Visa Inc.'s Submission to the Productivity Commission's *Draft Report on Competition in the Australian Financial System*

March 2018

20 March 2018

Peter Harris AO, Chairman
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

Dear Mr Harris

Visa Inc.'s Submission to the Productivity Commission's *Draft Report on Competition in the Australian Financial System*

Visa welcomes the opportunity to respond to the Productivity *Commission's Draft Report on Competition in the Australian Financial System*.

Visa also commends the Australian Government's commitment to increasing competition in the financial system in order to improve consumer outcomes and foster innovation. Visa sees electronic payments as key to advancing the Productivity Commission's objectives of balancing innovation with stability whilst designing a financial system that further empowers Australian consumers and contributes to economic growth.

This submission focuses specifically on the benefits of electronic payments and addresses select draft recommendations within the Productivity Commission's Report that impact payments in Australia. Visa remains committed to working as a trusted partner to the Productivity Commission's efforts.

If you have any questions regarding our response contained in this submission, please do not hesitate to contact me.

Yours Sincerely,

Julian Potter
Group Country Manager
Australia, New Zealand and the South Pacific

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Summary of Visa Inc.'s Response

Australia today benefits from the widespread adoption of electronic payments. Electronic payments help boost growth, create jobs, and increase tax revenue; drive innovation and the digital economy; support small to medium size enterprises (SMEs); create transparency in transactions; and deliver enhanced security for financial institutions, businesses, and consumers. There is clear evidence that shifting consumer spending from cash to electronic payments can significantly increase overall economic output and social welfare.

Payments play an integral role in achieving the Productivity Commission's stated objective of enhancing competition, innovation, and transparency in the Australian financial system. Electronic payments also serve as a catalyst for growth and resilience of the broader Australian economy.

There are an increasing number of new ways by which payments can occur, leading to increased competition and choice in the market. This continues to accelerate as technology makes it possible to further embed payments solutions into the everyday spending habits of consumers; municipal systems, such as transit; and government receipts, disbursements and procurement.

As a global leader in payments, Visa remains committed to ensuring that Australia remains a leader in the innovation of payments, while balancing the need for transparency and security across the payments system.

With respect to the Productivity Commission's Draft Report on Competition in the Australian Financial System, Visa wishes to address three specific draft recommendations in this submission: Draft Recommendations 10.3[1], 10.4[2], and 13.1[3].

Summary of Visa's Position on select Draft Recommendations:

1. **Draft Recommendation 10.3:** Visa strongly opposes the Productivity Commission's Draft Recommendation that the Payments System Board issue a ban on interchange.
2. **Draft Recommendation 10.4:** Visa supports making technology and information available that would enable merchants to make informed choices when accepting electronic payments, as referenced in the Draft Recommendation. Specifically, Visa believes that merchants should be able to take into consideration both the costs and value associated with different payments networks and must implement their routing decisions in a way that is transparent to consumers.
3. **Draft Recommendation 13.1:** Visa supports the Productivity Commission's Draft Recommendation that an Open Banking System should be implemented in a manner that preserves consumer rights, but would emphasise that any such implementation be

[1] Productivity Commission Draft Report, "Competition in the Australian Financial System," January 2018, pg 40
[2] Productivity Commission Draft Report, "Competition in the Australian Financial System," January 2018, pg 41
[3] Productivity Commission Draft Report, "Competition in the Australian Financial System," January 2018, pg 45

reserved to address a specific market failure, and must not compromise consumer rights and the overall safety and security of the financial systems and institutions.

Chapter 1: Interchange

Visa Response to Draft Recommendation 10.3: Visa strongly opposes the Productivity Commission's Draft Recommendation 10.3 that the Payment Systems Board issue a ban on interchange.

The Productivity Commission's recommendation to ban interchange eliminates a key mechanism for developing electronic payments and ensuring balance across a wide range of participants in the payments system. Regulation that helps reduce usage of cash has the potential to be significantly beneficial to the economy, but interchange fee regulation should ensure that issuance, acceptance, usage, and the technical development of electronic payments continues to be promoted. Australia has regulated interchange to some of the lowest levels globally, and further compression of interchange would undermine the ability of participants to deliver ongoing electronic payments innovation in security and useability vital to support increasing productivity and economic growth.

