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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Monday, 15 May 2006

Members: Mr Baird *(Chair)*, Dr Emerson *(Deputy Chair)*, Mr Ciobo, Mr Fitzgibbon, Ms Grierson, Mr Keenan, Mr McArthur, Mr Secker, Mr Somlyay and Mr Tanner

Members in attendance: Mr Baird, Mr Ciobo, Dr Emerson, Mr Keenan, Mr McArthur and Mr Somlyay

Terms of reference for the inquiry:

To inquire into and report on:

The 2005 annual reports of the Reserve Bank of Australia and the Payments System Board

WITNESSES

Committee met at 9.02 am

CHAIR (Mr Baird)—I declare open this public hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration inquiry into the Reserve Bank of Australia's and Payments System Board's annual reports 2005. This inquiry is an extension of the committee's biennial review of the Reserve Bank. Throughout this parliament the committee has taken a keen interest in the payments system. These hearings provide us with the opportunity to look at the issues in greater depth. The inquiry has received submissions and exhibits from a number of interested parties including an individual, two academics and several groups with direct involvement in the industry. Copies of submissions are available on the committee's website. The committee's intention for these hearings is to focus on the Reserve Bank's reform of both debit and credit cards as well as look at some other areas where reform is proposed.

The committee is aware that there is a variety of opinion on the reforms, which is why we have sought to hear from a range of witnesses. Today we will be hearing from representatives of the Reserve Bank, the Australian Bankers Association, the Credit Union Industry Association, the Australian Merchant Payments Forum, the Australian Consumers Association, Visa, MasterCard and academics Professor Joshua Gans and Dr Ric Simes.

[9.03 am]

BULLOCK, Ms Michele, Chief Manager, Payments Policy Department, Reserve Bank of Australia

LOWE, Dr Philip William, Assistant Governor, Financial System Group, Reserve Bank of Australia

VEALE, Dr John Michael, Head, Payments Policy Department, Reserve Bank of Australia

CHAIR—Welcome. I remind witnesses that, although the committee does not require you to give evidence under oath, this hearing is a legal proceeding of parliament and warrants the same respect as proceedings before the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. The evidence given today will be recorded by Hansard and will attract parliamentary privilege. Before introducing the witnesses I will refer members of the media who may be present at this hearing to the requirement to fairly and accurately report the proceedings of the committee. I am sure they always do. I welcome representatives of Reserve Bank of Australia to today's hearings. Do you wish to make an opening statement?

Dr Lowe—I have an opening statement. It is a pleasure to be here today in front of the committee to discuss the Australian payments system. I would like to say at the outset that the Reserve Bank very much welcomes the committee's interest in payments system issues. It appreciates very much the time that the committee has given to reviewing the bank's reforms. In my opening remarks I thought I could usefully do two things: firstly, provide an overview of the main reforms and their rationale and, secondly, provide a summary of their main effects to date.

As you are no doubt aware, the Reserve Bank's current role in the payments system was established by the government following the Wallis inquiry into the financial system. That inquiry concluded that there was considerable room for both competition and efficiency in the Australian payments system to be improved. It also concluded that these issues were sufficiently important that a separate board should be established within the Reserve Bank to address the issues of efficiency, competition and stability in the payments system.

Since its establishment, the Payments System Board has addressed each of these issues, although the work of improving competition efficiency has attracted the most attention. This work has examined five aspects of the payments system. These are: interchange fees, the restrictions imposed by the card schemes on merchants, access arrangements, the availability of information, and the governance and architecture of the system.

Before I discuss each of these at least briefly I would like to make three general points about the reform process. The first of these is that the Payments System Board has a very strong preference for industry based solutions and it has explored these wherever possible. In some cases, changes that promote efficiency have been achieved without regulation while in other cases this has not been possible without the use of regulations. That is perhaps not surprising given the significant and often opposing commercial interests that are sometimes at stake and the legal hurdles that can sometimes arise in voluntary reform.

The second general point is that the bank has consulted widely before using its powers. This consultation has been very useful and has led to a number of significant changes in the proposed regulations. While we might not always agree with the views put to us, we very much value the ongoing dialogue with industry and with the users of the payments system.

The third general point is that, in considering reforms, the bank has always had a whole-of-system focus. We have been particularly concerned not just with how individual systems operate but also with the potential for substitution between the various individual payments systems that make up the Australian payments system as a whole.

With those three general points as background, I would like to turn to the five specific aspects of the reform process that I mentioned a minute ago. The first and most controversial of these has obviously been interchange fees. These fees are payable between financial institutions and are not transparent to either cardholders or merchants, but they have a pervasive influence on the prices that financial institutions charge for payment services. These fees are not subject to normal competitive pressures and, in the bank's view, had been set in a way that was distorting payment patterns in Australia.

Prior to the reforms, the structure of these fees meant that cardholders were often charged by their financial institutions to make EFTPOS transactions, but they often received quite large subsidies through reward points and interest-free credit when making a credit card transaction. As a result, we had the rather anomalous situation where cardholders were being charged significantly more to use a relatively low-cost payment method. We could see no convincing reason why this anomalous pricing existed.

Given this assessment, the bank has reduced interchange fees in the credit card system and in the two debit card systems. The reforms to the credit card system in 2003 saw interchange fees there fall from about 0.95 per cent of the transaction value to around 0.55 per cent. More recently, just three weeks ago, the bank announced reforms that will see interchange fees in the EFTPOS system, which flow in the opposite direction to the credit card system, fall from around 20c a transaction to around 5c a transaction. Interchange fees in the Visa debit system, which again flow in the same direction as the credit card system, will also fall significantly.

This lowering of credit card interchange fees has, as expected, prompted a change in price signals. The prospective changes to the debit card system will have a similar effect. The fall in debit card interchange fees will also substantially reduce the risk that the Visa debit system and its MasterCard equivalent might eventually drive out the EFTPOS system simply because the structure of interchange fees made it much more attractive for financial institutions to offer and promote the Visa debit system.

In making this point I would like to make it clear, though, that the bank's regulation of the various interchange fees is not motivated by a desire to protect the EFTPOS system or by a desire to reduce credit card debt or by a desire to see greater use of the lowest cost method of payment. Rather, it reflects the view that the efficiency of the overall system is promoted when various payment methods compete on their merits rather than through interchange fees which themselves are not subject to competitive discipline.

I might also note that this interest in interchange fees is not just confined to Australia. Over the past few years these fees have been subject to regulatory intervention in a wide range of countries, including the United Kingdom, Spain, Switzerland, Israel, Mexico, Germany and the Netherlands. In the United States, these fees have been and continue to be subject to numerous court cases. In each of these countries the concerns are essentially the same as those expressed in Australia: namely, that interchange fees are not determined in normal competitive markets and that the levels at which they have been set are typically not in the best interests of the community at large.

The second issue is the restrictions that the scheme has placed on merchants. Quite early on in the bank's work we became concerned that various restrictions imposed by the card schemes on merchants were effectively eliminating or dulling price signals to cardholders. These included the restriction that prevented merchants from passing on to cardholders the additional costs associated with a credit card payment—the no-surcharge rule. The second was the restriction that required a merchant to accept Visa debit cards if it accepted Visa credit cards—the honour-all-cards rule. Then there was the restriction that prohibited a merchant who accepted American Express cards from steering customers to less expensive forms of payment—the no-steering rule. All three of these restrictions have been or will shortly be removed. As with the regulation of interchange fees, these reforms provide the basis for more soundly based competition in the Australian payments system.

The third issue is that of access. Over the years, the Reserve Bank has heard many complaints about how hard it is for potential entrants to join parts of the Australian payments system. Given this, the Payments System Board has been keen to ensure that inappropriate barriers to entry are removed. In general, the board's work in this area has proceeded more smoothly than that of reform of interchange fees, with the bank and the industry working cooperatively on a number of issues.

The first step in improving access was an access regime for the credit card schemes. This was done with considerably input from the industry. Prior to the regime being put in place, membership of the schemes was restricted to banks, building societies and credit unions, and penalties applied if a scheme member specialised in providing just credit card services to merchants. More recently, the bank announced an access regime for the EFTPOS system, with this regime coexisting with the EFTPOS access code developed by APCA and its members. This represents a successful example of the bank and the industry working together and it is a model that we hope will be used again. The bank has also been working with APCA to improve access arrangements, including the transparency of a number of Australia's payment clearing streams.

The fourth issue is transparency of information. When the bank started its work, data on interchange fees, merchant service fees and market shares were often treated in the same way as state secrets. Among other things, members of the credit card schemes were not permitted to disclose interchange fees to merchants. This general lack of transparency worked to the advantage of the card schemes and their members but to the disadvantage of cardholders and merchants. Today, we see that things are much more transparent. All interchange fees are now publicly disclosed and the bank collects and publishes data on average merchant service fees and on the market shares of the various credit card schemes. This improved flow of information is providing the basis for better and for more informed decisions by cardholders and particularly merchants.

The final issue is the governance and the architecture of a number of Australia's individual payment systems. While Australia was once recognised for having leading-edge payments system technology, it is fair to say that this is no longer the case. In a number of countries, there have been greater efforts to update the underlying architecture of the system, and in some countries we see more options being offered to both consumers and to businesses. At the bank, we have spent some time trying to understand why this is so and whether it is a problem.

While we have further work to do, I think Australia's payments system is notable for its heavy reliance on bilateral rather than multilateral contracts and, with the exception of the credit card schemes and BPay, the lack of strong central entities that develop and promote particular methods of payment. Whether alternative arrangements would promote more innovation is an open question, but it is also a very important one and one the bank continues to look at.

Our general approach in this area has been to raise the questions of whether the current architecture and the governance arrangements are conducive to the ongoing development of the industry. Our hope is that, in raising these questions, there will be greater industry focus on the issues of architecture and governance, since it is ultimately industry that is best placed to deal with these issues, rather than regulation. We have seen some steps recently, with industry trying to look more in detail at these issues than has been the case in the past, and we hope that this will continue.

In a nutshell, those are the five main areas that the Reserve Bank has been focusing on. I would now like to turn to a brief discussion of the effects of these reforms. Perhaps the most noticeable impact has been a marked reduction in merchants' costs of accepting credit cards. The average merchant service fee in the MasterCard and Visa schemes is now around 0.9 per cent of the transaction value, down from around 1.4 per cent immediately prior to the reforms. Based on current levels of credit card spending, this represents a saving to merchants of around $700 million per year.

I know a lot of people believe that this cost saving has not been passed on to consumers but, instead, has flowed straight through to merchants' profits. This is not a view that we share and it is one that sits uncomfortably with the normal dynamics of a competitive marketplace. If firms have lower costs, eventually prices too will be lower. Unfortunately, it is not possible to measure these price changes and their timing, particularly given the other, more significant, changes in firms' costs and prices that are going on all the time. But an inability to measure the change does not mean that it is not occurring.

The second effect of the reforms has been a change in the price signals to holders of credit cards. The value of reward points has been cut, some merchants have introduced surcharges, and annual fees have been increased. From our perspective, these are all welcome developments. On average, the value of reward points on those cards that offer points has fallen from around 0.8 per cent of the amount spent to around 0.65 per cent of the amount spent. In terms of surcharging, survey evidence suggests that less than five per cent of merchants levy an explicit charge on credit cards.

Surcharging is still relatively uncommon in most retail stores, but it is being increasingly seen in a range of other industries, including some which are subject to strong competition. These various changes in prices do appear to be having some effect on payment patterns, as expected, although it is difficult to disentangle the various effects. Spending on credit cards over the year to February was around eight per cent higher than in the previous year. That is around the slowest growth rate since the Reserve Bank began collecting statistics in the early 1990s. In contrast, spending on debit cards was up 13 per cent over the year to February, around its fastest growth since 1999.

Another change is the growth of low-rate credit cards, with a cut in the interchange fees prompting many issuers to re-examine their credit card products. With less interchange revenue available, some issuers are now attempting to attract cardholders by offering lower interest rates rather than by offering them generous rewards. As a result, a range of credit cards are now available with ongoing interest rates as low as 8.99 per cent, well down on the rates of 16 to 18 per cent applying on almost all credit cards just a few years ago. For many people, this represents savings running into hundreds of dollars per year.

In discussing these effects of the reforms I would like to address two issues that you are likely to hear quite a lot about today and tomorrow. The first of these is that the bank should have just required the removal of the no-surcharge rule and not regulated interchange fees at all. Those who put this view have argued that such an approach would have been sufficient to establish appropriate price signals for cardholders by merchants charging for credit card transactions.

The bank did consider this argument long and hard but, in the end, decided that simply removing the no-surcharge rule was unlikely to be enough. The main reason was that the long history during which merchants had been prevented from surcharging had contributed to a culture in which there was much customer resistance to surcharging. Given this culture, we judged that it was unlikely that surcharging would become commonplace within any reasonable time and, thus, just removing the no-surcharge rule was unlikely to establish more appropriate price signals. I think the evidence on surcharging so far is consistent with this judgment.

The second issue was the claim that the bank has given American Express a considerable advantage by regulating interchange fees in the MasterCard and Visa systems but not regulating American Express. This has led to calls for the same regulatory treatment to be applied to all schemes. In practice, the only way in which this could have been done would have been to require just the removal of the no-surcharge rule but not regulate interchange fees at all. For the reasons I discussed just a moment ago, the board did not think that this would be an effective option.

It is important to recognise that the main reason that American Express can offer relatively high reward points has nothing at all to do with interchange fees but, rather, stems from the relatively high price that American Express has been able to charge merchants for accepting its cards. With more merchant revenue per transaction, American Express and its partner banks have offered more generous rewards to cardholders, particularly to those prepared to pay the high annual fee associated with premium cards. Given this, the bank has been keen to see that the bargaining between American Express and merchants is conducted in as competitive and open an environment as possible. In particular, the bank has sought and obtained American Express's agreement to the removal of its no-surcharge and no-steering rules and to the publication of a broader range of data useful to merchants. This approach is having some effect, with the average merchant service fee charged by American Express having fallen by around 20 basis points since the reforms were introduced. There has also been an increase in marketing payments by American Express to some merchants which, if we could measure, would mean that the effective decline in American Express's average fee has been larger than this 20 basis points.

