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Payments System Review
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Payments System Review

Introduction

As background, I have been an investor for over 40 years, in both listed and unlisted companies. I am a Chartered Accountant and Fellow of the Securities Institute. I worked in direct investment in unlisted companies and infrastructure projects at an institutional level. For some years, I represented the Australian Shareholders Association on ASIC's Consumer Advisory Panel (the views here are my own).

I do not comment on much of the Issues Paper. My concerns are with BNPL arrangements and cross border payments, in particular their lack of transparency and high cost to retail users of those systems. My submission responds to consultation questions 3, 4 and 5; 6, 8 and 9

In September, the Senate Select Committee published its interim report (SSC Report) on Financial Technology and Regulatory Technology. Its recommendations 16 and 18 are relevant to my submission, below.

The **Terms of Reference** include the objective or hope, that “continued innovation of this key economic infrastructure [different payment platforms] will be central to *lowering transaction costs*, reducing the cost to doing business and supporting the economic recovery”; and

“The review will assess:

- How to create more productivity-enhancing innovation and competition in the payments system, including in relation to the pace and manner in which the New Payments Platform is being rolled out and enhanced by industry;
- Ways to improve the *understanding of businesses and consumers of alternative payment methods*;
- Global trends and how Australia should respond to these trends to ensure that it *continues* to remain internationally competitive.”

Buy-now pay-later

The Issues Paper also “acknowledges the concurrent review underway by the RBA’s Review of Retail Payments Regulation...[whose focus will be on] specific regulatory policy settings in place for the retail payment systems. To meet these objectives, the regulatory architecture must incentivise and encourage the development of secure payments technology that enhances user experiences, *supports businesses through lower costs and empowers consumers with greater choice.*”

I agree, but to date the foregoing objectives have not come about: buy-now pay-later (BNPL) costs are very high in Australia and, although BNPL gives consumers another payment method, it cannot be said that consumers are “empowered” or have “greater choice” by this. To achieve this will require better disclosures and consumer education. Moreover, I argue that BNPL, far from *lowering* costs to businesses, in fact increases them, except to the extent that they are then imposed on consumers.

The final Term of Reference presumes that Australia is already “internationally competitive”; in the case of BNPL and cross border payments systems, I don’t believe that it is.

I welcome the RBA’s review, and I hope that it will bring its customary level of analytical rigour and commercial common sense to its work. I conclude below that BNPL is enjoying much higher returns than other forms of credit, through consumer ignorance and weak regulation.

I acknowledge that, as the Issues Paper says, “The payment networks in Australia were developed over time by significant private sector investment (mainly by the major banks and large retailers) who own and run the infrastructure required to administer them.” The same applies to the BNPL sector, and it’s only right that it is able to earn fair returns for its innovations and the capital that it has put at risk in this investment. However, I believe that the limited data available demonstrates that the Australian BNPL sector as a whole is currently earning super- profits (before allowing for start-up costs and bad debt write-offs); this is implicitly supported by the extraordinarily high valuations placed on listed BNPL providers in Australia. The SSC Report prefers a *laissez faire* policy for this sector, which will enable super profits to continue to be earned and consumers overcharged.

I note ASIC’s recent report (REP672) and its earlier report (REP600) on the BNPL sector. REP672 is mainly concerned with the questions of consumers getting into financial difficulties and/or incurring high fees under the BNPL model. Although it discusses late payment fees, it doesn’t analyse the % costs of this system to customers and merchants compared with other payment methods, including for example credit cards or personal loans. This omission is particularly important with regard to the effective annualised percentage costs.

ASIC breaks down the sources of revenue to the BNPL providers, between merchant fee revenue, missed payment fee revenue, and other consumer fee revenue, but does not analyse the *effective* costs. It discusses (PP18/19) the further, crucial matter of surcharging- better described as hidden surcharges.