Interchange serves as a key source of payments system funding, which enables financial institutions to connect to merchants and cardholders all around the globe. Networks like Visa create the ideal balance of incentives for cardholders and merchants to maximise transactions across sectors. Interchange ensures that issuers, acquirers, and merchants invest in the payment system in a manner that benefits all participants. By balancing the economics and value among all participants, interchange also encourages more merchants to accept Visa.

1.1 Overview of Interchange

Interchange is determined in order to achieve balance in the system

1. Definition and Role of Interchange

Interchange is the transfer of value exchanged between the merchant's acquirer and the cardholder's issuer each time a payment card is used. Its primary role is to create the right balance of incentives and costs between the issuer, which promote and issue payment cards to consumers, and the merchants' acquirer, which enrol and process payment transactions for merchants. Rather than harming competition in the payments industry, interchange can foster competition and innovation.

2. Concept of Two-Sided Market

Interchange is a strategic tool to balance the two-sides of the payments market; that is the interest from consumers, businesses, and Governments in using electronic payments provided by issuers and the merchants' interest in accepting those payments via acquirers. For Visa, setting the right level and structure of interchange is not a mathematical formula or a cost-based exercise only, but a fine-tuning exercise of identifying the right balance in the market. Setting interchange too high or too low could affect one or the other side of the market. This may cause lower investments in acceptance or lower investment in issuance.

Like the Australian Government, Visa is committed to encouraging electronic payments. Visa does this by setting interchange rates that support the value each participant delivers to the payments system. Visa is responsible for setting interchange between an Acquirer and an Issuer to balance risk, security while encouraging issuance, account usage and acceptance. Visa does this by setting different interchange rates for different types of transactions *(e.g.* lower rates for segments with low electronic payments, higher rates for transactions that carry more cost to the Issuer). For example Visa have lower interchange rates for, education and government services and higher rates for Commercial products where the Issuer covers the cost of funding the cardholder and immediate cash flow to the merchant. Interchange rates sometimes also vary by the type of transaction (*e.g.*, rates may differ for face-to-face transactions compared to mail order/telephone order/online transactions because of the differing risks of fraud, greater value of accepting electronic payments for certain transactions, and other reasons).

Furthermore, Visa also has made its products more attractive to participants in its payments system by creating incentives via reduced interchange rates to encourage marketplace behaviours, including the adoption of technologies that reduce fraud, such as electronic authorisation of transactions in the 1980s, the PCI DSS [4] standard used to protect cardholder information and most recently, the secure EMV chip technologies. Visa similarly provides reduced interchange rates on transactions that are submitted with accurate data elements, processed in a timely manner, and (on commercial products) come with enhanced data, all of which improves the timeliness and accuracy of data in the Visa system to the benefit of all participants.

Finally, interchange also provides some of the economic means for banks to invest in security and payments solutions that benefit the Australian economy as a whole, which necessitates adequate revenue and consistency across the globe for issuers to support their card programs.

Investing in Innovation and Securing Payments

Interchange helps fund financial institutions' investment into new payments form such as mobile payments; connected devices; wearables, such as fitness trackers and watches; and the Internet of Things. Interchange also enables issuers to absorb fraud losses due to zero liability commitments to consumers. In instances where cards are lost or stolen, interchange helps fund costs associated with re-issuing cards. Interchange can also fund innovative security solutions that bolster security and reliability for consumers such as robust fraud monitoring, applications that allow for setting transaction limits, and controlling contactless functionality.

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[4] The Payment Card Industry Data Security Standard (PCI DSS) is a set of security standards designed to ensure that all companies that accept, process, store or transmit credit card information maintain a secure environment. https://www.pcisecuritystandards.org/pci_security/

Interchange has also been used as a tool to introduce both innovative and more secure forms of payment in Australia. For example, in June 2007, Visa announced the Visa Merchant Alliance Program, which provided reduced interchange rates to merchants that made various commitments to critical Visa acceptance and security standards, such as EMV/Chip. This provided a mechanism to move the Australian market to a more secure payments environment.