In the MasterCard and Visa schemes the competition between the acquirers meant that when interchange fees fell so, too, did the fees charged to merchants. In contrast, in the American Express system there is no competition on the acquiring side: American Express is the sole acquirer of American Express transactions. This means that the causation runs from merchant service fees to the fees to the partner banks, not the other way round, as it does in the MasterCard and Visa schemes. To repeat the key point here: it is the high merchant service fees in the American Express scheme that allow the generous rewards, not the interchange fees, as in the MasterCard and Visa scheme. The different regulatory responses reflect this basic point.

None of this means that we are not monitoring the competitive landscape very closely, although to date the changes in market shares have been small. The combined share of American Express and Diners Club has increased from around 14 per cent of the value of all credit card transactions prior to the reforms to around 16 per cent today. Looking forward, we expect that competition will lead to a further decline in American Express's average merchant service fee and, in time, this will be reflected in the structure of products that are offered in the marketplace.

In summary, the changes that we have seen are in the direction we expected. However, like other economic reforms that involve the unwinding of subsidies, not everyone is happy with these changes. Also, while the movement to less distorted price signals creates benefits for the community at large, these benefits tend to be less obvious than the higher prices paid by those previously receiving the subsidy. In the payments system, the importance of getting relative prices right is perhaps best illustrated with the example of cheques. When people were not charged for writing cheques they wrote lots of them, and a tremendous amount of resources were used in their processing. When banks did introduce a charge, people found other, more efficient, ways of making their payments. The result was that as a society we freed up considerable resources for use in other, perhaps more useful, things than processing payments. While nobody who writes a cheque today likes paying the charge, as a society we are better off facing lower prices for electronic payments than for cheque payments.

In this example it was ultimately the normal forces of competition that were important in getting the price more in line with the cost of processing, and that is how things normally work. However, as I have said a number of times already, these normal forces of competition do not work on interchange fees. The previously existing fees themselves generated strong incentives that encouraged the use of credit cards at the expense of the lower cost EFTPOS system, and there was no market mechanism to correct this distortion. The same is true when comparing interchange fees in the EFTPOS and Visa debit systems. In the absence of these normal competitive pressures, the bank's reforms have promoted more appropriate price signals and, as a result, are freeing up resources to be used where they are more highly valued. The reforms are also promoting competition, enhancing transparency and removing the long standard barriers to entry. While it will take a number of years for their full effects to be felt, they represent a significant step towards a more efficient payment system in Australia.

CHAIR—Is it the wish of the committee that the RBA submission dated 15 May, 2006 and the late submission by the National Retail Association be accepted as evidence and authorised for publication? There being no objection, it is so ordered.

Thank you very much for that, Dr Lowe. The paper is easily understandable and I think it is a very useful starting point for those who are looking at this whole process. Last time, when we had the roundtable, we did not have the benefit of all the arguments at that point. As you may recall, last time we did this, with the various operatives in this area, it was behind closed doors. This time we have decided to make it an open situation. This might be interesting for the media, because I think they were making judgments on our comments without having listened to some of the arguments that were put forward.

Having said that, before we ask questions on your opening statement, in an article in today's *Daily Telegraph*, Darren Behar, who is here today, talks about a report by Fujitsu Consulting which compares Australia to the US, the UK and Canada and claims that we have amongst the highest fees in the world for credit card holders and other things. I know that you have not seen this report before. It quotes card rates of 9.1 per cent on average, which compares less than favourably with others, and the cost of standard transactions et cetera. I do not know whether you want to make any initial comments about that. I know that you have not seen this report before. I will give you this report and when you appear before us tomorrow you might have some comments about the legitimacy of the claims that have been made. Do you have any comments to make on that?

Dr Lowe—We have not seen the report. Perhaps we could look at it during the course of the day and come back with some comments tomorrow morning.

CHAIR—A number of the claims in your paper make good sense in terms of their economic argument. But, when we look at the bottom line, is it not the reality that the consumer has not seen any change? It would appear that there is no effective way of measuring the impact on the consumer of the change in the transfer fees, and that, if anybody is a beneficiary, it would be the retailers who are simply keeping the benefit. There has been a change of cost. With these changes, we have seen an increase in fees by the credit card providers and a reduction in the benefits offered. There is somewhat of a distortion in that the high-cost card providers are able to provide greater rewards and shift the market towards them—at this stage it is not dramatic, but it is nevertheless occurring. What are your comments on that?

Dr Lowe—There are three issues here: whether the costs savings have been passed through by retailers; what is the direct effect on cardholders; and the competitive landscape between Visa, MasterCard and American Express. They are the big issues that people want to discuss.

CHAIR—That is right. On these hang all the law and the profits.

Dr Lowe—On the issue of whether the costs savings have been passed through by retailers to cardholders, no-one has any evidence of this on either side. But we hear all the time from business: 'Government needs to reduce cost impediments on industry so that we can be more competitive. Firms need to find more efficient ways of producing goods and services so they can lower their prices.' Costs are an important determinant of price, and here we are asked to suspend that normal connection, that somehow our merchants collectively have enough market power that they, even when faced with the reduction in cost, can keep all of that for themselves. That does not sit comfortably with the dynamics of a competitive marketplace, and it runs counter to almost all basic economics.

CHAIR—When you interfere with the market and you cannot prove the results of that interference as being beneficial to the consumer, do you think it is appropriate that people should think about the wisdom of doing that? While in theory it may appear to be a good move, nevertheless, if there is a distortion in the market, perhaps some of the premises on which the argument was built may be questioned.

Dr Lowe—It is certainly a legitimate question, but there are many things that one cannot measure and so one has to rely on, in some cases, your analysis of what is going on. To question the proposition that firms can have a reduction in costs and keep that all as profits runs counter to both normal competitive discipline and basic analysis. The reality is no-one can prove it one way or the other here, but in the absence of that proof the analysis is relatively strong. You said there is a distortion in the marketplace. In retailing, there is no distortion. By and large, it is a competitive industry.

CHAIR—No, it was in the credit card market.

Dr Lowe—Then the distortions lessened the costs and the merchants had lower costs as a result of that.

CHAIR—That does not really answer my question: aren't you just shifting the cost, because there has been a significant increase in credit card holder costs? You do not pay it on one side, but you pay it on the other.

Dr Lowe—Yes, and interchange fees are really about where the cost lies. They transfer costs from one side of the market to the other, and so you are right. What we have seen is a costs saving on behalf of merchants flowing through into lower prices, though on the other side of the market, cardholders—

CHAIR—A reduction in costs to the merchants, but you are about to say 'flowing on to the consumer', but you cannot actually prove that.

Dr Lowe—No, we cannot prove that, but in the absence of that proof, the analytical point is relatively strong. People question that because there is no proof, but the link between costs and prices is a long one and has been around for many, many years. There is reason to have confidence that ultimately the lower costs flow through to lower prices, but no-one can prove it. On the other side, it is true the cardholders are paying more for using credit cards, but that was what the reforms were about—that is, getting the price signals more appropriately aligned than they were before. The users of credit cards were extremely heavily subsidised. There are not many products in this country that you can use not only for free but also, if you are heavy user, you are paid to use. People were getting paid by their financial institutions to use their credit cards. Why was that? When we looked at why that was the case, the interchange fees were a large part of that.

Removing the interchange fees has taken some of that subsidy away, so people are paying for using credit cards—but that is what the reforms were really about. As I said in my opening remarks, it is a bit like the example of cheques. When people were not charged for writing cheques, they used them a lot. Nobody likes actually paying the $1 charge or whatever their bank charges but I think that as a society we are better off when we face a price for a service that reflects the cost of providing that service, because we find other ways of making our payments and we free up resources to be used where they are more highly valued. In a sense the same is true here. We have removed or lessened the subsidy on credit card usage and now people, at least those at the margin, find it slightly more attractive to use a debit card in the EFTPOS system.

The typical transaction pushed through the EFTPOS system has lower costs associated with it than a transaction pushed through the credit card system, so by getting prices and costs more appropriately aligned we are freeing up resources to be used where they are better valued. As with cheques, people do not like paying a charge but the Reserve Bank's responsibility is to look at the efficiency of the overall system. I think the introduction of a charge on cheques improved the efficiency of the system just as the reduction in the subsidy for credit card users has improved the efficiency of the system. In a sense, getting the prices right was what all this was about; and the benefits are diffused and the costs tend to be relatively concentrated, so many people do not like what is happening because they cannot see the benefits, just as it is difficult to see the benefits of the $1 charge on writing a cheque.

CHAIR—Thank you, Dr Lowe. I am sure there are many other things that we want to talk about, including the three-party system. We will have Dr Emerson and then Mr Ciobo asking questions.

Dr EMERSON—I will make a brisk journey through your submission. It will not take long. I will start at the end of it with the reference to unwinding subsidies. These are obviously not government subsidies, as we understand subsidies in conventional terms, but it is the cross-subsidisation of credit cards by debit cards—that is, the cost of credit cards is below its true value. Is that an accurate summary and why have credit card providers chosen to do that, to subsidise the provision of credit?

Dr Lowe—I would express it slightly differently. I would not say it was a cross-subsidy between debit and credit cards, because essentially there is no payment between the two systems. In a credit card system prior to the reforms, whenever you used your card the merchant's bank had to pay the issuing bank, your bank, one per cent of the transaction value. Typically, that was more than its cost and so it was able to pay you reward points to encourage you to use the card. In the EFTPOS system the fee goes the other way. Every time you use your EFTPOS card your bank has to pay the merchant's bank on average 20c. It costs your bank more when you use your debit card than when you use your credit card, so in a sense you are being encouraged by your bank to use your credit card because it is much more attractive to it for you to do so. So there was no cross-subsidy between the systems but the structure of the interchange fees was such that you were being subsidised to use your credit card by the fee that the merchant was ultimately paying, whereas with the debit card system up till recently your bank was typically charging you to use the debit card because it had to pay.

Dr EMERSON—Isn't that pretty strong evidence of anticompetitive behaviour?

Dr Lowe—Our point has been that these interchange fees, which really have driven the pricing to the cardholder to such an extent, are not determined in a competitive marketplace. You see in the US that the interchange fees between MasterCard and Visa have kept going up and up over time. The reason they have gone up is because if you have a higher interchange fee you can give more reward points to the cardholder. So Visa thought, ‘We can attract issuers by giving them more revenue and the ability to offer more reward points by having a higher interchange fee than MasterCard.’ So they have gone up from around 1.3 per cent in the early 1990s to more than 1.6 per cent now.

Our basic point all through this has been that these fees are not subject to competition. They have been set for whatever reasons, they are very difficult to change and they drive pricing in the system. In the absence of any competitive discipline being exercised on these fees, and given that we thought they were having a pervasive influence on payment patterns, we thought it was appropriate to adjust them to get pricing back in line more closely with costs.

Dr EMERSON—Is that a strange way of operating, though, if we go back to our first principles in economics that where there is anticompetitive behaviour there must be some barrier to entry to allow anticompetitive behaviour to continue? It seems that the Reserve Bank has said, ‘There are these barriers to entry but we will get into this anticompetitive behaviour by dictating a lower fee.’ Wouldn’t it be better to remove all barriers to entry?

Dr Lowe—Essentially we have done that as well. The schemes were restricted in their entry, and we have required them through regulation to remove those barriers to entry. The issue is that in payment systems the competition has forced the interchange fees up. You see it in the United States. There is no barrier to entry for a new scheme establishing itself, but when the schemes are in existence the way that they have found to compete is to raise this fee. The issue is that the merchants find it very difficult to refuse acceptance of credit cards. So up to some limit they are prepared to pay a large amount to accept credit cards. The schemes know that and so they are essentially able to get a revenue flow from the merchants to the cardholder through the interchange fee.

Dr EMERSON—But it seems contrary to everything: you deregulate to encourage more competition, and the price goes up.

Dr Lowe—It is the nature of interchange fees.

Dr EMERSON—So if you completely deregulated it, then the interchange fees would go to exorbitant levels. Why don’t we remove all competition and the price will go down?

Dr Lowe—Ultimately there is some resistance, because at some point the merchants are not prepared to pay. As I said in my opening remarks, the fact that these interchange fees are not subject to normal competitive pressure is being reflected in competition authorities in many countries now taking a look at these fees. This is not something that the Reserve Bank dreamed up.

Dr EMERSON—No, and I am not being critical of the Reserve Bank—

Dr Lowe—Competition authorities in a dozen countries have noticed that, because of the structure of the market, these fees are not subject to the normal competitive discipline that we see on most other prices in the economy. Opening entry is not the solution.

Dr EMERSON—Is part of the lack of competition the existence of these reward systems, which are very difficult to compare? It requires an enormous amount of information to compare their generosity. So you get an asymmetry in information and people say, 'I get this terrific reward system, I think, and I think that it might, on balance, be better than another reward system, so I will go with it, even though I am paying more for the transaction.' Is that a valid observation?

Dr Lowe—It is valid to note that the reward schemes are often quite complicated and difficult to compare. But I do not think that is the issue here. There is plenty of competition on the issuing side. You see credit card issuers advertising all the time, promoting their cards, so there is plenty of competition there. There is plenty of competition on the acquiring side—the provision of credit card services to merchants. The banks compete aggressively there. So on both the issuing side, which is the provision of credit card services to cardholders, and on the acquiring side, which is the provision of credit card services to merchants, there is a lot of competition.

Where the competition does not work is in the payment between the issuing and the acquiring side. It does not work anywhere around the world. From our perspective, it is very difficult to see a market based mechanism coming up with a price that we think is in the public interest in that case because of the very nature of that market. Regulatory authorities around the world are increasingly coming to that conclusion as well.

Dr EMERSON—My final question at this stage refers to page 7, where you say that there was a real slowdown in the growth of credit cards and a pick-up in the growth of usage of debit cards, but at the same time interest rates on credit cards fell from 16 per cent or 18 per cent to as low as 8.99 per cent. That is what the consumer sees. It is a huge reduction—more than 50 per cent—in credit card costs. Wouldn't that of itself be the much stronger signal and therefore shouldn't we see the use of credit cards rising relative to the use of debit cards? That is a massive change in relative prices.

