HOUSE 'ECONOMICS' (EFPA) COMMITTEE

REVIEW OF RESERVE BANK PAYMENTS SYSTEM POLICY

SUPPLEMENTARY COMMENT: PETER MAIR - MAY 2006

CARD PAYMENTS POLICY

The Reserve Bank fairly had last-say at the 'payments system' hearings with the House Economics Committee last week: others had a rare chance to speak at these hearings and the RBA, inevitably under fire about its payments system policy, had the opportunity to respond.

Private interests, given rein, give self-serving evidence. No matter what nonsense is served up, provided it is on the public record, it is exposed for what it is and pending international inquiries are also forearmed. There is one thing worse than nonsense in the first instance, so there is no repeating it here. Even so, while it not the most deserving of a critical reaction, it is appropriate to address some evidence given by the RBA.

'merits review': unwelcome but appropriate

The RBA's tactically critical evidence was its reaction to the prospect of 'merits review': sensibly invited to embrace 'merits review' for regulators in general and itself in particular, the RBA did not. The clincher, after pleading risks of 'protracted legal appeals', 'unwarranted costs' and 'attendant delays', was the suggestion that its decisions were already subject to 'judicial review'.

Ask the retailers about the pointless waste of time and money entailed in 'judicial review' of RBA decisions, when the review process cannot consider 'merits': then ask the retailers about processes, like the Australian Competition Tribunal, when the judgment can be guided by expert evidence on merits.

This is not a semantic point. Later today my take on the *Rethinking Regulation* report will become accessible at *cfoweb.com.au*: merits review is almost surely coming to a regulator near you – not least the RBA – and benign 'judicial review' becomes largely redundant. Moreover, the hearings last week unfolded in a way akin to 'merits review' and on the face of it the RBA was found wanting: in the wash up, there could be no confident expectation the RBA's decisions would be vindicated 'on their merits'.

Not to labour the point but, after ten years and still no indication that the RBA is about to get it right, necessary investment in corrective delay has considerable attraction. In the same vein, is the feeling that the expenditure, by Visa, of some tens of $millions in legal costs, and the resulting 'lock it in' of a 55 cent interchange fee for its credit card transactions, was among the most profitable investments it ever made (however inadvertently).

The further suggestion, that the House 'Economics' Committee was also an effective arrangement for 'merits review' does not pass muster in the wake of RBA-only evidence to the hearings for the past 8 years. That, incidentally, is no criticism of a Committee with limited time – averaging less than one hour a year on payments policy matters in open hearings -- and working without expert advisers.

three other shortcomings

(i) confusing self-interest

The RBA's suggestion -- that other evidence was 'almost without exception' tainted by self-interest – was hardly fair to the retailers, for example, who the RBA earlier agreed would 'pass through', in lower retail prices to customers, any superficial gains from further reductions in credit card interchange fees paid to banks. As well many would concede my own evidence was frank, independent and well informed.

Conversely few, if any, may say the same for an RBA seemingly compromised by years of protracted investigations and 'deals' settling consultative stalemates. In the event the RBA eventually conceded the possibility that a 'no interchange fee' policy warrants further exploration (but did not explain why it abandoned in 2002 a previously announced policy of essentially the same effect.)

In essentially the same context, the RBA seemingly continued to regard 'credit cards' as some uniquely separate product when the simple addition of a line of credit to EFTPOS debit cards would duplicate that critical functionality and open the way for other 'credit card only' functions to be added to customers' debit-card accounts.

(ii) 'david' does Goliath again

In many ways an over-long and fruitless debate has been sustained by a semantic distinction of no real substance and, ironically, this point may be practically driven home by the 'davids' of the financial system.

Credit unions, about to be fairly denied the easy revenue flow from VisaDebit transactions, can compensate by newly offering their customers credit cards on terms restricting their entitlements to be net borrowers of any substance. If ‘scheme debit’ (i.e. VisaDebit) is effectively ‘regulated out’, the prospect is for the replacement credit-card activity to surge and for interchange fee income of VisaDebit card-issuers to be restored, but with no material increase in the net indebtedness of customers previously using those VisaDebit cards.

Achieving regulatory merit in policy about VisaDebit also requires setting to zero the interchange fees for credit card transactions.

(iii) ‘no new entry’ means ‘no new competition’

One of the more disturbing aspects of payments policy discussions is the alacrity with which it is suggested that ‘new entry’ and attendant ‘new competition’ have come to characterize the retail payments industry. Nothing could be further from the truth in any meaningful sense and the ‘evidence’ being tendered about ‘new entry’ and ‘competition’ is, to my polite mind, more akin to wishful thinking.

The relevant market for retail payment services policy is critically defined by the institutions offering their customers day-to-day transaction deposit accounts with ATM and EFTPOS access and credit cards (or VisaDebit cards). This market is dominated by the four major banks, and a couple of other smaller banks have a material market presence. There has been, and will be, no new entry into this market of any material consequence – on the contrary all the portents are for this element of the retail banking industry to continue to become ever more concentrated (not least the constant pressure to allow mergers among the four pillars).

The reason, as I submitted and endorsed in evidence given, is the unassailable competitive advantage held by those few banks holding substantial transaction account balances on which no interest is paid of any consequence. The disbursement of banks’ earnings on the investment of those ‘free’ deposits is essentially unaccountable. It is mainly (but only partly) used to cross-subsidize the provision of ‘free’ and under-priced transactions to their customers who are happy to play this barter game because they get free services rather than taxable interest income.

A very useful contribution to understanding the retail payments system could be made by the Reserve Bank making a well-informed assessment of the ‘size’ and ‘distribution across banks’ of the transaction account deposits on which a proper market rate of interest is not paid. We do not need a two-year study for this to be done credibly enough.

With total bank deposits running to some $800 billion or more, it is posssible that some $200 million or more of that is in transaction accounts either paying ‘no’ interest or on which a proper market rate of interest is not paid – by inference the earnings available to banks for cross-subsidization perhaps run to some $10 billion per annum now. [And for those interested in the banking industry’s rocky road in the late 1980s -- imagine the consequences in this general context of market interest rates approaching 20% p.a. at that time.]

Much apparent ‘new entry’ has little relevance to the payments policy debate. At best one could concede some modest impact at the margin where transaction accounts may overlap a little with other deposit and loan accounts. [In the card payments industry I understand the only ‘new entrant’ is Money Switch -- and only as a processor of card transactions.]

The well publicized **‘new’ credit card issuers** are rarely deposit taking institutions as distinct from retailers offering loyalty reward schemes and wanting to take a cut of the lucrative market for ‘high interest’ rate credit-card debt. Much of the noise about competition for credit card business is accordingly about lending, at lower interest rates, than seeking the day to day transaction activity that brings a ‘river of gold’ as interchange-fees.

Most well-publicized **‘new’ deposit-taking banks** are typically operations akin to cash management trusts attracting quite stable deposit bases at attractively ‘high’ interest rates. These institutions are generally not able to offer high volume day-to-day transaction account services to their customers who must also have a day-to-day transaction account with a major player in the retail payments system.

Similarly there is no material inference to be drawn about ‘new entry’ and ‘new competition’ in the retail payments system said to emanate from the innovation of **‘mortgage loan brokers and originators’**.

As I said, all the talk about new entry is wishful thinking of little consequence.

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