As an alternative to default multi-lateral interchange rates, issuers and acquirers can enter into bilateral agreements setting the interchange that would apply to transactions between them. However, with over 16,000 financial institutions issuing Visa cards and over 44.0 million merchant locations globally, this would necessitate millions of separate negotiations between issuers and acquirers. In addition to the practical obstacles and inefficiencies presented by such an approach, the payments system would be left more at risk of opportunistic behaviour by both issuers and large acquirers that could result in both driving down acceptance of electronic payments and harming merchants and consumers.

3. It is essential to distinguish Interchange from the Merchant Service Fee

Merchants and consumers do not pay interchange. Merchants pay what is known as a Merchant Service Fee ("MSF"), which is negotiated with their acquirer and may include interchange, the cost of transaction processing, terminal rental and customer service, and the acquirer's or processor's margin, among other costs. This is a market-based fee set by each merchant's acquirer operating in a competitive marketplace. The acquirer generally pays interchange, thus banning interchange would not necessarily lower a merchant's costs for card acceptance. Merchants can choose the acquirer that collects and reconciles their payment card transactions in the same way cardholders can choose the financial (or payments) institution that issues their card. Interchange is only one component of this cost of doing business.

1.2 Interchange in Australia

The full impact of the interchange regime changes that followed the Reserve Bank of Australia's detailed *2015-2016 Review of Card Payments Regulation* came into effect in July 2017 and has still to be assessed.

Visa asks that the Productivity Commission respect the work conducted by the RBA in determining the appropriate regulatory approach to interchange in Australia and allow for the regulation to be implemented in full before any further changes are considered. Visa would also suggest that the Productivity Commission conduct an assessment to evaluate the impact of the RBA's interchange regulation reforms – as other regulatory and governmental bodies do globally – before proposing further modifications.

1.3 Global Perspectives on Interchange

When assessing the impact of interchange regulation in other markets, researchers have found that there are often unintended consequences of regulatory approaches. For example, the quality of services may fall, innovation and adoption of payments technology can be impacted, and banks may seek alternative sources of revenue. In many instances, interchange regulation creates a distortion in the market by providing a windfall to large merchants and increasing fees on financial products and services directly borne by consumers.

In the United States, for example, research conducted by the Federal Reserve found that the provision of free current accounts and ATM services reduced dramatically following the implementation of the Durbin Amendment. Studies also determined that not only did small merchants not benefit from the Durbin Amendment – both the interchange fee regulation and the network routing provision – but in some instances, particularly for small businesses and those with a high volume of low-value transactions, payment acceptance costs increased. In those instances where merchants did see a reduction in costs for accepting electronic payments, there was no evidence that such savings were passed down to consumers.

These global trends, which are detailed further in the appendix of this submission do not just relate to Visa's perspective on interchange regulation, but also provide some context on the impacts merchant choice routing might have to the consumer experience in Australia.

Chapter 2: Merchant Choice in Routing

Visa Response to Draft Recommendation 10.4: Visa supports making technology and information available that would enable merchants to make informed choices when accepting electronic payments, as referenced in the Draft Recommendation. Specifically, Visa believes that merchants should be able to take into consideration both the costs and value associated with different payment networks and must implement their routing decisions in a way that is transparent to consumers.

Australian's are early adopters of innovation and have shown a strong desire to use electronic and contactless payments with the result, that electronic payments now represent above 80% [5] of personal consumption expenditure (PCE), amongst the highest in the world. As noted in the Payments System Board 2017 Annual Report, credit and debit cards combined were the most frequently used method of payment by Australian consumers, accounting for over half the number of transactions in 2016 and this steady increase in use has been facilitated by contactless functionality. The use of contactless payments as a share of payment methods in Australia tripled between 2013 and 2016. [6]

Visa supports the Government's call for industry to enable merchant choice in routing for contactless payments on dual network debit cards and is collaborating with industry participants

[5] VisaNet Data 2017

[6] 2017 Annual Report of the Payments System Board, Reserve Bank of Australia, "Trends in Payments, Clearing, and Settlement Systems," pg 29

to ensure merchants are informed on both the cost and *value* associated with the different payment networks in Australia.

