. If the customer rejects the 'home currency' offer, then the customer pays the (displayed) price in the merchant's currency.[23]

DCC transactions generally involve the merchant, the merchant's service provider and, potentially, a third-party currency exchange provider. The transaction usually doesn't require extra information to be provided to or from the system provider or the customer's service provider. However, DCC transactions provide an example of the customer experience with direct charging of card fees.

Direct charging may be limited for low value contactless card transactions. These 'tap and go' transactions do not require the customer to interact with the card terminal, for example, by choosing the relevant account for the transaction. The transaction is processed through a single step where the terminal sends information to the customer's service provider but does not require information to be returned to the terminal from that provider.[24] Low-value contactless transactions cannot be used for DCC and would not be able to include a direct charge to the customer that is displayed on the terminal.

While low value contactless transactions cannot set a direct customer charge, this is not a problem for the regulation. On such transactions, the marginal customer fee is zero. If the customer's service provider does not wish to supply these transactions without cost then it can simply lower the relevant value threshold for a 'tap and go' transaction, or decline to offer this functionality with its payment cards. Alternatively, the service provider may choose to set a higher fixed annual fee for a card that has 'tap and go' transactions capability. The customer will then be able to choose between competing card offerings when choosing which payment cards to carry.

---

[23] For a discussion of DCC, see *Australian Competition and Consumer Commission v Visa Inc*. [2015], Federal Court of Australia, FCA 1020, (4 September 2015) at paragraphs 6-48.

[24] See Tyro Payments Ltd 2014, *Tyro submission to Financial System Inquiry.*

Merchants should not be charged a fee per transaction

If a customer chooses to pay with card x, we want the customer to see the cost of providing that payment service so that she can choose the best for her (possibly the lowest cost). This does not happen at the moment. Currently the customer may pay in two different ways: via a surcharge imposed by the merchant, and through her own bank or card company. Further, the customer may not face all the costs associated with her choice, for example, if the merchant does not pass all the merchant services fee through a surcharge. This is complicated and opaque.

Our proposal is to get the merchant out of the stream of transaction payments so that the customer making the card choice sees the costs of that choice.

There are two requirements on the merchant's side:

- First all surcharging should be prohibited so all customers will be charged the same price regardless of payment instrument. By this, merchants would not be allowed to recoup the cost of a particular choice of payment from customers so differential costs have to be recovered somewhere else.

- Second, merchants should not pay their merchant services provider a fee per transaction. (They might be charged an annual fee for equipment.) By this, merchant services providers would not be allowed to recoup the cost of a particular choice of payment from merchants so differential costs would have to be recovered somewhere else.

The "somewhere else" in both statements is from the customer's side of the transaction.

The second rule is needed to limit the cross subsidies we see at the moment. Presently, if a merchant charges the same price for goods sold using a credit card, a debit card or EFTPOS, she receives different amounts after paying the transaction fees. From the merchant's viewpoint, the credit card customer is getting the product more cheaply than some other customers. More of the merchant's costs are thus being met by customers using cheaper form of payment which is an inappropriate cross-subsidy.

Will direct charging be effective?

Direct charging is a simple and transparent way to reorganise payment card transactions to reduce regulation while increasing both the efficiency and equity of the payment system. Further, it is feasible with existing technology.