Dr Lowe—That is the interest rate that you pay if you do not pay off by the end of the month.

Dr EMERSON—Sure.

Dr Lowe—That has fallen considerably. I do not think that that is encouraging greater use of credit cards, although at the margin it may.

CHAIR—But you cannot at one stage say that your lowering of interchange fees will produce benefits to the consumers and stimulate demand without also agreeing with that.

Dr Lowe—At the margin, if you are paying less for debt you may take a bit more on.

Dr EMERSON—It is a lot less. It is a 50 per cent reduction.

Dr Lowe—That is debt. We are mainly talking here about the use of a credit card for a transaction purpose.

Dr EMERSON—But when people buy something on credit they think that, unless they are really astute managers of it, they will end up paying these interest rates, and they have halved—that is what you are saying. To pick up the chair's point, this massive change in relative prices on the credit side and a fairly small change on the debit side seems to have produced perverse results, where the growth in credit has slowed down dramatically compared with the growth in the use of debit cards.

Dr Lowe—I would not accept the proposition that these are perverse results. This is what we expected to happen—that the growth in credit card spending would slow relative to the growth in debit card spending.

Dr EMERSON—Despite a halving in the price.

Dr Lowe—Of credit card debt. At the margin, the reduction in that debt may have encouraged people to use credit cards a bit more than they otherwise would have, but that is quite a small effect. The more pervasive effect is the surcharge and the reduction in rewards points. We have seen credit card spending grow at its slowest rate in a decade and a half as people face more appropriate price signals at the transaction level.

CHAIR—The secretary and I have just been looking at the submission from the National Retail Association which arrived late—it was only received this morning. Their summary says:

NRA accepts that as a general proposition the changes introduced as a result of the reforms are beneficial to the retail industry. NRA is however not able to quantify the benefit or to assess the extent to which benefits have been realised across the full spectrum of the retail sector. It is probable that only a minority of retailers would have recorded a significant benefit.

Mr CIOBO—Just on the point that you were discussing with Dr Emerson, would it be fair to say that essentially the RBA's view is that the reason there has been a slowdown in credit card use is because it is more expensive for consumers now?

Dr Lowe—The price signals have changed and people have responded to that, yes.

Mr CIOBO—So it is more expensive.

Dr Lowe—It is. It is less generous.

Mr CIOBO—Okay. So the subsidy has decreased and the annual costs have increased so it is not as cost effective for people to use credit cards as it was before. In summary, it is more expensive for consumers.

Dr Lowe—Yes.

Mr CIOBO—Which part of the market do credit card companies, the issuers, go for—the transactors or the borrowers? Which is more profitable for them?

Dr Lowe—Are you talking about the credit card issuers?

Mr CIOBO—Yes, the broad categories—I believe the industry uses the terminology ‘borrowers’ and ‘transactors’. Which is more profitable? Who are they after?

Dr Lowe—I do not think I can answer that question. You might have to ask one of the private banks. We do not have that detailed information on profitability by customer type. Presumably both classes generate profits.

Mr CIOBO—Sure. If it were that transactors proved to be higher yielding customers than borrowers, it is more difficult now to attract transactors using MasterCard or Visa than using Amex or Diners. Is that a fair statement?

Dr Lowe—Are we talking about the bank issued American Express card?

Mr CIOBO—Yes, the cobranded cards.

Dr Lowe—American Express will pay the issuing bank some amount of money, and that amount of money has allowed those issuing banks to offer more generous reward points on those American Express cards, that is true.

Mr CIOBO—Obviously with the lower cost credit cards, the introduction of which you have spoken about, it would be better for the borrowers now?

Dr Lowe—It would.

Mr CIOBO—Is there anything that prevented the lower cost credit cards from coming onto the market prior to your reforms?

Dr Lowe—Nothing prevented them. In fact, I think Virgin Money came in earlier or around the time of the reforms. But the predominant model prior to the reforms was to attract cardholders through the reward schemes. You did see in the second half of the 1990s tremendous growth in credit card usage, as people woke up to the value of the reward schemes.

Mr CIOBO—With respect to your assertion that you have made a couple of times now that market forces do not operate with respect to interchange fees, can I put a proposition to you: at the end of the day, generous reward schemes are paid for by customers anyway, aren’t they, because a higher merchant service fee is presumably passed on to consumers? Your assertion is that a lower one is passed on to consumers, so presumably a higher one is also passed on to consumers. Would that be correct?

Dr Lowe—Consumers generally. I think it is important to distinguish—

Mr CIOBO—Sure. It is a cross-subsidy.

Dr Lowe—cardholders from consumers because only, I think, 55 per cent of adults are credit card holders. So there is a distinction between cardholders and consumers generally, which I think is important.

Mr CIOBO—So those additional costs are passed on to consumers more generally?

Dr Lowe—Yes.

Mr CIOBO—That is the cross-subsidy that the RBA has raised with the committee before?

Dr Lowe—Yes. The merchants had passed on this higher cost. People using credit cards were essentially getting it back through reward points, but the people who were using their EFTPOS card were paying a higher level of prices—they were actually paying to use their EFTPOS card as well.

Mr CIOBO—So we have now, effectively, moved a widespread cost on the community and narrowed that same cost—you would argue that the cost has decreased slightly—onto just cardholders?

Dr Lowe—That is right.

Mr CIOBO—That is part of the reason why we are seeing decreased credit card usage?

Dr Lowe—Yes, that is right. I think that is a fair assessment.

Mr CIOBO—In your opening statement you outlined three restrictions that either have or will shortly be removed. With respect to the access arrangements that you put in place, would you be able to give the committee some idea about how many new specialised credit card issuers have entered the market since you put in place the access regime?

Dr Lowe—Yes, to date only one specialist credit card institution has come into existence. It is in the process of providing acquiring services to merchants. We know of a number of others who are currently in discussion with APRA about getting a specialist credit card institution licence. So there has been one and there are others in the pipeline—not a large number, but more than one. I think reform of access is important not only in the new entrants that it brings in but also in the threat of entry. We have seen a number of new—

Dr EMERSON—Contestability.

Dr Lowe—Yes, contestability. You have seen a number of new issuers of credit cards come into the Australian marketplace who are not banks, building societies or credit unions. They have the option of becoming a specialist credit card institution and running their business that way or teeing up with a bank to run their business with a bank backing them. A number of them have chosen that second model. But because they had the other model there—because the market was now contestable—it is arguable, and I think correctly, that they got a better deal from the bank who was backing them because they had an alternative way of coming into the market. There has only been one new entry as an SCCI—there are others in the pipeline—but the market is more contestable, and I think that has had an effect on how the market has evolved.

Mr CIOBO—Can I just touch on the governance and technology aspect. You spoke about how Australia was leading the way for some time with respect to the payments system, but that, as I understand it, has largely fallen away. I am slightly concerned—you talk about how you are intending to keep monitoring the situation. What impact do you believe your reforms have made on technology and governance—on the architecture—in the payments system?

Dr Lowe—The reform of interchange fees has had no effect on the rate of innovation in the system. Ultimately, reform of access may, because specialist institutions can come in and provide acquiring services and they may have different technology. But that is still a possibility rather than a reality. The reforms to date have not really touched on the technology and governance issues. They have had very little effect on developments there. They are really issues that we are flagging that need closer scrutiny by the industry.

Mr CIOBO—Do you think a less profitable position by the banks with respect to interchange fees encourages or discourages innovation when it comes to new technology platforms?

Dr Lowe—The answer to that is that it has very little, if any, effect—because, remember, interchange fees are about the distribution of revenue within the system; they are not a source of revenue to the system. The source of revenue to the system comes from charging merchants or charging cardholders, not by the distribution between the two sides.

Mr CIOBO—The two are related, though.

Dr Lowe—The two are related, but there is no regulation on charging cardholders or merchants. What we have regulated is the payment that goes between. That is not a source of revenue to the system.

Mr CIOBO—Yes, but with due respect, you cannot separate the two like that. You yourself have indicated that lowering the interchange fee has brought down the merchant service fee.

Dr Lowe—Yes.

Mr CIOBO—So there is less revenue coming into the system, isn't there?

Dr Lowe—There is less revenue from merchants, but more from cardholders.

Mr CIOBO—Are you saying they offset each other?

Dr Lowe—There is a significant offset, but they do not completely offset.

Mr CIOBO—The cost to revenue has been about half, hasn't it?

Dr Lowe—Annual fees have gone up, which has generated some offset, and reward points have been cut, generating a saving as well.

Mr CIOBO—Consumers are paying more. We know that. That is going into the system.

Dr Lowe—Yes, and less is coming in from merchants. So it is true that to date there has been a modest reduction in the amount of revenue to the system.

Mr CIOBO—About what amount do you quantify?

Dr Lowe—It is difficult because we do not have good numbers on the reduction in the value of the reward points. We are probably talking about a couple of hundred million dollars net reduction in revenue in the system.

Mr CIOBO—I saw a figure of, I think, $1.4 billion pre reform and $700 million post reform. Does that sound correct?

Dr Lowe—I could not answer that without more context. There has been a reduction in merchant revenue of $700 million. The annual revenue from the typical account has gone up by about $30 an account.

Mr CIOBO—So the long and short of it is that you do not believe there is an impact of R&D or the roll-out of new technology?

Dr Lowe—It has very little effect. There are other more important issues that determine the amount of innovation in the system.

CHAIR—They almost cancel each other out, though, because you say that the overall benefit is $500 million. If there is $700 million less revenue coming in, then we are not likely to see a huge amount of benefit to the consumer?

Dr Lowe—It is getting the price signals right. It is back to my cheques example. People will say, 'We don't really like this,' but ultimately as a society, if we face prices that are broadly reflective of the costs, consumers make the right decisions and only buy services where they get the value from them. I think that is what has happened here as well. The issue of technology in the system is a very important one, but I do not think interchange fees is the thing that has driven that.

Mr CIOBO—Well, revenue overall. You keep saying 'interchange fees', probably because I mentioned them first, but the point is: revenue into the system, you are saying, does not have an impact on that.

Dr Lowe—I would not go that far. I would say it is not the main issue here. The main issue is structural characteristics of the industry.

Mr SOMLYAY—Is there any evidence that the consumer is getting smarter with the great proliferation of financial services and options? For instance, someone with a flexible mortgage account can pay off their credit card account and transfer an 18 per cent credit liability down to a 7½ per cent credit liability. That is just one example of money in and out within any one month. People are getting smarter and using that. Does that distort the bank's ability to be able measure the credit card effect?

Dr Lowe—I would agree with your first remark, that people are getting smarter. People worked out what a good deal credit cards were, and plenty of people responded to that. That is why we saw very rapid growth in credit card spending in the second half of the 1990s, when these reward schemes came into place. People did not work it out on day one, but within a short period of time everyone was working it out. At every dinner party you would go to, if you were not talking about property prices you were talking about your reward points. So people worked that out in the second half of the 1990s. I do not think that is distorting our ability to measure what is going on. We have quite comprehensive data collections from financial institutions and I think we have been able to separate out the various things that are going on. There is always scope to get better data but, by and large, the data we have is allowing us to analyse what is going on.

Mr KEENAN—Taking up the point that Mr Ciobo was making about innovation, what are the products that consumers and businesses have access to in other countries that Australian consumers and businesses do not have access to?

Dr Lowe—There are two things that we have drawn to people’s attention recently. One is online EFTPOS, if you like. If you want to buy tickets to a concert or the cricket or buy a plane ticket, and you go to a website to do that, you have typically got to type in your credit card number if you want to do it online. In some other countries you can essentially use your EFTPOS card to do that: you can go in on the website and it will take you back to your bank’s website, where you type in your PIN number, and you can pay for that online transaction through a method other than credit cards. We do not really have that in the Australian marketplace. In other countries where they have got it the banks have got together and said, ‘We need to find some type of online debit solution.’ There have been some discussions here, but we do not have that product in the Australian marketplace so you have to use your credit card if you want to buy something online. There are many customers who do not like that and, as I said before, only 55 per cent of adult Australians have a credit card, so they are excluded from those sorts of transactions. That is a big issue.

The second is a more arcane one but it is important in business-to-business messaging. When you are using the direct entry system, which is a direct credit or a direct debit, the message formats are very inflexible. If you go onto your internet banking site and you want to send someone some money, you have only a few characters to write, for example: ‘This is an invoice from me to you. This is the invoice number.’ For most consumer payments that is not really a big issue; you can work out some way of overcoming that limitation. But for business-to-business payments it is a much bigger issue. In other countries the banking industry have got together and worked out more flexible message formatting that will allow more flexible business-to-business payments. There have been some efforts here but, really, we have not moved on and we have technology that is—what?—decades old—

Dr Veale—Yes, 20 years old.

Dr Lowe—whereas other countries have made an effort there. Those are two examples that really have nothing to do, I think, with the interchange fees. They are really about the industry getting together and saying: ‘There is an issue here. There is customer demand. We need to develop some payment solutions to meet the demand.’

Mr KEENAN—Would you hazard a guess why Australia has fallen behind?

Dr Lowe—I do not think I have the complete answer to that. As I said in my introductory remarks, many parts of the system are built around bilateral contracts—NAB would have a contract with Westpac, Westpac with ANZ et cetera; there is a web of contracts—so, if you want to update the system, each party essentially has to negotiate and rewrite their contracts. In some other systems around the world there is more centralisation and you join a system. The credit card system is a good example of that. In the credit card system, each of the main banks has a relationship with Visa or MasterCard; they do not have a relationship with each other. When you have that central entity, the banks are in position to promote innovation—perhaps more so than in a more decentralised bilateral system. So that is one possibility. I think the banks would probably disagree with the assessment that that is important, but it is certainly a characteristic of the Australian system which is not shared by many other countries, and its bilateral nature makes coordination more difficult than when you have some type of central entity. That may be a reason and there may be others as well. I do not think anyone has the answer here, but there are some possibilities.