It is not the case that contactless debit transactions which are routed to and processed by the international payment networks are, as some have suggested, always more expensive than transactions routed to the domestic payments scheme. Each payment transaction can carry a very different set of charges and costs depending on card type, the value of the transaction and the merchant. Oversimplification of the cost of electronic payments creates misunderstandings – and potentially greater costs – for merchants.

2.1 Value vs. Cost

There is a difference between delivering value to the market and deploying low-cost payment solutions. When considering the merits of the international payments networks (such as Visa and Mastercard) verses national, domestic schemes (for example, Eftpos), it is important to recognise that the value propositions are fundamentally different. For example, there are benefits that are unique to a Visa transaction, including: Visa Zero Liability, Visa chargeback rights, and Visa fraud protection. Other innovative applications and benefits exist on Visa cards with specific issuing banks such as Visa transaction controls (allowing consumers to stop, restrict, block and manage their spend, therefore promoting and enabling responsible financial management) and insurance.

Visa understands the importance for merchants to be able to manage their costs of payments acceptance. However, establishing a system where payments networks are competing on merchant cost alone will negatively impact the ongoing investment in innovation, security, and value-added services that benefit both merchants and consumers and ultimately create increased productivity and economic growth. Visa would also highlight that merchants in Australia already have the ability to manage their costs of payments acceptance through their ability to surcharge to appropriate levels.

Merchant choice as opposed to 'least cost' routing is an important distinction to consider as merchants may see the benefits in choosing certain payments acceptance solutions that are higher cost, but that provide greater value both to their businesses and to their customers. Innovation in payments does not just pertain to new capabilities for cards, or the use of new form factors (like mobile phones or wearables), but also the deployment of new point-of-sale solutions. For instance, today retailers are providing technologies that enable consumers to pay in instalments. In addition, small businesses are selecting point-of-sale technologies that not only facilitate payments acceptance, but also power inventory management, payroll processes, and more. Many of these acceptance solutions may cost merchants more on a monthly basis but deliver important sources of value and certainty.

2.2 Ensuring Transparency across the Payments Ecosystem

As industry moves to implement merchant choice in routing of payment transactions, we need to ensure transparency for the consumer and preserve an environment that encourages continued innovation in the electronic payments industry in Australia. Industry needs to work together to ensure a frictionless commerce experience, while ensuring choice for both merchants and consumers. Financial products and services should perform in the way that they are marketed and sold to consumers.

Today, financial institutions are increasingly offering services to their customers that provide access to their financial data, create broader controls over their payments products, enable more robust security solutions, and generate more convenient means of payment. From early fraud detection, to setting limits for everyday spend – these services are not necessarily network agnostic and often depend on transactions flowing over a specific network. Consumers will not benefit from these services in the manner they expect when their transactions are routed over an alternative network which cannot deliver on the specific services, and against the brand promise of the product.

Further, issuing institutions may not be able to guarantee that consumers' financial products and associated benefits – regardless of network – are functioning consistently depending on how merchant choice in routing is implemented. As such, it is important to ensure that consumers are educated and that there is transparency at the Point of Sale in routing arrangements.

Visa proposes that industry should be given the opportunity, in concert with the appropriate government agencies, to develop a framework that enable choice and transparency across the system without creating added points of friction to the payments experience and discouraging the adoption of more sophisticated electronic payments products.

Chapter 3: Open Banking and Data Access

Visa Response to Draft Recommendation 13.1: Visa supports the Productivity Commission's Draft Recommendation that an Open Banking System should be implemented in a manner that preserves consumer rights, but emphasises that any such implementation be reserved to address a specific market failure, and must not compromise consumer rights and the overall safety and security of the financial systems and institutions.

Visa strongly supports fair, open and competitive regulation and is committed to helping boost Australia's digital economy. Secure and reliable electronic payments systems are vital for the future of commerce. Consequently, consumer trust in the payments system is paramount. In recognition of this responsibility, Visa is relentless in fortifying the security of both our own systems and the broader payments sector.