The Issues Paper notes “BNPL arrangements operate on top of or in conjunction with existing payment systems but can also be used at the point of sale. This has led to questions as to whether such arrangements constitute a payment system, and the RBA in its ongoing review of retail payments regulation is examining the ‘no-surcharge’ rule imposed on merchants by some BNPL providers.” This is very welcome. It’s clear from REP672 that merchant fees represent over 50% of total revenue of the BNPL sector, and 80% or above for several leading providers. Except for the longer term purchases, it’s likely that most of this revenue is in the form of surcharges. In any case, all such fees, being paid by the merchants, are likely to be opaque to consumers.

The tone of REP672 is unfortunately, acquiescent and incurious. Much more publicity needs to be given to the size of fees that BNPL charges to merchants. There has been wide discussion, including from the RBA, of whether merchants should be allowed to apply (overt) surcharges when consumers use BNPL services. I firmly believe that they should. This would enable consumers to understand the costs applied and make their own choices whether they wish to use those methods of payments, or others including credit cards (with lower effective surcharges) or pay in cash. At present the BNPL providers have a distinct advantage against other payment methods- in that their customers do not know or understand the whole cost structure, and therefore cannot make informed choices. A more serious problem is that these costs are hidden and built in to the costs of goods and services, and thus effectively an impost incurred/ subsidy paid for by the large numbers of consumers who are not using BNPL. This is inefficient and anti-competitive. It runs absolutely contrary to the ethos of the Terms of Reference.

REP672 does reveal some interesting statistics: p12 “missed payment fee revenue” for the BNPL sector was over \$43m, which was 11% of their \$398m total revenue in FY19 but “only” a 3.7% return on the mid-point outstanding balance of BNPL finance provided during that year i.e. \$1.15B (P8). The total revenue of \$398m represents a 34.5% gross return on the \$1.15B average finance provided; given the sector’s rapid growth rate, if one instead used monthly balances of funds outstanding the annualised return was probably even high than 34.5%. Even if this capital was entirely funded by equity, it would constitute an extremely high return on capital invested.

Also REP672 shows that there is a distinct mismatch between the market shares of total transactions financed in FY19 and balances outstanding at June 19. This (below) shows that Afterpay has a very high rate of turnover of its funding capital compared with the other BNPL providers, with Zip being the second highest, after a large gap. In turn this suggests that Afterpay is the BNPL provider that is getting the most benefit from not being subject to the National Credit Act (NCA), and Zip, after a long gap, the second such party. It is likely, but not capable of being proved from the ASIC data, that Afterpay predominantly, then Zip, are earning much higher returns on capital than the simple average of 34.5% that I calculated above for the sector, with the others below that average. I hope that the RBA’s analysis will investigate these returns thoroughly, and the significance of the components (especially merchant surcharges) that go into them.

\$M/ % market shares	Afterpay	Zip	Certegy	others
Transactions financed	73%	11%	11%	4%
Outstanding balance	27%	23%	37%	11%

Although BNPL arrangements are regulated as credit under the ASIC Act, providers are generally considered not to be regulated under the *National Consumer Credit Protection Act 2009* (NCA). They should be. They exploit a loophole regarding credit periods of less than two months; this is despite the fact that most BNPL firms (except perhaps for very high value purchases) intend to create enduring customer/ provider relationships, to fund a succession of purchases, not one-offs.

In my opinion, self regulation in this large and rapidly growing payments sector is inadequate. The 11 November press release of the Australian Finance Industry

Association (AFIA) was predictably delighted that the SSC Report “also strongly supported the BNPL industry’s efforts to self-regulate and raise standards, and called out the Code as a clear example of industry working constructively together to respond to stakeholder concerns.” Yet that Code “will [only] be published and become effective from 1 March 2021.” The Code is important, but it is a necessary, not sufficient condition. Further regulation and consumer education (especially) are necessary.

The draft version of the [BNPL] code didn’t deal with the high costs, weak hardship policies or overselling of credit to people who are already under financial pressure. I concede, as ASIC says, that the sector has made some improvements between the dates of the two ASIC reports, but they are not yet sufficient.

REP672 notes that from October 2021, design and distribution obligations will apply to most products that ASIC regulates, including BNPL. That is too long to wait. ASIC’s reports are useful, but incomplete, and the SSC Report’s laissez faire approach is unhelpful. Consumers will therefore have to rely on the RBA’s work to push for more disclosure and regulation, and to open up more competition against other credit products and drive better pricing.