CHAIR—Thank you, Dr Lowe. You have set the scene for us—the parameters of the debate. It is a very interesting paper and it has been a useful discussion. As you know, you will be followed by Professor Gans, whom you have heard speak before in that very interesting debate down at the Melbourne Business School. They had a seminar on the payment system. To hear the other side of the equation, on whether it has been a success or failure, we will listen to other people as well. Thank you for your attendance today and thank you for your paper. We look forward to talking with you tomorrow, when we will know a little more or perhaps a little less.

Proceedings suspended from 10.06 am to 10.17 am

GANS, Professor Joshua Samuel, Melbourne Business School, University of Melbourne

CHAIR—Welcome. Do you have any comments to make on the capacity in which you appear?

Prof. Gans—I am a regulatory economist and have studied credit card schemes for approximately five years.

CHAIR—Although the committee does not require you to give evidence on oath, you would know that these proceedings have the same standing as those before the parliament. This inquiry has received a written submission from you. Would you like to make an opening statement?

Prof. Gans—Yes. My purpose in providing a submission to this inquiry was, given the nature of the reforms that had taken place, to look back and see whether the things that had occurred had aligned roughly with expectations. Truth be told, there was a large range of predictions about what impacts the reforms might have. On the one hand, concern was had that the reforms would lead to abject disaster. On the other hand, Professor Stephen King, who is now with the ACCC, and I put forward a hypothesis that certain aspects of the reforms would have a mild beneficial effect—such as improving access to credit card schemes and eliminating the no-surcharge rule—and that the changes to the interchange fee would have a modest impact or perhaps no impact whatsoever on the overall use of credit cards relative to other payment instruments.

With that in mind, since the reforms, I had not looked particularly at the issue until a couple of months ago. At that time, with a conference occurring at the Melbourne Business School, I looked at the wealth of data now being collected by the Reserve Bank on the performance of different payment schemes and instruments to see where, with such a dramatic reform as the slashing of a key price by 50 per cent, its impact had shown up. It is very rare to see such major changes. But, in any other industry, one would expect a major change in a price to result fairly soon in a noticeable effect somewhere—particularly if it is a wholesale price that is paid between banks, as was the case here.

But, as my submission outlines, on a—and I will admit this—casual look at the data, that effect does not appear to be there. There appears to be no dramatic effect or sharp shock into the system. This is even more surprising, given that, unlike elsewhere, interchange fees in Australia had been fixed for two decades; so this industry had never had experience with changing interchange fees. As we heard just previously, the fees changed prices. They resulted in lower merchant fees and higher cardholder fees. However, in many respects, this seems to be shifting around who gets to pay what, and there is enough material to suggest that revenue coming into the system is much the same as it was before.

Bearing that in mind, my message is that ultimately the Reserve Bank appears to have taken out an insurance policy. Looking at what has been happening with interchange fees, in particular in the US, and how they are driving credit card revenues, the Reserve Bank has taken out an insurance policy to suggest that this would not happen in Australia. Other than that, the reforms were of little consequence, except to remove dinner table conversation about frequent flyer points.

The only other thing I would say is that, in hindsight, given the impact of the Reserve Bank taking—on the scale of things—a fairly conservative approach to regulating interchange fees, the uncertainty that ensued for two to three years from the initial Reserve Bank-ACCC report until this was finally resolved a couple of years ago was quite considerable and quite disruptive. If there is any lesson to be learned, it is how we might have avoided that. That is all I have as an opening statement.

CHAIR—Thank you. I had the opportunity to hear you in Melbourne; it was a very interesting conference. The next time you put on a similar conference I think the entire committee should come down and listen because it was very useful. With your experience of having collected the data, what do you see as the trends overseas? A visiting French economics professor has been very critical of the changes and the Federal Reserve Bank in the 'land of the free'—the US—has not taken such a step. What can we learn from the international experience? Are the Americans facing a significant problem through not having taken the action that the Reserve Bank of Australia has taken?

Prof. Gans—I will put my answer in fairly simple terms, looking at this industry in the US and comparing it with that in Australia. There is a sense of irony, given that Australia has had the more interventionist response; in fact, there has been none in the US, at least from a direct governmental standpoint. Interchange fees in the US are many per cent higher than the half a per cent they are here. As a result, it is extremely valuable to get more transactions on to the system because the merchants pay for the interchange fees for every one of those transactions.

Given that they are so attractive and that there are so many issuers in the US, the issuers compete extremely vigorously for consumers. We do not have the phenomenon that they have there: I have heard it estimated that one billion solicitations for signing up to credit cards are sent out in the US per year, which is four for every man, woman and child. That is a symptom of distorted pricing—people competing for cardholders to put transactions on these cards so that someone can reap the fees later on at the merchant end. The other effect is the credit card debt that gets spilled over by encouraging the use of credit cards. While we do not have that here, which is very encouraging, and I do not have a theory about why our interest rates on credit card debt are much lower, in the US they tend to be very high and are also charged on contracts that appear to allow variations that include the ratcheting up of interest rates as debt stays on.

Those things should send any regulator's alarm bell ringing; you do not want that to happen. Truth be told, in Australia we have not had the same movements at all. Our interchange fees, since they began, have been set and fixed. You could ask participants about it, but I gather that, when the system began and nobody had credit cards, nobody knew precisely at what rate to set these fees and did not adjust them thereafter. We have not seen the continual ratcheting up of fees as has happened in the US, so there has been a sense that the private setting of these fees has not moved in that same direction. However, the reason I say that the Reserve Bank took an insurance policy is that that will not happen in Australia now—at least not because of interchange fee changes, because the interchange fee is capped.

This also highlights another point. I must admit that there is concern in the US about increasing levels of credit card debt and, in particular, high interest payments on that debt. In the US, there is concern also about inducements to get consumers in—such as a zero per cent interest rate for six months and things like that, which get people used to debt—that seems to be the bigger concern here. The use of credit cards as payments instruments is accompanied by the risk of debt that might not be repaid, which is something that I think has received insufficient attention.

CHAIR—So were the changes introduced by Dr Lowe and his team a good thing? Were they economic theory rather than the way the market works in the practical real world? Where do you see the situation going in the longer term, with the projections?

Prof. Gans—In the end I cannot say whether it is a good thing or not, because my ultimate instinct is that it has had very little effect. As an economist, I think that getting rid of things like prevention of surcharging seems like a good idea so that people who are causing costs on a merchant are paying for those costs; that would be good. But, in the end, that would have been more useful had interchange fees been very high and those costs very large. If your intention was to bring those costs down, that was not going to have as big an effect. Somewhat surprisingly, we have not seen much instance of surcharging emerge, even where they might be able to get away with surcharges that are higher than the actual merchant service fee. We know that, if you pay by card for taxi fares, you pay 10 per cent more. One would have thought we would have seen more of that, but we have not, which is surprising.

CHAIR—And supermarkets or wherever else. Is that what you are talking about?

Prof. Gans—Supermarkets or any other place might have done that, but we have not seen it. It is somewhat ironic in that you do see it in some places. Recently I booked a holiday with an American Express travel agency and received a surcharge for using an American Express card. The good news about that is that it suggests nobody is really promoting card use any more. So you see it in funny places and it is more of an annoyance than anything else.

I do not think we have seen any other impacts. There is a concern that charge cards may have been given a leg-up in the marketplace because of these reforms. Certainly the merchant fees on charge cards, as ever, remain much higher than they are on credit cards. In addition, they have not fallen by the same level of degree, so there is a sense that that is now a distinct model, but we do not know whether that trend would occur anyway. American Express and Diners did not have a big benefit suddenly on 1 October 2003, so we just do not know whether that was the effect. In the end, I do not think it has had much impact at all. That is why I have characterised it as an insurance policy; it may be preventing something that might have occurred in the future.

Dr EMERSON—The Reserve Bank's opening statement says that interchange fees are not determined in normal competitive markets, but in your submission you say that credit card reform is not a competition policy issue. I am getting more and more confused. It seems to me that this sort of conversation would have occurred before about 1984, with a heavily regulated financial system. At that time people were talking about how to remove or modify some of the charges or fees that were being applied by intervening and saying, 'We'll reduce this interchange fee.' I just go back to first principles and ask why not just open up the market and make sure that competitive pressures are brought to bear? But you seem to be saying that it is not a competition issue anyway. My question is: given that your colleague Professor King has gone to the ACCC, isn't there a role for the ACCC in ensuring that, through its powers, there is proper competition in this area?

Prof. Gans—We have to start where any competition analysis starts, by asking: what is the market here? My understanding is that when you go to purchase anything you have a range of instruments you might choose to use. You have cash, which is, by the way, monopoly controlled by one bank—

Mr CIOBO—Which bank?

Dr EMERSON—No, a different bank.

Prof. Gans—you have cheques, you have EFTPOS, which is a significant force in Australia, you have credit cards and now you have other forms of payments coming up—Billpay, PayPal, other forms of things. You have a wide range of choices in that respect and, in a sense, all of those instruments compete with one another for customer business. When we are looking at competition policy, that is the fundamental thing: is there competition, are there choices amongst payment instruments and are they coming from enough different providers so that no one person is controlling that choice?

When it comes to the credit card fees, I think it is perfectly natural to be perplexed by the entire arrangement, because it stands out as a strange model in an economy. Normally when firms do things like credit card associations, they do it once—one firm does it, they handle all the bits of it, they do not have to worry about interchange fees, it is going on in some black box inside a company—and they get on with it. But with credit cards, the way they have evolved is they have had a coordinating brand or association that has brought disparate groups together on both sides of a market—the people who deal with consumers and the people who deal with the merchants—and attempted to coordinate them one way or another by setting the payments between them, which is the interchange fee.

In order to make that collection of firms work to promote the thing that the association is doing—namely, credit card use—they have to set these fees; but unusually in credit cards they have just set the interchange fee. No-one has tried to set all of the other fees going around or anything like that, they have just set one fee and then had some membership details and then let it work out for itself. In a sense, it was some sort of collective, but what is really odd is that all of the banks that were members of it had conflicting interests. On the one hand, they would like to move away from cash to save and to have credit card transactions; on the other hand, they had control over EFTPOS and other means like that which they might have been wanting to promote as well.

All that led to some forms of competitive forces. The problem with it all is that it is very hard to conceptualise. It is not as easy to see as when we lose half the banana crop and the price of bananas goes up. It works on two different sides of the market, and the profits you make on one side of the market depend on your ability to compete on the other side of the market, and it gets into quite a conflicting and complex set of things. It is somewhat of a miracle that we are able to make head or tail of it at all. It is also that same reason that made everybody very nervous about intervening in it, as no-one understood fully all of the interacting forces going on.

Dr EMERSON—When we have a market that displays less than competitive behaviour and we are examining how that market is able to do that, one area is usually government regulation that stifles competition. Another area is information—that is, asymmetric or imperfect information. I refer to the Reserve Bank's statement of this morning that said:

When the bank started its work, data on interchange fees, merchant service fees and market shares were often treated in the same way as state secrets.

It seems to me that maybe this is where the problem is: this lack of transparency and lack of information. In that context, do the reward schemes help perform that function of limiting information by creating confusion? Do people say: 'I don't know. I've got have this reward scheme, though, and that seems pretty interesting. I don't know how good that is compared with another reward scheme.' I am looking for the devil in the market. Is it the reward schemes?

Prof. Gans—I do not know if it is just that. This reform is all meant to be about consumers making the right payment instrument choice when they get there. The key issue with the reforms was that if I don't care if I use cash, credit card or something else—it is all the same to me—and then somebody gives me a bit of inducement to use a credit card, I will end up using a credit card if I have one. The problem with that is that if that choice has differential impacts on the merchants, that means that some people who are getting the benefit of using the credit card will be pushing costs onto those who are not. And if only 55 per cent of Australians have credit cards, that means 45 per cent will be bearing the costs as they are distributed around.

However, you have hit on something very important, which is that we are assuming that just altering some of these prices and other things like that will make the consumer choice clearer. It is not just the reward schemes, for which even working out your points are is an issue, let alone what you may or may not be able to spend them on and have as a return in the future. It is also the interest-free period that you might face at any given point in time in a month. Five years ago, many banks halved their interest rate periods. That caught a lot of people unaware and moved them into a revolver status for a little while. It is something you have to keep tabs on all the time.

Finally, there are the problems associated with what would happen if you go into debt, what interest rates you would face and how long you might take to repay that debt. All the cards that are offered have different options in that regard. On the one hand, having an array of options—different choices about whether you like reward points or you are worried about credit card debts or you are worried about your annual fee or you face other charges—is a good thing. On the other hand, there is the issue of potential confusion, which only becomes a policy concern if it turns out that that confusion is leading people to make choices that might cause them to go into debt. I am less concerned about choices where people sign on to credit card schemes and it turns out the frequent flyer points are not as lucrative as they expected or they cannot use them. I think it is of more concern if people get into some sort of cycle of debt or something else as a result of funny pricing that causes people to be a bit more short term.

I often deviate from a lot of my economist colleagues in that, when it comes to consumer decisions, I think consumers, especially when making decisions about things that are impacting over time, are not necessarily 100 per cent rational. What concerns me is when you see practices that might be exploiting that. The caveat on that is that when you look at the data on credit card usage you see there is a sense that people anticipate this a bit. Credit card usage drops dramatically in November before rising in December. My guess on that is that people anticipate that they will be going into debt in December and they plan for it. So you can only go so far in terms of thinking about what consumers do. But I am worried about the consumers who do not anticipate the consequences of short-term inducements to use credit cards. That is where I indicated that I was not sure that this was a competition policy issue but something more like a consumer protection issue.

CHAIR—That is where it started off, of course, and then it was flick-passed over to the Reserve Bank as an issue.

Mr KEENAN—Picking up on the point that you do not think that competition policy is very effective and it should go back to more of a consumer protection perspective, what sort of policy do you think the government should pursue if we were to go down that consumer protection line?