Given the importance of security to the stability of the payments system, Visa suggests caution in the development and implementation of Open Banking requirements. Visa believes that financial institutions should have the flexibility to open their systems based on market demand and only once the right technology solutions and robust security and risk management protocols are in place. Doing so can help reduce business, financial, and security risks for financial institutions and other payment service providers.

Visa recognises that the financial services industry is rapidly evolving, largely driven by the emergence and growth of Fintech firms and the development of a wide variety of technological solutions that facilitate the delivery of financial services. In such an environment, Visa believes that Open Banking should be market driven and agrees with the position outlined in Treasury's Review into Open Banking – that a regulatory approach should only be applied in the event of market failure.[7] If market forces are insufficient, Open Banking regulation should avoid an overly prescriptive approach and seek to minimise market disruption, while requiring transparency to account holders (including informed consent), addressing potential privacy concerns, ensuring robust security measures that do not compromise consumer ease of use, and establishing clear financial accountability rules should fraud or data breaches occur.

3.1 Visa Developer Platform – Core Principles

Technology is rapidly transforming the financial services landscape, changing the way consumers interact with their financial institutions by facilitating the payments process and offering new options for consumers, ultimately helping them make better financial decisions. In order to stay competitive in this evolving environment, many financial institutions are forging close partnerships with Fintechs, and many are opening APIs to third parties, providing opportunities for new and creative service offerings.

Similarly, Visa is committed to staying at the forefront of innovation by putting greater emphasis on openness, collaboration and engagement with the wider economy. Visa believes that innovation can, and will, come from anyone, anywhere. There is a need for market players to collaborate in new ways and build partnerships with new types of service providers who are adding value to the payments system. Opening APIs to third parties can facilitate these collaborations.

Below are Visa's core principles for the Visa Developer Platform, which could be instructive as the Productivity Commission examines Open Banking:

- **Support innovation and competition:** Visa supports a fair, open and competitive environment that facilitates innovation in financial products and services. A level playing field incents continued investment in banking and payments system infrastructure and services that benefit consumers and businesses.
- **Ensure security:** Visa supports robust data protection measures necessary to protect personal consumer information against fraud and other risks. Visa promotes secure access,

[7] The Australian Government the Treasury, "Review into Open Banking: giving customers choice, convenience, and confidence," December 2017, pg. 9.

storage and use of consumer bank data, risk management protocols. Safeguards of the information in the existing banking and payments system should be paramount.

- **Protect data and consumer privacy:** Visa supports privacy protections for consumers that allow access to their data, including transparency on how data is used and that it is used responsibly, including a system that does not compromise safeguards of the existing banking and payments system.
- **Support financial literacy and capability:** Providing access to data should ensure that consumers understand what they are consenting to when they share their data. Data access policies should aim to provide better financial products for more consumers, rather than excluding certain consumer groups.

  Visa believes that any open API standard should be flexible while providing clarity in relation to access requirements and allow scalability for future innovations.

Separately, Visa is also providing more detailed perspectives on Australia's proposed Open Banking regime in response to Treasury's Review into Open Banking.[8]

About Visa

Visa is a global payments technology company that connects consumers, businesses, financial institutions and governments in more than 200 countries and territories worldwide. Visa is proud to adhere to its corporate vision of being the best way to pay and be paid, for everyone, everywhere. That is, we aspire to connect the world through the most innovative, reliable and secure electronic payments network that enables individuals, businesses and economies to thrive.