In general the law takes a commercially unsophisticated approach to these arrangements, which depends on the length of time and whether interest or fees are charged. This is absurd: BNPL arrangements clearly are credit in a commercial sense, even if no “interest” is charged. They provide financial accommodation over a given period, and this is paid for by the provider earning merchant fees and account or late payment fees. Even if no late fees apply, the financial package is obviously designed to provide an attractive overall return to the BNPL provider for the use of its capital. This is certainly de facto credit, irrespective of what its components are called, and whatever methods are used to avoid the application of the NCA.

Anecdotal evidence is that the levels of surcharges, and perhaps also the fees paid by users, are considerably higher in Australia than in other countries that use BNPL systems. This indicates that in Australia disclosure loopholes are being exploited, to the detriment of consumers, and that super profits are being made by providers.

The SSC’s **Recommendation 16** is that the government '*establish a culture of innovation and competition in financial services by supporting self-regulation where innovative products emerge, whilst ensuring strong consumer protection*'. Commenting specifically on the Buy Now Pay Later sector, the Committee comments that

'The development of an industry code of practice in the Buy Now Pay Later (BNPL) sector is an example of where industry is working constructively to respond to stakeholder concerns and seek to achieve appropriate regulation that benefits consumers...Because innovation like BNPL often occurs on the fringes of regulation, it is inappropriate to force each innovation into a one size fits all approach. Industry self-regulation provides an initial framework to protect innovation which can later be backed up by a policy statement or a form of co-regulation (collaboration between industry and government)'

This is naive and disingenuous, especially as the Code of Practice won't even be published until March 2021. BNPL is a useful product, but its "innovation" is largely in finding a way to exploit the NCA. It does not have the creative or scientific brilliance of quantum computing or vaccine development, for example. The true test of commercial innovation is whether consumers would be worse off if it had never happened, and I submit that, in the case of BNPL, they would not. By all means let BNPL prosper as an alternative to credit cards, personal loans etc, but the public will only benefit if BNPL is required to play on a level playing field, with fair disclosure and protections that are required under the NCA.

So far, the "innovation" of BNPL has not led to any reduction in the extremely high rates charged on most credit cards, even in the last two years of very low wholesale interest rates. This indicates that it has had no material competitive effect.

Although some providers have late payment caps, I believe that all should be required to cap the amount of missed or late payment fees that a consumer can be charged; and prevent consumers from making further purchases when they have missed a payment.

Their offer documents should clearly set out the effective *annualised* percentage cost of using their systems under various worked samples of late payments. Their average charges to merchants should also be regularly published and updated.

All of these changes can and should be introduced promptly to improve competition, both by other payment systems (or cash) and to encourage other BNPL providers to emerge. They will not stymie innovation, despite the strident claims to the contrary of the providers.

Cross-border payments

The Issues Paper notes "A 2019 report by the ACCC into Australia's foreign currency conversion services found that a confluence of factors led to Australians facing high costs *when remitting money abroad*. These factors included a lack of price transparency, consumer inertia and a lack of strong competitive forces in the industry. The ACCC also identified regulatory requirements such as due diligence and AML / CTF requirements as potential barriers to new entrants and recommended action to assist firms meeting such requirements." I agree with all these observations, but they also apply equally –for relevance and cost- to the receipt by Australians of foreign remittances.

I note and agree with the comments on fees made under the heading " **Foreign exchange transparency**", in paragraphs 4.147 to 4.160 of the SSC Report. Fees and commissions are disproportionately large for conversion or remittance/ receipt of small foreign currency amounts, say below \$300. This is acutely true of cash conversions at foreign exchange booths at airports and similar shopfronts.