Prof. Gans—In the absence of any glaring instances, at a first glance it would mean that you would have to have monitoring—and there is monitoring of this that occurs. It is just to make sure that that monitoring brief, as to what is happening to credit card debt and what its impacts are on consumers on different levels of income, would be useful to do. Given there is interest in credit card associations, my main point is that I wonder whether the resources and attention are on the right thing and whether we should be worrying about how credit cards are doing relative to debit cards or other payment instruments insofar as one wondering who is getting into credit card debt and what terms and conditions they are facing that might prevent them from paying back that debt. My guess is we are not in any situation like that in the US regarding this because there is not as much pressure or competition for people to get into debt. Nonetheless, if there were an area of concern that you wanted to look out for and give attention to it would be that. So I have no specific policy recommendations other than that, given we are spending time here talking about a lot of other things.

Mr KEENAN—So essentially it is monitoring the actual procedure?

Prof. Gans—It could be the ACCC, as it plays a role in this as well. The ACCC is charged with consumer protection across a whole variety of things. This is not consumers acting like investors; this is consumers acting like consumers, so I suggest that maybe the ACCC should be given more jurisdiction in this regard.

Mr KEENAN—I am interested in this particularly if competition policy is not something that the government can use to influence consumer behaviour. So you would have no suggestions as to other mechanisms that might be useful?

Prof. Gans—The usual mechanisms that are used for consumer behaviour are things that improve awareness. If we wanted to go as far as we could go, we could require various bits of transparency of information so that people know, at the time they are thinking of getting into debt—as opposed to later and in relation to some information that might come their way through a newspaper in June—that if they get into debt what the consequences of that might be. So you have to think about the provision of information. Other countries have gone further regarding this with other industries. In Portugal, with regard to the choices people make regarding mobile phone carriers, they are requiring the provision of information to be assembled by the competition authority, which is going to be able to tell people what the cheapest plan for them is. I do not know how they are going to achieve this—it seems like a very complicated task—but that could be part of what is provided. But I am not advocating this as anything that suggests that there is even any need for intervention in this regard. It just seems that is the potential concern. If you are worried about credit cards, then you are worried much more about consumer protection than about a lack of competition.

Mr CIOBO—Focusing on credit cards for the moment, I take it that at an aggregate level what you are saying is that there has been no real impact as a consequence of this regulation of interchange fees—and this is in respect of interchange fees for the time being. Is that correct?

Prof. Gans—Yes.

Mr CIOBO—Let us take it from an aggregate level down to a micro level. Dr Lowe indicated earlier that it is effectively almost like a perverse form of insurance: you see a cost that is borne by the whole community but the benefits are enjoyed by a much narrower band. We now have those costs focused on cardholders so cardholders are the ones paying the total cost, therefore for cardholders consumer costs have increased significantly and their benefits have dropped as well and we are seeing evidence of that. Is that correct?

Prof. Gans—Yes.

Mr CIOBO—So the value of being a credit card holder has dropped significantly. Is that why we are seeing decreased usage?

Prof. Gans—My issue is whether we are seeing decreased usage. I do not think it is at all clear that that is the case. All of these newer payment instruments have had growth in one way or another. The credit card ones have been growing significantly. It is only recently that we have seen some sort of shift towards debit cards, although it is almost too soon to tell, and it is not clear that all of that would not have happened anyway.

There are two forces at work here. What determines the total volume of credit card transactions is (a) whether I hold a card and also (b) whether I can use it. It is true to say that the benefits of holding cards have been reduced—although there is an instance where they may have been rebalanced: reduced frequent flyer points but reduced interest rates on credit card debt—but the benefits to merchants of accepting credit cards have increased. They face lower fees as a result of that—

Mr CIOBO—It is not really a benefit—you are saying costs to merchants have decreased rather than benefits have increased.

Prof. Gans—The costs have decreased—that is right. The costs have decreased; they face lower merchant service charges. Moreover, if they are not happy with that they can now surcharge. So, especially for goods where you did not see credit card transactions or which are high volume, there is a bigger benefit for accepting them now.

Mr CIOBO—The point is, though, for a credit cardholder under four-party schemes the costs have increased.

Prof. Gans—The inducement to use credit cards has decreased, would be more accurate. I do not know if people are paying higher fees to actually hold the card.

Mr CIOBO—They are; that is the evidence that we have had. Let us move beyond that. My question then is with respect to the three-party schemes—Amex and Diners Club, for example. I am assuming that there has been no net effect on them whatsoever because merchant service fees have dropped slightly, I believe, but effectively the benefits for consumers remain high, cross-subsidised by non-cardholding consumers.

Prof. Gans—Well, you have to think about it now. The one place where you do see surcharging have a signal is with the use of charge cards. Whenever I have seen a surcharge occur there is a differential rate for American Express and Diners versus Visa and MasterCard. That was what this was all about.

Mr CIOBO—So are you seeing any evidence of fall-away?

Prof. Gans—No, not necessarily, because what happens is—

Mr CIOBO—Market share has actually grown, hasn’t it?

Prof. Gans—Their market share has grown relative to credit cards slightly—that is right. It is not clear it would not have been happening that way anyway, but it has grown slightly. You can see it because, for high-end users anyway, the award schemes are more lucrative, so it is not surprising that that is going to have that effect. These charge cards and credit cards compete with one another. They are competing for the very same customers and the very same merchants, and they compete on the basis of cardholder fees and merchant service fees. The ability to set and reset those remains. The interchange fee was but one cost that acquirers were bearing and one benefit issuers were receiving, and that has changed, but not in terms of being able to offer cards that potentially go out and attract the same sort of consumers as American Express and Diners.

Mr CIOBO—At an aggregate level.

Prof. Gans—Yes—why not?

Mr CIOBO—There is a big difference, though.

Prof. Gans—Where are you going with this?

Mr CIOBO—In terms of the value proposition for the consumer, there is a big difference. We can talk about price signalling, and I am comfortable with the price signals that are sent out. But, as a value proposition for a consumer, there is now a lot less value in using a four-party scheme credit card than there would be in using a charge card.

Prof. Gans—As I said, the number of merchants who accept charge cards is much, much lower than those who accept credit cards. That means that, as a consumer, if I have to pay a $50 to $150 yearly fee to have an American Express or a Diners Club card and another fee to have rewards on that as well then I am going to be thinking about how many retailers in my daily life are going to accept this card before I get into it.

Mr CIOBO—Sure. All I am saying is that the evidence does not support your assertion because we have seen their market share increase slightly.

Prof. Gans—Slightly.

Mr CIOBO—We are not really seeing a fall away in usage from surcharging either, are we?

Prof. Gans—But do we know that has anything to do with these reforms?

Mr CIOBO—I am asking you.

Prof. Gans—I have seen no evidence that we can attribute it to that. It did not happen in 2003. It has happened more recently. The shift has been relatively modest, as these things could go, and I am not sure whether that was the result of the reforms as opposed to other market forces.

Mr SOMLYAY—If you walked into a department store down the street and asked 100 people how the payments system has affected their credit card usage, I think you would get some pretty strange looks. This exercise has told us that the demand for financial services is inelastic, that it does not really have an impact on the consumer—there is no evidence that there has been an impact on the consumer—and, therefore, that fees going up would have no impact on the consumer. Do you think this provides ammunition for the financial institutions to raise fees in other areas?

Prof. Gans—No, I do not. I really think that the impact of the interchange fee was higher than you would expect because you are dealing with a market that has two sides. To get a credit card transaction going you need two people: a cardholder and a merchant—a consumer must hold a card and a merchant must accept it. If you shift the interchange fee around and it causes consumers to want to use cards less but merchants to be happier about card usage, things can balance out. It need not have happened that way, but there is a balancing force—as opposed to what happens with a normal transaction fee: if you put a fee on the use of internet banking, consumers will use internet banking less. Internet banking is a distinct service. It does not require two people to make it go, and the fee involved is not fee shifting between two different businesses but fee shifting between a consumer and a business—and that is a very different proposition. So I would not conclude that we can just raise fees and not see a response in other areas of financial services.

CHAIR—Thank you, Professor Gans. We appreciate your involvement in the sector and your provocative papers that have been coming out. We hope that in the future you will invite this committee to come down to the conferences. Hopefully, it will be an annual event, because the input is very useful. We very much appreciate your coming today, especially from Melbourne.

[10.53 am]

SIMES, Dr Richard Mark, Consultant, Access Economics

CHAIR—Welcome. Although the committee does not require you to give evidence under oath, you would obviously be aware that these proceedings have the same standing as proceedings of the parliament. You have made a submission and we have a copy of it. Is it the wish of the committee that Dr Simes's submission be accepted as evidence? There being no objection, it is so ordered. Dr Simes, I now invite you to make an opening statement.

Dr Simes—I should say at the outset that as a consultant I have worked on the payments system issues for Visa International and on related matters for ABA, FICA and APCA. I have also co-authored papers for academic conferences with Professor Ian Harper, from the Melbourne Business School, Craig Malam, from CRAI, and Annette Lancy, from Access Economics. I understand that the committee has copies of two of those papers as exhibits. I also understand that I was invited to appear before the committee primarily to discuss some of the implications of the paper that we presented in March to the payments systems conference at the Melbourne Business School. That paper related to the relative costs and benefits of different payment instruments.

As advocated by the Wallis committee and others, the RBA has taken a number of steps to create a more transparent payments system with more limited barriers to entry. However, it has gone further than this. The most contentious element of its regulations has been the imposition of cost based interchange standards. This is quite an interventionist form of regulation and one that should only be contemplated if there is strong supporting evidence. My view is that such evidence simply is not there and that the RBA should rely on less interventionist forms of regulation. To begin with, the RBA downplays the efficiency considerations arising from the two-sided nature of payments networks. As is now widely recognised, the two-sided nature of the market means that cost based regulation on one side is not justified from a theoretical point of view. In fact, the RBA acknowledges this but still has adopted its cost based standards based on what it views as pragmatic grounds.

What are these grounds? The first one seems to be quite artificial and imposed on it from the outside—namely, the payments system legislation requires that, for there to be regulation, the RBA must develop what is labelled a standard. A list of costs can be used as that standard, whether or not those costs are aligned to what may be assessed as the optimal level of interchange fees. The more substantive reasons relied on by the bank relate to the direct incentives to use different instruments as well as to the relative costs of different instruments to the economy overall.

For our paper, we have put to one side the considerations associated with the two-sided network effects and concentrated instead on three propositions on which the RBA's position seems to be based: that the resource costs involved in using credit cards for transaction purposes exceed those for other payment instruments, especially those associated with EFTPOS; that net benefits to consumers from using credit cards for transactions exceed those from using other instruments; and that net costs to merchants of accepting credit cards exceed those from accepting EFTPOS—that is, consumers have an incentive to use what is viewed as a costly instrument, credit cards, while merchants might not like this but do not have the bargaining power not to accept the cards. Our paper looks at the marginal costs and benefits from using different instruments for face-to-face transactions at retail outlets. I should stress that a lot of simplifying assumptions are needed to derive the results, and we view the estimates as providing a broad indication of the relevant costs and benefits.

The three charts that I have handed out summarise the main results. Two of the charts confirm two of the RBA's premises; the third does not. The first chart shows that, for a merchant that has EFTPOS and credit card capabilities, there is little difference in the net costs they face for small denomination transactions, but as the transaction size increases so does the cost of using credit cards relative to EFTPOS. The chart shows the net marginal cost to merchants of $10, $50 and $100 transactions using different instruments.

The second chart also confirms that consumers do, in fact, have an incentive for using credit cards as the transaction size increases, primarily because of the interest-free period and, increasingly to a lesser extent, because of reward points. Note that the incentive is only a few cents for, say, a $50 transaction, and hence in practice we see the use of both EFTPOS and credit cards still growing strongly in the economy, notwithstanding some of the earlier comments.

It is the final issue—namely, whether credit cards are a more resource intensive form of making payments than EFTPOS—where the RBA's position is weakest. Recall that we are talking about the costs and benefits of the incremental purchase and ignoring any distributional issues. So the types of costs we are talking about are additional telecommunication costs or additional processing costs et cetera. Intuitively, it would seem that these differences are small. And, on the material presented in our paper, there is little difference in the marginal cost for society overall from using credit cards versus EFTPOS as a transaction tool.

The differences in this chart, especially given the uncertainties involved and the fact that they ignore the network benefits of card systems, would not seem to warrant intervention in the marketplace. This analysis may seem rather narrow. It may be argued that other aspects of credit cards are costly. This could take one of two forms: firstly, at least some consumers build up credit card debts that need to be serviced and, secondly, there is an additional infrastructure on the back of the infrastructure already in place in financial institutions that needs to be supported.

I would like to finish my opening remarks by commenting on both of these issues. The RBA is not regulating in order to influence debt levels, but it seems to me that this does affect the broader environment in which the issues are being debated. Of course, we could debate whether household debt levels represent a problem that deserves an explicit policy response; but my starting point would be that, given that the benefits that credit cards have provided as a flexible form of credit for many, often low- and middle-income, householders, I doubt that constraining the use of credit cards for this reason would represent good policy.

Finally, there is a separate infrastructure associated with the card networks. The instruments are not close substitutes for many purposes. The estimates I have discussed here will tend to favour EFTPOS since they do not capture the wider range of benefits and uses of both cash and card networks. For the card networks, these facilitate transactions at a much wider range of outlets than EFTPOS, including purchases made over the internet or by phone, at certain retail outlets including many restaurants where EFTPOS is not available, and purchases made when travelling overseas.

In addition, the roll-out of credit and signature debit card networks has facilitated a wider range of economic benefits by assisting innovation and competition in the retail sector throughout the economy. For example, the card networks have helped small retailers compete with larger chains by effectively providing a substitute for in-store credit cards. Credit and signature debit cards have also been instrumental in the growth of purchases over the net or phone. While other solutions are possible, the card networks have proved to be the most reliable and effective means of doing that today and of encouraging innovation in that sector of retail activity.

In fact, the various instruments are not close substitutes across the full range of their uses. This underlines the need for circumspection in designing the appropriate regulatory framework. The card companies employ different business models and technological platforms than those provided to support transactions accounts at financial institutions, so as to be able to provide services across a wider range of outlets. In these circumstances it is hardly surprising that the card companies adopt different pricing and promotional strategies than financial institutions for their EFTPOS accounts. The question then arises as to the circumstances under which direct intervention in pricing mechanisms may be warranted.