Visa is one of the world's largest retail electronic payments network, with 3.1 billion cards worldwide and $10.2 trillion in total volume across our products. Visa supports 160 currencies and is accepted at 44.0 million merchant locations globally. Visa partners with over 16,300 financial institutions and operates in 160 currencies. This activity is powered by one of the world's most advanced processing networks, VisaNet, which is capable of handling more than 65,000 transaction messages per second reliably, conveniently and securely.[9]

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[8] Australian Treasury, "Review into Open Banking: giving customers choice, convenience, and confidence," December 2017

[9] Inside Visa: https://usa.visa.com/dam/VCOM/download/corporate/media/visanet-technology/aboutvisafactsheet.pdf

Appendix: Impacts of Interchange Regulation in the United States

3.1.1 Introduction [10] [11]

The Durbin Amendment mandates a regulation aimed at reducing debit card interchange fees and increasing competition in the payment processing industry in the United States. The Durbin Amendment directs the Federal Reserve Board to regulate debit card interchange fees so that they are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction". The latter subsequently issued Regulation II (Debit Card Interchange Fees and Routing), which took effect on October 1, 2011. Credit card and prepaid card interchange fees were not regulated.

- The regulation establishes a cap on the debit interchange fees; on
- Financial institutions with more than $10 billion in assets.

The fees were set based on an evaluation of the issuers' costs associated with debit card processing, clearing and settlement.

Interchange Fee Regulation	Impact on Issuer Income
Regulation took effect in 2011. It applied to banks with assets over $10 billion. The average interchange fee charged by issuers that were regulated fell from $0.51 per transaction to $0.24 per transaction. The average interchange fee for exempt banks also fell—from an average of $0.53 per signature-authenticated (Visa, MasterCard & Discover) transaction in 2011 to $0.50 per transaction in 2015, and from $0.32 per PIN-authenticated transaction in 2011 to $0.26 per transaction in 2015.	Large issuing banks lost around 5% of non-interest income.

3.1.1.1 Caps introduced with interchange regulation in the United States

The cap, which took effect on October 11, 2011, cut the average interchange fee for covered banks from $0.50 to $0.24 per transaction.

[10] Debit Card Interchange Fee Regulation: Some Assessments and Considerations, Zhu Wang, Economic Quarterly. Volume 98, Number 3. Third Quarter 2012. Pages 159.183
Price Controls on Payment Card Interchange Fees: The U.S. Experience, Todd J. Zywicki, George Mason University School of Law, Geoffrey A. Manne, International Center for Law and Economics Julian Morris, Reason Foundation George Mason University Law and Economics Research Paper Series http://ssrn.com/abstract=2446080

The resulting $0.24 interchange cap is composed of the following:

- A base fee of 21 cents per transaction to cover the issuer's processing costs;
- A 0.05% charge of the transaction value to cover potential fraud losses; and
- A 1 cent per transaction to cover fraud prevention costs if the issuer is eligible.

By regulating the interchange fee, the goal of the Durbin Amendment was to lower merchants' costs of accepting debit cards and to pass along the cost savings to consumers in terms of reduced retail prices. However, it is unclear how effectively the regulation has fulfilled its intention.

3.1.1.2 Impacts since Durbin Amendment implementation

Overall impact

The cap reduced annual revenues from interchange fees by between $6 billion and $8 billion. Covered banks have recouped these losses in indirect ways. In particular, they have:

- Reduced the availability of fee-free current accounts. The total number of banks offering free current accounts fell by 50% between 2009 and 2013. In comparison, fee-free banking actually increased at banks not subject to the Durbin Amendment.
- More than doubled the minimum monthly holding required on fee-free current accounts between 2009 and 2012, from around $250 to over $750.
- Doubled average monthly fees on (non-free) current accounts between 2009 and 2013, from around $6 to more than $12.
- These fee increases and loss of access to free checking contributed to an increase in the unbanked population of approximately 1 million people, mainly among low-income families.
- Consumers have shifted their payment usage from debit cards to credit and prepaid cards, which were not subject to price controls.

Merchant Impact

67% of the merchants which took part in a survey titled, "The Impact of the Durbin Amendment on Merchants: A Survey Study", Zhu Wang, Scarlett Schwartz, and Neil Mitchell, reported no change or did not know the change in their overall costs of accepting debit cards post-regulation. Among those who did see a change in debit costs, about three times as many (25% over 8%) reported a **cost increase** as those who reported a cost decrease. A similar pattern is found for a small-ticket transaction, while nine times as many (27% over 3%) respondents reported a cost increase as those who reported a cost decrease.