However, for larger amounts the much bigger problem is the exchange rate at which the currency is converted to/from AUD, even for very liquid currency pairs. I agree with the comments made in the SSC Report paragraphs 4.153/4/5, yet the problem is not "information overload" but the lack of financial literacy of most consumers. For example, they can be seduced by offers of "No commissions" but fail to realise that these small benefits are usually outweighed by unattractive exchange rates. I suggest that at bureaux de change it should be compulsory for customers to be given the results of the conversion before they choose to proceed with it. It's unsurprising that

customers are confused in cases where they feel that they need to make a snap decision (e.g. at an airport or bureau de change); what is more surprising is why most consumers appear not to shop around (including on the internet) when they have the time to do so, with respect to non-cash transactions. It could be, as suggested in 4.147 of the SSC Report, that “*customers rely on the advice of trusted financial services providers to make decisions on FX and international payments.*” Sadly their trust is not being rewarded by their financial institutions.

The comments by Dr Anthony Richards of the RBA (in paragraphs 4.144/5 of the SSC Report) are absolutely right and go to the heart of the matter. Moreover his reference to “you will often pay about four or five per cent” would apply to either a buy or sell transaction. I.e. before allowing for processing costs, the big banks would be making a total two-way spread of at least 8%. This is even for internet- based transactions, which do not have the overheads of maintaining a shopfront or handling paper money. Since the banks would be able to hedge their aggregate net FX risk through the wholesale FX market in real time, or with minimal delay, they cannot argue that the need to compensate for the risk of taking their customers’ FX exposure is more than a tiny part of the spread.

These huge spreads arise even for relatively large “retail” transactions, for over \$100,000. My experience is, as Dr Richards says “that if you go to one of the non-traditional providers, one of the new business models, you might pay something closer to 70 basis points or 100 basis points”. I have made several FX transfers both into and out of Australia (in the range \$20,000 to \$200,000) via non-traditional providers where the spread charged was about 70 basis points (and no fees); on the same days, the big 4 banks would have charged between 3.5% and 5% for those transactions i.e. 5 to 7 times as much spread. Even for much smaller amounts, the spread quoted by non- traditional providers was about 100bp. Since the big banks would, if anything, have access to tighter interbank FX rates (albeit perhaps less than 10bp advantage for the more liquid currencies) when transacting on behalf of their customers, there is no explanation for the huge spreads other than that the banks are making much higher profits, from their retail and small business customers. There is no difference in remittance speed, and the service from the new competitors is often better.

I welcome the entry of competitors into the Australian FX market. The mystery is why they haven’t so far been able to divert more FX business (for retail and small business customers) from the major banks. This must be a matter of low customer financial acumen and/or stickiness of retail/small business banking relationships.

Consumers have enjoyed increasingly better pricing (by banks) of housing loans over recent years, but there has been no such improvement in international banking, especially in the retail consumer segment. The margins above demonstrate this. Moreover, some Australian banks have for 3 or 4 years been charging 3% “conversion” surcharges for so-called “foreign transactions” on credit cards, even when the payment was made overseas in AUD, and an overseas bank had already charged a spread on converting the amount into AUD. I would argue that this practice, and description, is deliberately misleading, and certainly commercially unjustifiable. In any case, 3 % is far more than the wholesale cost to the bank even when a genuine FX conversion is required on credit card payments. I don’t know whether the banks keep all of this surcharge, or share part of it with the credit card providers.

I agree with the SSC Report that “[8.75] the need for transparency in the area of foreign exchange fees appears self-evident to the committee. The committee agrees that consumers should be empowered to know how much they are paying in foreign exchange fees, and that this transparency would lead to increased competition.”

The SSC’s **Recommendation 18** is “[8.77] that, if the ACCC finds poor industry adherence to its best practice guidance for foreign currency conversion services and international transaction fees, the development of a market code of best practice to promote integrity and transparency within the foreign exchange market should be considered.” I would argue more strongly than this: this area has long been a major problem of bad pricing and opacity, and progress has been glacial. Clear disclosure of all fees and commissions, and the exchange rate applied, along with the net proceeds of the proposed conversion, should be made mandatory before the actual conversion proceeds. The greater problem is consumer financial education, which is badly needed. At present, their ignorance or inertia is costing them perhaps over \$100m pa.

Richard Wilkins

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