Our paper does confirm that consumers are being encouraged at the margin to use credit cards. But acknowledging that the incentives faced by consumers in favour of credit cards are not large when all costs and benefits are considered, that the net marginal costs of using credit cards tend to be similar to those of EFTPOS and that merchants can cap any impact on their marginal decisions, should they find one instrument being used excessively from their perspective, by surcharging or refusing to accept particular instruments, then the case for basing regulations solely on a comparison of costs and incentives at particular retail outlets would appear to be weak. Instead, sufficient flexibility should be allowed for the business models relating to each of the bundles of services inherent in the various payments instruments to be designed in such a way that companies’ ability to develop all aspects of business will not be harmed.

CHAIR—Thank you very much. That was quite a comprehensive paper and quite provocative in terms of some of the conclusions you reach. You say on page 1:

My view is that such evidence—

about the interchange standards and so on—

simply is not there and that the RBA should rely on less interventionist forms of regulation.

Do you mean the other changes that they brought in, such as the ability to surcharge, upstreaming et cetera? Is that sufficient in itself, or would you want to see other measures?

Dr Simes—I do not see the need for other measures. If you have a reasonable industry structure, you worry about barriers to entry, you encourage transparency, you encourage monitoring, a bit of moral suasion if needs be—like we have with petrol and with other parts of the economy—and that is where you should stop unless there is an overriding concern that there is something fundamentally wrong. When I look at this closely, I do not see that. It comes down to market structure and transparency; I think they are the starting points.

CHAIR—Why do you think we have not seen an Aussie Home Loans style card—I know they have been talking about coming into the market—where they could clearly boast of the low costs and interest rates they would provide to their users and see what would happen to their market? It seems to me, as Mr Somlyay mentioned before, you have non-elastic pricing going on.

Dr Simes—I am not quite sure what an Aussie Home Loans style card would be. We already have no-frill cards in all senses, apart from interest rates.

CHAIR—It seems as though, if we look at some of the major marketing that goes on at the moment—and prime amongst them would be Amex, which is promoting all of the benefits of 2.5 points per dollar spent et cetera, but little in terms of costs—it does not relate to the actual cost of the card. It does not seem to have gone the route of businesses saying, 'We are the lowest in the business' at all; the market has gone more towards benefits.

Dr Simes—You have seen it go in that direction already with interest rates coming down a long way—

CHAIR—Yes, that is true.

Dr Simes—and also, with some, you have seen some annual fees go down associated with fewer rewards. There is a greater range of cards today than there were five or 10 years ago; there is no doubt about that. Have we seen one that is aggressively no-frills or where only the costs need to be covered? It is not as though—

Mr CIOBO—It is not a charity.

Dr Simes—No, it is not a charity. I do not know the precise financials behind issuing a card, but that is what seems to me to be the case.

Mr CIOBO—Dr Simes, I appreciate your opening statement. Effectively, the take-home message I get from your statement is that with the removal of the restrictions on surcharging et cetera, the three that were outlined by Dr Lowe—were you here for his opening comments?

Dr Simes—I was here for the second half of them.

Mr CIOBO—The three that were outlined by Dr Lowe would have been ample, from your assessment, to promote a net benefit to the community without the need for regulation of interchange fees.

Dr Simes—Yes, that is right, although just slightly different. I do not know that what we have done to interchange fees represents a net benefit.

Mr CIOBO—No, that is my point. That is what I am saying.

Dr Simes—The other parts of it are: do they represent a net benefit? It is hard to say, to tell you the truth, except that they do too. But I don't think they are a real cost, either. I think it is line ball.

CHAIR—And with respect to interchange fees? You are saying neutral, cost or benefit?

Dr Simes—With respect to interchange fees, I do not think we have seen big changes to date. I think we have seen a redistribution within consumers but little effect net on consumers overall. The greatest uncertainty, though, is we have changed the signals, incentives and restrictions going forward and how that is going to play out over the next five years or whatever.

CHAIR—I would not recommend we go back to 95.

Dr Simes—The regulatory environment of 95 or the quantum?

CHAIR—Ninety-five to 50—

Dr Simes—With interchange fees? I do not think that we can tell. The first-round effects will be initial effects of being 95 or where we are today at 50. I think they are having small effects on consumers on average.

CHAIR—Part of my involvement in terms of looking at this from a committee perspective is the intervention, the designation of the four-party schemes versus the three-party schemes. We talk about the no-surcharge rule, the honour-all cards rule and the no-steering rule. With respect to those three, you will say that marginally a net benefit may flow from that. With respect to regulation of interchange fees you are saying that it appears to be neutral or of no real benefit.

Dr Simes—Initially, with a question mark longer term.

CHAIR—What is your prediction longer term?

Dr Simes—It is very hard to say whether that is going to inhibit innovation. That can be narrowly to do with what the card networks are doing themselves, but it can also be how they are used in the community.

CHAIR—Innovation in terms of new payment methods—platforms?

Dr Simes—And new outlets and the like.

CHAIR—What about with respect to security?

Dr Simes—With respect to security, I just do not know.

CHAIR—Do you see the connection Dr Lowe raised in terms of the architecture of the scheme and governance and technology, the issue that Australia is falling behind? Perhaps there was not a strong relationship between interchange fees and pricing thereof with investment in new R&D in these areas or the adoption of overseas technology. Would you agree with that assertion or disagree? What is your perspective on that?

Dr Simes—I find it hard to accept that the revenue stream going into a particular activity does not affect the types of innovation or investment decision making on that side of the market.

CHAIR—So lower revenue you think will ultimately mean that existing technology will be utilised longer to try to offset new capital investment?

Dr Simes—Yes. I do not know if it is right or not, but one of the comments I have heard is that it makes it hard, for example, for new signature debit schemes to get up.

CHAIR—So the fall away we have seen in Australia being a leader when it comes to, for example, some of this technology may be attributable in your opinion to the regulation of interchange fees?

Dr Simes—Sorry—you are saying we have already seen a fall away in innovation and things?

CHAIR—Correct, and the RBA acknowledges that itself.

Dr Simes—This does not help. If you cut revenues there is no way that it helps.

CHAIR—Okay. With respect to the other side of the argument, that the RBA has touched on as well, which is the issue of three-party schemes versus four-party schemes and that three-party schemes have not benefited, do you think that if we remove the no-surcharge rule, the honour-all-cards rule and the no-steering rule but did not have this heavy interventionist approach on interchange fees, there would be any net advantage to the three-party schemes or the charge card schemes? If we had adopted a regulatory model that removed the no-surcharge rule, the honour-all-cards rule and the no-steering rule, but did not regulate or price cap the interchange fee, do you think that would have had any impact? Would it have unfairly advantaged or disadvantaged the three-party schemes over the four-party schemes?

Dr Simes—Conceptually, because of the higher level of merchant service fees for the three-party schemes, there could be a tendency for more surcharging there. My understanding of what we have seen to date is—

Mr CIOBO—Do you mean surcharging for the consumer?

Dr Simes—Yes, and that would—

Mr CIOBO—Presumably that would make it less attractive?

Dr Simes—That is right.

Mr CIOBO—But at the moment, because they have a higher interchange fee—and I use that term advisedly, Mr Chairman, because I know the dispute is that they do not really have an interchange fee—and there are marketing fees et cetera and all of those types of things that are paid to merchants, some of that is offset. So, if I use a charge card, a three-party scheme, it is possible for Diners or Amex to provide a higher kickback to help offset that higher merchant service fee. Is that your understanding?

Dr Simes—Yes.

Mr CIOBO—My point is that even though merchant service fees are higher now for three-party schemes, that is partly offset because they can also pay that higher kickback.

Dr Simes—To merchants, you are saying?

Mr CIOBO—Yes, and to cardholders through higher reward points and to issuers.

Dr Simes—The main effect at the moment is that they are able to provide more attractive packages for cardholders.

Mr CIOBO—And to issuers as well?

Dr Simes—Yes, and to issuers. That is just a different distribution channel, if you like, to cardholders. Take the first one, the surcharging rule: if all you did was to enact that part of the new regulations then, given that the merchant service fees for Amex are higher than the four-party schemes, one thing that could happen is that you would have a higher incidence of surcharging going on for the three-party schemes or for Amex than you would for the four-party schemes. That narrowly, by itself, could tend to disadvantage Amex over the three-party schemes.

Mr CIOBO—But it is more transparent pricing.

Dr Simes—It is more transparent pricing, yes. My understanding of what we are seeing today with surcharging is that the incidence of surcharging has not really varied very much between the three- and four-party schemes, so I do not know how big that effect is. The dominant competitor neutrality issue is really on interchange.

Mr CIOBO—With respect to issuers, though, at the moment an issuer is receiving more money under a three-party scheme than they would be able to under a four-party scheme.

Dr Simes—Yes.

Mr CIOBO—Is there not now an incentive to issue a charge card rather than a credit card because there is a higher kickback? This is the point I am getting at. So if you did not regulate interchange fees, from an issuer point of view there would be competitive neutrality, a level playing field, would there not?

Dr Simes—Yes.

CHAIR—I think ‘commission’ is probably the word, rather than ‘kickback’, Steven.

Dr EMERSON—This is not the Cole inquiry.

CHAIR—Thank you, Dr Emerson, you are next.

Dr EMERSON—Do the owners of the card schemes not have only themselves to blame for the regulation of interchange fees, when the Reserve Bank and others have identified three restrictions, maybe more, within that industry, being the no-surcharge rule, the honour-all-cards rule and the no-steering rule? Are those three restrictions not all prima facie evidence of a lack of competition, and is it not the case that the Reserve Bank has then come in with a remedy which the industry does not like? Would the industry not have been better off it had not employed these anticompetitive practices in the first place?

Dr Simes—Your basic premise that there were not a lot of signs of active competition in this area in the nineties is right. The fact that interchange fees were so stable for so long despite the fact that the market grew in a big way is partly to do with the transaction costs involved in resetting interchange fees. Even so, it looked like there was not the flexibility that you would like.

Take the no-surcharge rule. That is an interesting one in that, particularly for the development of the market, having a no-surcharge rule does help the network externalities or the growth of the market. It binds it together, and you can look at theoretical models which highlight how it helps economic efficiency to have a no-surcharge rule. I think the bank's argument is that that becomes more problematic as the industry evolves. I think the fact that it was there at the outset and has been used around the world in the growth of these networks does not present prima facie evidence that it is not competitive. To me, the greater sign is the lack of flexibility in some of the terms and conditions in those markets.

Dr EMERSON—It seems to me that the industry is crying foul because the Reserve Bank has come in with what the industry regards as an inappropriate regulation to deal with anticompetitive behaviour. It might have been smarter for the industry to behave more competitively, after a while at least, accepting your argument, and then you might not have had the Reserve Bank come in with what the industry considers to be an inappropriate regulation.

Dr Simes—There is no doubt that the industry could have been smarter.

Dr EMERSON—In your view, would the Reserve Bank removing each of these limitations—that is, the no-surcharge rule, the honour-all-cards rule and the no-steering rule—provide sufficient competition, without it having done the other thing that is has done, which is to regulate the interchange fee?

Dr Simes—You can never be 100 per cent sure but, given the nature of the differences involved that are highlighted in our paper and so long as you continue to try to provide information to monitor what is going on in the industry, I think that is where you stop, and I do not think that is wildly different to how we treat the regulation in a lot of other parts of the economy where we have some concerns that there might be a lack of competition. You want to test it, you want to worry about industry structure or the rules or whatever and you want to worry about transparency, and then after that let us monitor it. Let us not get in there and try to direct it.

CHAIR—I have heard your colleague Geoff Carmody talk about market failure on various occasions and why there needs to be some degree of regulation. Do you think that in terms of the way the payments system operates that constitutes market failure and therefore we have a need for government intervention in the sector?

Dr Simes—Market failure is a funny thing. As I think Dr Lowe said, there is a lot of competition on the issuing side and the acquiring side of the market in Australia, and it comes down to the nature of asymmetric information and the nature of contracts in this industry. I would not class the fact that you have these information issues as evidence of a market failure in the normal sense where you need to jump in. There can be a bit of a parallel with other platforms. If you are involved with the wholesale market in financial markets, you do not want a whole lot of different platforms competing with each other; you want one or a few platforms so that the flow of information between the two sides of that market is efficient and then you want competition on either side.

In effect, that is what the card system is like. You do not have a lot of players in the middle providing the platforms, but as long as you have competition on both sides responding to demands by consumers and demands by merchants and all the rest of it, then I think that you are a bit more comforted that you have a reasonably competitive environment.

CHAIR—What is the motivation for merchants to be able to demand of card providers that they lower their fees? Not much, if they want to participate in the market. That is why we probably have not seen too much surcharging by Amex or Diners. They want the high-yield customers.

Dr Simes—We also have not got wildly different incentives for merchants on both sides of it. Have merchants got market power? You would say with EFTPOS they have lots of market power because they were able to negotiate it in the other direction. The real difference between EFTPOS and credit cards, it seems to me, is that the suppliers of credit cards and signature debit needed some incentives provided to consumers in order to develop a new network. With EFTPOS you did not need that because you already had your banking relationship and EFTPOS rode on the back of it. The fact that merchants have had reasonable market power compared with the banks, if you like, meant that you have those different things. So it is the nature of the incentives facing the consumers in those two markets I think that has given that result.

Mr SOMLYAY—Why is it so difficult to measure the outcomes of these measures, and is it going to take time? Will we know more in five years time?

Dr Simes—I have a sense of how the committee has been looking at that. The starting point has been that we can measure the first-round effects, which are $580 million or whatever of fees that merchants had been paying to banks and are no longer paying, but that is one—

Mr SOMLYAY—But you cannot measure whether that has gone to the consumer.

Dr Simes—No, because that is more or less a share of the economy, so it is hard to see in the CPI. We know that first-round effect and we assume that some of it will be passed on to the consumer—it is hard to measure. We also assume that banks will have clawed back some of it through direct measures on cards or through other pricing in their whole bundles. The numbers are small enough compared with the whole economy, and the logic is such that you would expect that as much of the reduction in MSFs that might have flowed through to consumers would have been offset one for one by what banks are doing on the other side; hence you come down to the position that the biggest effect is not going to be consumers overall—that is going to be close to zero—but some consumers versus others: the relative position of individual consumers.