The majority of the respondents (75%) reported no price change due to the regulation. For those who had a price change, 11 times more (23% over 2%) reported price hikes than cuts. Meanwhile, most respondents (76%) reported no increase or decrease in the restrictions on debit card use. For those who did report a change, they are even on each side (12% and 12%).

Merchant Average	Decrease	Stay the Same	Increase	Don't Know
Cost Change	8%	41%	25%	26%
Small-Ticket Cost Change	3%	47%	27%	24%
Price Change	2%	75%	23%	0%
Debit Restriction Change	12%	76%	12%	0%
	Minimum Amount	Surcharge	Discount	Others
Before Durbin	26%	24%	20%	55%
After Durbin	29%	20%	20%	58%

3.1.1.3 Consumer Impact and the effect of Durbin Amendment on Retail Prices: "Merchant Reactions"

Consumer Impact

Most large retailers, however, have seen significant cost reductions as a result of the Durbin Amendment, yet to date there is no evidence that those cost savings have been passed-through to consumers. Interchange fees have increased for merchants that make small-ticket transactions, as networks have eliminated discounts that they previously received, and smaller merchants have not seen any reduction in their merchant discount rates. Thus, while consumers have seen large and immediate increases in the cost of bank accounts, to date there is no evidence of reduced prices at the pump or checkout. We estimate that as a result of the Durbin Amendment, there will be a transfer of $1 billion to $3 billion annually from low-income households to large retailers and their shareholders, which have been the primary beneficiaries of the Durbin Amendment to date[12].

When Interchange is Artificially Capped, Merchants Selling Small Ticket Items are Disadvantaged, and Pass on the Additional Costs Disproportionately to Low-Income Households

Consider the effect of the Amendment on the interchange fees charged for small ticket items. Prior to the Durbin Amendment, the interchange fee for signature debit purchases set by Visa and MasterCard on transactions of $15 or less was 1.55%of the transaction value, plus $.04.75 Thus, the interchange fee for a $5 purchase was $.11. After the implementation of Regulation II, however, this more than doubled—to $.23 (i.e., $0.21 + $0.01 +0.05%). As one commenter noted, reviewing the card processing statement from a café in October 2016, "unfortunately, the capped rate's $0.22 transaction fee is much higher than the uncapped $0.04 fee. This difference increases processing costs substantially for small ticket merchants." As he

[12] Price Controls on Payment Card Interchange Fees: The U.S. Experience, Todd J. Zywicki, , George Mason University School of Law, Geoffrey A. Manne, International Center for Law and Economics Julian Morris, Reason Foundation George Mason University Law and Economics Research Paper Series http://ssrn.com/abstract=2446080

concludes: "Unfortunately, businesses that routinely process small transactions will be negatively affected by the Durbin Amendment."

It is not surprising, therefore, that in the Richmond Fed survey 31.8% of merchants reported that for small ticket items debit costs had risen, while only 2.8% reported that costs had fallen. Nor is it surprising that the survey found that debit acceptance costs rose more in some sectors than others. In particular, the study found that costs rose for 65.7% of fast food merchants, 54.1% of grocery stores and 47.8% of home improvement stores. By contrast, debit acceptance costs fell for 25.9% of both merchants selling home furnishings and those selling sporting goods.[13]

The Durbin Amendment has also served to increase costs for some smaller retailers and sellers of small-ticket items. Among those most adversely affected have been grocery stores, fast food outlets and similar establishments, a significant proportion of which have raised prices since the Amendment was implemented. Again, these effects hit low-income households the hardest.[14]

Due to their lower sales volumes, SMEs only have limited bargaining, or buyer, power, which puts them at a disadvantage when negotiating MSFs and other charges with acquiring banks. In contrast, large merchants are better able to benefit during such negotiations as a result of their large sales volume.[15]

The effect of Durbin Amendment on Retail Prices: "Merchant Reactions"

The analysis in the study suggests asymmetric merchant reactions to changing debit costs. On the one hand, few merchants in the sample are found to reduce prices or debit restrictions as their debit costs decrease. This also related to the fact that a relatively small fraction of merchants in our sample reported a decrease of their debit costs in the first place.