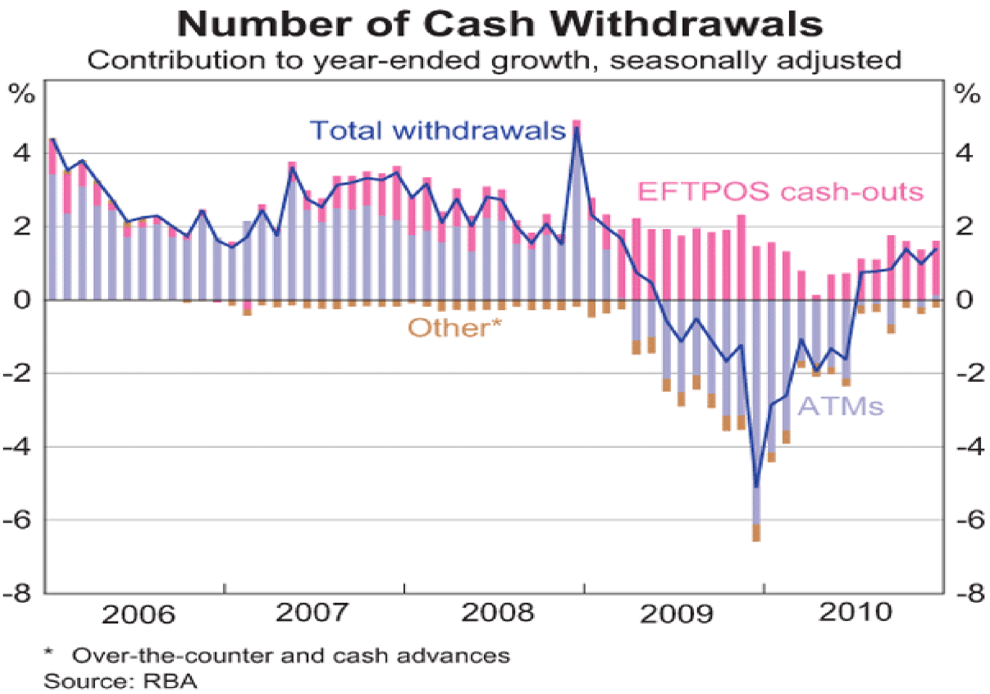
Direct charging will only 'make a difference' if customers respond to the displayed fees and actively make their choice of payment method based on those fees. Experience with ATM direct charging, shows that this is exactly how customers respond.

In March 2009, ATM fees were reformed in Australia to make them more transparent to customers. Prior to the reforms, customers who used a 'foreign' ATM for a transaction only found out about the fee associated with that transaction when they received their monthly bank statement. With the reforms, customers are told transaction charges and have an option to 'continue' or 'abort' when they make the transaction.[25]

The reforms, which are analogous to direct charging for payment cards, led to significant changes in customer behaviour.

"All of the available information continues to suggest that consumers are responding to the pricing signals inherent in direct charging, and ATM owners are responding by increasing the availability of ATMs".[26]

This response is highlighted in figure 4 (taken from the March 2011 RBA Bulletin), which shows the reduction in growth of ATM withdrawals following the reforms.



[25]For details on the reforms see Filipovski, B and Flood, D 2010, Reform of the ATM system – one year on (Reserve Bank of Australia Bulletin, September Quarter), pp37-45.

[26] Flood, D., Hancock, J and Smith, K 2011, *The ATM reforms – new evidence from survey and market data* (Reserve Bank of Australia Bulletin, March Quarter), pp.43-49 at p.43.

Customers actively responded to the transparent fees, even though, in general, the customers had been paying around the same fees before the reforms.

"Around 10 per cent of respondents indicated that they had planned to make an ATM cash withdrawal in the past month but cancelled the transaction because the ATM owner charged a fee".27

It is likely that the customer response to direct charging for payment cards would be at least as great. If a customer finds a payment card fee too high then it is relatively easy for her to cancel a transaction and use an alternative payment instrument, including an alternative card. In contrast, cancelling an ATM transaction due to a high fee often means that the customer must either find an alternative, lower-fee ATM, or go without the cash withdrawal.

Conclusion

The current regulatory model used for payments is unnecessarily complex, involving judgements about efficient costs of provision, requiring multiple points of intervention and inducing ongoing interventions to address loop-holes. Nor is the model robust to changes in institutional arrangements.

We have proposed a simpler alternative. It involves no regulatory judgement and is robust to different ways the parties might organize themselves.

The central insight is that by making the full cost of using a particular payment instrument clear to the customer actually making the payment, customer choice will squeeze out inefficient forms of payment.

We have seen similar selection processes work with transparent charging for using ATMs. Customers are responsive and will make informed choices.

We can get rid of a whole mess of cumbersome regulation in the process.

[27] Flood, D., Hancock, J and Smith, K 2011, *The ATM reforms – new evidence from survey and market data* (Reserve Bank of Australia Bulletin, March Quarter), pp.43-49 at p.45..

About the Australian Centre for Financial Studies

The Australian Centre for Financial Studies (ACFS) is a public interest research centre within the Monash Business School.

It aims to facilitate industry-relevant, rigorous research and independent commentary, drawing on expertise from academia, industry and government to promote thought leadership in the financial sector.

Together, ACFS and Monash Business School aim to boost the global credentials of Australia's finance industry, bridging the gap between research and industry and supporting Australia as an international centre for finance practice, research and education.

For further information see: www.australiancentre.com.au | business.monash.edu

For more in this series, visit: http://australiancentre.com.au/publications/working-papers/