Mr CIOBO—Do you feel it is likely to be the same outcome with respect to the proposed regulation of the debit system? The RBA stated:

The fall in debit card interchange fees will also substantially reduce the risk that the Visa Debit system (and its MasterCard equivalent) might eventually drive out the EFTPOS system ...

Do you see parallels between your comments with respect to credit card schemes and with respect to the proposed regulation?

Dr Simes—I do not think that the incentives are large enough to have a big effect. If your financial institution—a credit union or whatever—is providing you with a Visa debit instead of an EFTPOS type card, so be it. The biggest issue I think is more the other outlets where you can use a Visa debit and not this direct comparison about what card you use at Woolies. Visa debit at the moment allows you to buy things over the phone or whatever, whereas EFTPOS does not.

Mr CIOBO—I guess what I am asking is: are you saying that there should be regulation of the interchange fee there or not?

Dr Simes—I do not see a need to regulate that one either. The monitoring should be enough. The question is: why haven't financial institutions been a lot more aggressive in promoting Visa debit as opposed to EFTPOS if there was a strong incentive to go that route, if the consumers thought they were going to benefit a lot from going that route?

CHAIR—Thanks very much, Dr Simes. Thanks for your input, which was very useful and very helpful. We appreciate you coming today.

[11.31 am]

BELL, Mr David Peter, Chief Executive Officer, Australian Bankers Association

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy, Australian Bankers Association

CHAIR—Welcome. You have been through this before but, nevertheless, I need to remind you that although the committee does not require you to give evidence under oath the proceedings before this committee are the same as proceedings of the parliament. Do you wish to present a submission or make an opening statement to the committee?

Mr Bell—Yes, we would. We would also like to table a document.

CHAIR—Thank you very much. Do you have a copy of the document?

Mr Bell—I have a copy of the document I would like to table. I will make reference to it in my remarks.

CHAIR—Is that your only copy?

Mr Bell—No, this one is for the committee.

CHAIR—Is it the wish of the committee that this document be officially received? There being no objection, that is so ordered.

Mr Bell—We would like to thank the committee for inviting the Australian Bankers Association to give evidence before your hearing into the payment systems reforms. In its submission to the government's regulation taskforce, which I have just tabled with the committee, the ABA recommended reforms to the regulatory architecture of the payment system to foster more accountability and better regulatory decision making. This in the ABA's view is a prerequisite to promote innovation and investment.

The most important of these recommendations is one for the introduction of an independent merits review of Reserve Bank payment system decisions. Currently, Reserve Bank decisions can be reviewed on procedural or administrative grounds, but there is no avenue to have an independent party review decisions on their merits. The industry is advocating that the scheduled 2007 review of payment systems reforms is undertaken by an organisation independent of the reform process so far, such as the Productivity Commission.

By way of background, in 1998 the Commonwealth parliament passed the Payment Systems (Regulation) Act, giving the Reserve Bank, through the newly established Payments System Board, the PSB, powers to designate payment systems and then set access regimes and standards for those designated systems. While stronger than in any other country, the powers were understood at the time to be reserve powers only. Since 1998, these PSRA powers have been used to effect changes in the operations of the payments systems. The powers have been used both directly, as in EFTPOS, credit cards and Visa debit, but also indirectly in the case of cheque clearing, ATMs, BPay and statistical collections and, indeed, with EFTPOS access.

In October 2000 a major ACCC-Reserve Bank joint study into interchange fees and access arrangements for credit card, EFTPOS and ATM systems was published. Its main finding was that interchange fees were promoting credit card use over EFTPOS even though credit cards were more costly to provide. This and other findings began the RBA's regulatory reform process. The following examples demonstrate why the ABA is arguing in favour of merits review for payments regulation. I refer to Amex and Diners Club. In August 2002 the Reserve Bank published its first credit card regulations. The central regulation was the imposition of a cost base methodology for setting the credit card interchange fee in four-party schemes. But there was no equivalent regulation for the competing three-party schemes, Amex and Diners Club. The RBA disagreed with concerns that its proposed regulations would favour the three-party schemes. In its 2002 regulatory statement, it said:

> The Reserve Bank does not accept that its reforms of the designated credit card schemes constitute a regulatory bias that favours the three party card schemes ... The Reserve Bank has not been persuaded that competition in the payment card market, strengthened by its reform measures, will encourage the growth of the smaller, higher cost card schemes over the larger, lower cost schemes in Australia.

But we now know that, as a result of interchange regulation, Amex and Diners Club did increase their market share by around 15 per cent. To protect their customer base, some Australian banks responded to the Reserve Bank's credit card regulation by entering into commercial agreements to offer their customers Amex and/or Diners Club cards.

I refer to the cost base interchange fee. The methodology used by the Reserve Bank to regulate interchange is a cost based methodology whereby the interchange fee is set no higher than the sum of the eligible costs. In economic theory on two-sided markets, of which credit cards are one example, there is currently no consensus that a cost based interchange fee will maximise social welfare. The range of eligible costs allowable by the Reserve Bank is arbitrary and excludes costs that would normally be considered legitimate costs, such as the cost of capital. The Reserve Bank has stated that it has no guidance on the optimal setting of interchange fees and that there is no proposal to discontinue this approach. Without a strong academic underpinning, the cost based methodology used by the Reserve Bank will remain vulnerable to arbitrary change. For the banks this means continued uncertainty.

A policy objective of the Reserve Bank's credit card interchange regulation was to lower the prices of goods and services by reducing the merchants' cost of accepting credit card transactions. For this to happen it required, firstly, all banks passing on interchange savings to retailers through lower merchant service fees and then, secondly, retailers passing lower MSFs to customers in lower prices. Merchants are receiving around $580 million in annual savings from reduced merchant service fees, but there is no evidence that this amount is reaching customers. The flip side of lower merchant service fees has been increases in annual fees and reductions in loyalty program benefits for credit card holders, eroding the value of these products for the consumer.

While it is reasonable to assume competitive elements in retailing will in time pass on the savings, the reverse is true for industries where market power exists: supermarkets, department stores, taxis, air transport, telecommunications and utilities. When the interchange fee fell, the competitive conditions the banks faced meant that lower MSFs were passed on quickly, but no evidence has been produced showing a similar decrease in prices charged by retailers. The importance of this issue is amplified, given that the Reserve Bank's reforms also gave merchants the freedom to surcharge customers for using credit cards. The possibility therefore is that merchants with market power are not only paying lower MSFs but in addition are securing more income by surcharging more than the MSFs. This may partly explain why merchants lobbied so strongly for the credit card reforms.

BPay is a joint venture between the banks, building societies and credit unions, providing customers with a convenient bill-paying service. To make the system work, an interchange fee, known as the capture reimbursement fee, is used between the participating banks. The Reserve Bank wrote to the BPay scheme, requesting publication of its interchange fees. Interchange fees provide valuable information to competitors, so the scheme was willing to publish only if its main competitor, Australia Post, was also required to do a similar disclosure. The Reserve Bank saw this as unacceptable and threatened BPay with regulatory intervention. BPay now publishes its interchange fee, so Australia Post now has information about BPay's cost base but has retained confidentiality regarding its own costs.

The banks, through the Australian Payments Clearing Association, or APCA, developed rules making EFTPOS participation easier for those seeking access. Once the technical provisions of the new EFTPOS access code were settled, the Reserve Bank threatened designation unless the access price was set in such a way that only one existing participant would recover the costs of facilitating a new entrant. All the other participants now effectively subsidise new entrants. This, in the ABA's view, is not good policy. More broadly, a consequence of this regulatory approach is to make businesses reluctant to engage in self-regulatory initiatives in the future.

In its final policy announcement regarding EFTPOS interchange regulations, the Reserve Bank announced it had modified a previous position and had decided to exempt from interchange regulation EFTPOS transactions where the customer withdraws cash in addition to paying for goods and services. There was no consultation with the banks on this exemption, even though ABA understands it requires a further investment to bank systems to make separate interchange fees for cash outs feasible. There remains some doubt as to whether the EFTPOS access regime is feasible with a nonstandard interchange fee. The cash out transaction exemption also raises the question of whether the assumption of payments transaction substitution between credit and debit cards is as strong as often stated.

ATM and EFTPOS payments networks are based on bilateral links between participating banks. This means that banks exchange transaction messages directly with each other, and not via a central hub switch such as used in the Visa and MasterCard systems. Last year the Reserve Bank questioned whether the current bilaterally linked systems are technologically redundant, and provided arguments favouring a move to replace the bilateral links system with a centralised switch system. This has come at a time when the federal government is requiring expensive systems upgrading to deal with anti money laundering, counterterrorist financing and fraud generally. Large investments in security upgrading are also underway. They include ATM and EFTPOS encryption. With the Reserve Bank floating the merits of changing EFTPOS and ATM networks, the case for upgrading the current systems is complicated by regulatory uncertainty.

Business investment thrives on certainty. If the Reserve Bank intends one day to force adoption of a central switch, there is little incentive to invest now in the current system.

Lastly, one of the justifications for payment systems reforms was that the privately set interchange fees encouraged use of more expensive payments instruments. Credit cards were identified as being of particular concern. A shortcoming of this analysis was the absence of a formal study into the cost of cash usage. Notionally, one would expect cash to be more expensive than other electronic based systems. Cash involves the cost of handling, transport, insurance and security. Without this understanding, the risk of a poor overall reform outcome is higher. In conclusion, we believe the examples above demonstrate there are questions over the certainty, predictability and accountability of payments regulation. That is why the ABA is advocating the rights of merits review for all payments systems regulation.

The question now is: where do we go from here? Looking back, we trace much of the difficulty in payments regulation to the RBA-ACCC joint study of October 2000. This document claimed that public interest could be improved by regulating interchange fees and making participation of systems easier. Broadly, the industry has supported initiatives to open access and remove unnecessary restrictions. The main problem has arisen from attempts to set interchange fees. These fees should be competitively set by the systems owners with future growth and investment as the objective. As with all economic reform, it should only be undertaken where a clear net benefit can be demonstrated. As a final point, the industry is advocating that the scheduled 2007 review of the payment systems reforms is undertaken by an organisation independent of the reform process so far, such as the Productivity Commission.

CHAIR—Thank you very much, Mr Bell. That is a very interesting and, not surprisingly, a provocative document. I am not sure to what extent bankers read the *Telegraph*—

Mr Bell—Every day.

CHAIR—Have you got any comments on the article on page 8 titled ‘Our banks are most expensive’ and ‘Australian fees and charges top US, UK rates’. It says:

… banks are slugging families with some of the highest fees and charges in the Western world.

The extent of the Australian bank “gouging” was exposed by an international comparison of accounts, credit cards, loans and mortgages—

and that—

… research reveals families here are getting a raw deal compared with consumers in similar nations with the margin on mortgages alone costing the average Sydney homeowner up to $1850 a year more than those overseas.

As a starting-off point, what is your response to that?

Mr Bell—We spoke to the journalist who wrote that article on Friday—

CHAIR—I think he is here today.

Mr Bell—by phone, and explained to him that we thought his interpretation of the Fujitsu data was incorrect. The Fujitsu data, as best as we are aware at this stage, looks at up to 30 years worth of data. Our point to the journalist was to say that it costs more today on the basis of data, which includes loans and other banking—

CHAIR—It has 2005-06 net interest margin comparisons, so it is not over 30 years—

Mr Bell—I spoke to the Fujitsu Consulting person who wrote that report. He confirmed to me that that data was over a period of 30 years, which we did explain to the journalist.

CHAIR—Okay. But you have a comparison on credit cards and it says Australia, the year, net interest margins, comparisons 2005-06: Australia, 9.10 per cent; Canada, 7.85; the UK, 7.55; and the US, 8.55. It is a direct comparison in terms of this financial year.

Mr Bell—Again, if that is sourced from the Fujitsu data—

CHAIR—Yes, it is.

Mr Bell—the consultant I spoke to on Friday from Fujitsu confirmed that it was 30-year data. I guess our contention is—

CHAIR—That is one financial year within that 30-year period perhaps, but it is still a valid comparison.

Mr Bell—On that particular basis it might be.

CHAIR—Maybe you could come back to us on that. We would be interested in your response, seeing it was in today's paper. As the economic committee, we would be expected to take an interest in that.

Mr Bell—Yes, certainly. The other thing we would also be prepared to provide to you is data to show you the constant decline in bank margins over the last 15 to 20 years based on regulations. The Reserve Bank themselves every year in their bulletin on fees, which is going to be released this week, say the one thing all the time, which is that, generally speaking, if you add up the effect of declines in margins netted against the increase in fees, people are better off.

CHAIR—Nevertheless, at the same time, bank profitability has continued to increase. It is interesting how those two do not necessarily fit.

Mr Bell—That of course can be explained by the fact that there are increased volumes in banking.

CHAIR—That is right. It is a successful economy managed by a great government, but that is another issue.

Mr Hossack—Could I add one point on the article this morning. One of the statistics was that the margin on a housing loan was 189 basis points. Without getting into the methodology of how they arrived at that, our understanding is that a person looking for a home loan today would be looking at getting a loan with a margin of about 110 to 120 basis points. So the 189 does not reflect the margin for a current seeker of a loan.

CHAIR—Seeing we have international comparisons and you are concerned about the time frame in which this operated, it would be most useful to provide a comparison based on reliable, credible and independent sources of how they do compare.

Mr Bell—Certainly.

CHAIR—Today we are predominantly focusing on the question of the interchange fees. Not surprisingly, you do not agree with the changes made by the Reserve Bank. Do you believe any change was needed or that the changes that were made in terms of no surcharging, honouring all cards and no steering was enough?

Mr Hossack—Are you referring to credit cards?

CHAIR—Yes.

Mr Hossack—Our view is that the Payments System Board has got a charter, and that is to look at efficiency and competition in the payments system. That is reasonable. Every government should be concerned about those issues. We have supported broadly the efforts by the Payments System Board to look at those questions. We have, as you would know from David's opening statement, had disagreements over some of the decisions which have been taken under those powers. But as to whether the Reserve Bank or somebody should have the right to look at those questions, yes, they should. We support that.