The survey suggests that the regulation has had a limited and unequal impact on merchants' debit acceptance costs. The majority of merchants in the survey sample, 66%, reported no change or did not know the change of debit costs post-regulation.

Around 25% of merchants reported an increase of debit costs, especially for small-ticket transactions. Less than the remaining 10% of merchants reported a decrease of debit costs.

The fact that MSFs for small and medium size merchants were not reduced significantly in the year after the Durbin Amendment came into effect is likely a result of the different ways in which MSFs are calculated for large and small merchants, which makes the rates charged to smaller

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[13] Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses, Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, International Center for Law & Economics (2017)

[14] Ibid

[15] The Economic Impact of Interchange Fee Regulation, Europe Economics Staff, Europe Economics on Behalf of MasterCard (2014)

merchants less responsive to changes (both increases and decreases) in interchange fees. Over time, it can be expected that small and medium size merchants will see somewhat lower interchange fees, although it is not clear how long that will take or how completely their MSFs will decline in the end. Still that reality is consistent with the predictions of knowledgeable observers, which is that even if merchants do pass-through savings in lower retail prices, that pass-through is typically slower and less-complete for merchants than for banks.[16]

IFR consistently shows no evidence of merchants lowering their prices to consumers as a result of interchange reduction.

Excerpts from Studies on the Impact of Interchange Regulation in the U.S.

> "Most large retailers have seen significant cost reductions as a result of the Durbin Amendment, yet to date there is no evidence that those cost savings have been passed-through to consumers. Interchange fees have increased for merchants that make small-ticket transactions, as networks have eliminated discounts that they previously received, and smaller merchants have not seen any reduction in their merchant discount rates. Thus, while consumers have seen large and immediate increases in the cost of bank accounts, to date there is no evidence of reduced prices at the pump or checkout."[17]
>
> "Simply reducing interchange fee rates, however, does not necessarily mean that consumers or businesses will be better off in the end, and it certainly does not mean that consumer prices or merchant costs will necessarily be reduced. Whether that will be the case depends on two things: first whether and by how much the cost reduction is passed through, both from the acquirer to the merchants well as from the merchant to the consumer; and second whether and by how much any cost reductions incurred by acquirers are transferred to merchants in the form of improved services rather than lower costs."[18]
>
> "The evidence presented in this paper contradicts the claim that the costs resulting from the Durbin Amendment have been offset by merchants charging lower prices. Indeed, the majority of consumers —and especially those with lower incomes —have experienced higher prices overall."[19]
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> "For consumers to benefit from merchants' cost savings, lower costs must be passed on to consumers in the form of lower prices (or else reallocated to provide consumers with better

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[16] Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses, Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, International Center for Law & Economics (2017).
[17] Price Controls on Payment Card Interchange Fees: The U.S. Experience, Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, International Center for Law & Economics (2015).
[18] Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses, Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, International Center for Law & Economics (2017),
[19] Ibid.

service). But they aren't. According to the Richmond Fed Durbin Impact Study, the vast majority of merchants—77.2% —did not change prices at all following the implementation of Regulation II, and only 1.2% reduced prices —leaving a significant minority (21.6%) that actually increased prices.

And even if merchants did pass on their entire cost to consumers, the savings would be small: according to one estimate, it would result in a maximum retail price reduction of only $.07 on a $40 purchase. But with such small cost changes, it is possible that the savings would not, in fact, be passed on at all. Particularly in markets with fluctuating prices, such small price changes would be difficult (or impossible) to discern. Not only does this call into question the claimed magnitude of any estimated benefits from reduced prices (assuming they exist at all), but it also suggests that they may not exist: Even in competitive markets, cost-induced price reductions are unlikely to materialize if they aren't actually discernable by consumers. Indeed, prior economic studies suggest that such small marginal increments in cost are unlikely to be realized in the form of lower consumer prices. And, even if those cost savings are eventually passed through to consumers, there remains the question of how fast that will occur and how completely."[20]

[20] Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses, Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, International Center for Law & Economics (2017)