CHAIR—So you do not think the fact that the charge to retailers of about $500 million less a year is a valuable thing to the Australian consumer?

Mr Bell—The answer is yes, if indeed the savings flow through to the consumers. We are not aware at this stage that there is any hard data or evidence to show that savings have flowed through to consumers.

CHAIR—But in terms of the cost to the retailer, isn't it appropriate to assist the small merchants—they have no market power to be able to dictate to you if they think a fee is too high?

Mr Bell—In fact, the effect of the reforms has been to drop the merchant service fees. There is official data to show that and, yes, that is a good thing.

CHAIR—Well, it would not have happened without the Reserve Bank's intervention—

Mr Bell—But you have to look at the flip side of it, and there are at least two. One is that there is no evidence that those savings will flow through to consumers, and the other is that the effect of those reforms in the credit card area was to increase the use of credit cards. So, at some stage someone is going to have to reconcile the numbers, and it will be interesting to see whether in fact that the consumers are in net terms better off.

Dr EMERSON—The restaurant industry would not welcome a board overseeing it, because the restaurant industry is a very competitive one. It would be saying, ‘Why should we have the Reserve Bank checking the prices that we charge?’ It seems to me that, going back to the restrictions that we spoke of—the no-surcharge rule, the honour-all-cards rule and the no-steering rule—the Reserve Bank reasonably saw evidence of anticompetitive behaviour. The fact that the ABA has supported the involvement of a payments system board suggests to me that it too acknowledges that there was anticompetitive behaviour. I guess the generation of $580 million of savings in merchant service fees also suggests that maybe there was some anticompetitive behaviour in that area, so why would you believe that retailers or merchants would not pass on those savings when there is not any particular evidence of anticompetitive behaviour amongst major retailers?

Mr Bell—In the first instance, I do not think we would accept that there has been evidence of anticompetitive behaviour. As to why merchants would or would not—

Dr EMERSON—Wouldn’t you then have absolutely opposed the Reserve Bank or any payments system, just as the restaurant industry would say, ‘Stay out of it: we’re highly competitive. We don’t need any involvement by a regulator here, other than food standards and so on’? Why wasn’t there a revolt on, basically saying—

Mr Bell—There was a revolt. Five years ago, when the credit card proposals were put to the banking industry, we were highly concerned about them. We pointed out things then which have now taken place. One of those is that the cost of credit cards—

Dr EMERSON—Sure, but why would you welcome or support a payments system board?

Mr Bell—The payments system is an important thing. It is fundamental to the economy. Everybody uses payments instruments. Disruptions in the payments systems can be very quickly transferred between institutions. Given that it is an important thing, we think it is legitimate that an agency such as the Reserve Bank, which has responsibility for overall stability, has a legislative mandate to look at questions of efficiency, competition and safety in that system. In terms of those objectives, we are relaxed that a government agency such as the Reserve Bank looks at them. But that is different from ‘Do we agree with everything that the Payments System Board has done?’—no, we do not.

Dr EMERSON—No, at no point did I say that. You just said that it is good that there is some board looking at efficiency and competition. If you are a highly competitive market, you should be really hostile to the establishment of any board to look at that, surely.

Mr Bell—I do not think so.

Dr EMERSON—It seems to imply that you accept that there have been anticompetitive practices in this industry.

Mr Bell—I think they are different points. We accept, because of the central importance of the banks, that we are properly regulated. We accept, for example, the need to have a very strong prudential regulator. We accept the need for an organisation like the Reserve Bank to have oversight of the payments system. I think the issue is how they went about making the changes.

Dr EMERSON—Sure. Can I just get my answer then? What is it that you see in the retailing industry that would cause you to be sceptical about $580 million of savings in merchant service fees being passed on? What anticompetitive behaviour do you see going on amongst major retailers such as Coles, Woolworths, IGA and so on? How would they get together and say, 'We're not going to pass those savings on to consumers'?

Mr Bell—I am not a retailer, so I do not know the answer, but I do know that the evidence—

Dr EMERSON—No, but you would be able to see the sort of behaviour of retailers and anticompetitive behaviour. If you have got a competitive system, they will pass it on—

Mr Bell—I do not know the answer to that question. We believe that those savings have not been passed on. If you look at the evidence, you will see examples of surcharging occurring where there is market power amongst those service providers able to impose a surcharge.

Mr Hossack—I think the ABA would really share concerns by the ACCC and other policy groups that look at these questions about industries that are dominated by a few players with very large market shares.

Dr EMERSON—I would be careful when talking about that being evidence of anticompetitive behaviour. Your industry is dominated by a few players with quite a market share.

Mr Hossack—It is mainly utilities, telecommunications, taxis and supermarkets.

Dr EMERSON—I am not here to defend Coles and Woolworths. Major retailing seems to me to be a very competitive industry. Yet you say there is evidence that, despite this high level of competition, they have not and will not pass these savings on.

Mr Bell—We are saying that there is no evidence that they have passed those savings on.

Dr EMERSON—And there is no evidence that they have not.

CHAIR—How would you structure it to know that they had passed it on, if you were from Access Economics and charged with that responsibility? It would be fairly difficult would it not?

Mr Bell—Our view is that, if you are a regulator or someone who puts into place regulation, there should be a post-implementation review. One of those things should be to check that the merchant service fees have been passed on—and they have been and the Reserve Bank has produced publications to that effect. Presumably the Reserve Bank or some other entity should check to see whether those fee savings have in fact been passed on.

Dr EMERSON—I am not saying that I am an advocate of cost based regulation. However, I wonder whether the industry, in a sense, got what it deserved. It behaved in an anticompetitive way for a long time and then a regulator came in—and we have seen this happening time and time again. If we accept your evidence that the regulator stuffs it up, you would then complain and say, 'We want another body to regulate the regulator.' Behave competitively and create no reason for regulators to come in or to stay in and then get the best result not only for the industry but for consumers. It seems that that would be the best way to go.

Mr Bell—Again, I do not think there is any evidence that the industry has been acting anticompetitively.

Dr EMERSON—The no-surcharge rule, the honour-all-cards rule and the no-steering rule: according to the Reserve Bank, these card schemes on merchants were effectively eliminating or dulling price signals to card holders.

Mr Bell—But that does not necessarily mean that the industry is anticompetitive. The interchange fees as they were previously structured supported the cost of running the system. It costs a certain amount of money to run a very sophisticated payment system. If you change one of the inputs into that system, you slash interchange fees by half. The cost has to be borne elsewhere. In this case, one of the costs that have been borne has been borne by credit card holders. I do not know about paying the industry back or teaching the industry a lesson. What has happened is that holders of credit cards now pay more for using that payments instrument.

Dr EMERSON—Notwithstanding that the interest rate on those credit cards has halved in some cases, are you saying that that is completely different?

Mr Bell—Are we talking about the fees that are charged?

Dr EMERSON—No, I am talking about the interest rate on it.

Mr Bell—I think that would be a separate issue. That would be born by increased competition in the credit card market.

Dr EMERSON—What do you say to the suggestion that the reward schemes are designed not to reward but to confuse?

Mr Hossack—I think the banks use reward schemes as an encouragement for people to choose their product. It is a way of attracting customers away from providers that do not have reward schemes. It is part of the normal business practice of trying to get customers, which is a good thing for customers.

Mr KEENAN—You were saying that you think the Productivity Commission would be an appropriate body to look at the mechanism. What is the ABA's preferred model if you were to design something for credit card transactions today?

Mr Bell—Do you mean our preferred model for how the interchange fee should be structured?

Mr KEENAN—Yes.

Mr Bell—I will ask my colleague to answer to that. In answer to the first part of your question, the reason we would prefer that the inquiry be conducted by the Productivity

Commission or a body like it is that the Reserve Bank, notwithstanding that it is a very able body that is staffed by very independent officials, has a vested interest in the outcome.

Mr KEENAN—I understand why you want another body to do it, but does the ABA have a position on what sort of model it would like?

Mr Hossack—Yes, we do. I suppose that where a reform initiative is put forward which, it can be demonstrated, will help on restrictions to competition in the market, the industry has shown it is willing to support it and indeed to make the removal of the restriction work. I think the concerns have lain more with the direct regulation of interchange fees. In other words, if you can improve access so that people can access the system more easily—remove unnecessary restrictions and allow surcharging by merchants—we would ask whether we really need to cost base regulate the interchange fees or whether we should allow them to be set commercially by the schemes or banks in bilateral agreements and, through that interchange fee, compete against other providers and other payment instruments.

Mr KEENAN—So you believe the interchange fee would decrease if it was deregulated?

Mr Hossack—It is difficult to know that. There has been an obvious regulatory induced change. But what would happen if the Reserve Bank decided it was not going to cost base regulate the interchange fee? It would go up a bit, I presume, but probably not to where it was before. That is purely speculation. It might go up a little or it might stay where it is. Who knows?

Mr KEENAN—But the holders of credit cards would be the ultimate beneficiaries?

Mr Hossack—The interchange fee allocates systems cost between merchants and cardholders, and who pays the greater proportion of the costs depends on how that changes. If the Reserve Bank removed itself from cost base regulation, and the interchange fee for some reason went down under a scheme decision, then merchants would get even further discounts than they already have whereas cardholders would pay more. If it went the other way, the reverse would be true. That is the thing about the interchange fee: it is an allocating mechanism. So where it settles depends on who pays what.

Mr CIOBO—The Reserve Bank has a number of times said that interchange fees do not operate in a normal competitive market. Why is it that interchange fees did not decrease as the market got more competitive?

Mr Hossack—ABA obviously was not part of the team, or the schemes, that were looking at those fees at the time. But I think that it probably in part goes to the nature of the interchange fee itself in that it is an allocating mechanism. Businesses, both acquirers and issuers, I suppose structure their businesses around the interchange fee. It becomes, in a sense, part of the business model. When that is locked in, I guess the forces of change would always face the fact that it has always been there so what would be the case for change—particularly if the mechanism has proven popular.

Mr CIOBO—Is it not a fundamental assertion that this, by some strange quirk of nature, is not subject to normal competitive market forces? I am trying to ascertain why that is. You say that there has not been a need to lower interchange fees because it is status quo, and the result of that has been in part the regulation and forced capping of interchange fees. From a public policy perspective, I want to get to the bottom of why there is a need for regulatory intervention. Some witnesses have testified to the committee that we could have done it with the removal of the no-surcharge on all cards rules et cetera, and that there was no need for interchange regulation. The RBA is of the view that obviously there was. I am asking the ABA why interchange fees have not fallen in line with increases in competition. 'Status quo' does not seem to cut the mustard. Is that the answer?

Mr Bell—Again, Mr Hossack explained the interchange fee as an allocated mechanism. So it allocates costs between, if you like, one side versus the other. That has been its primary use. It was working.

Mr CIOBO—So costs have not declined over the years?

Mr Bell—It allocates the costs; it does not actually go to the scale of the costs. It allocates which way the costs flow.

Mr Hossack—I guess that one observation you can make is that credit cards and debit cards are popular instruments. They have done well.

Mr CIOBO—It is the chicken and egg though, isn't it?

Mr Hossack—They are widely accepted by both merchants and credit card holders and users. A very high proportion now of payments in the system goes across those two systems, which is good, because some of the alternatives are a lot more costly, such as cash and cheques.

Mr CIOBO—The RBA would argue, though, that the reason consumers use them is because it is an issuer's incentive to thrust them on consumers. 'Thrust' might be too strong a word, but I think you understand the point I am making. What is your response to that?

Mr Hossack—I think that from the consumer's point of view a credit card and a debit card are good products because you can walk into a store without cash, without having to write a cheque and you can buy something—

Mr CIOBO—And get rewarded for it.

Mr Hossack—In the case of a credit card you have to pay an annual fee, but you may get a loyalty point if you have a scheme that gives you that.

Mr CIOBO—This is basically what the RBA has been driving at, isn't it? It is to say that if we lower interchange fees, we lower the value proposition for using credit cards. So we have seen a significant fall away in the growth of credit cards according to the RBA figures over the last few years.

Mr Bell—That may be linked, of course, to the interchange reforms.

Mr CIOBO—Possibly not, but the RBA would argue that they are. The RBA concedes that you have gone from a situation where the costs are borne by the consumers, the community at large, and now the same cost is focused on credit card holders. Presumably you are putting up annual fees, et cetera on credit cards because you have seen a fall away in revenue from lower merchant service fees. Is that all correct so far?

Mr Bell—Correct. In fact, that was one of the anticipated pricing mechanisms. If you stand back and look at it and say, 'If the changes had not been made, you have a choice between two outcomes. One outcome is the current outcome, which is that credit card holders, compared to before, pay more fees, and potentially have to pay a surcharge.' Also, the various reward schemes that are linked to their cards have been degraded. Balanced against that, of course, is that fee savings have been passed on to merchants to the tune of $580 million. We know those fees have been passed on. We do not know whether savings have been passed on. So in those terms have the reforms benefited customers? I think the jury is out.

Mr CIOBO—I would be pretty happy to concede that in the long term they will be of benefit to consumers with respect to that. The question is whether that could have been achieved without the regulation of interchange fees and whether it was necessary. But the point is that you have recovered, I take it, costs or the loss of merchant service fee revenue through increased costs on card holders. Have all those costs been recovered?

Mr Hossack—We do not have the data to know.

Mr Bell—A proportion of those costs have been recovered.

Mr CIOBO—Rewards have gone down, which the RBA says is fine because overall the community is benefiting from lower prices, in theory. My question then is an issue for your members. I am interested in the level of incentive that would apply to a bank, for example, issuing a co-branded card with an Amex or a Diners Club where there can be a higher commission—I think that was the word the Chairman wanted me to use—going back to the issuer rather than a four-party scheme. Is that correct? Am I right in that thinking? Is there more incentive to issue an Amex now if you are the NAB or Westpac or the Commonwealth than there is to issue a MasterCard, for example?

Mr Hossack—I do not think you can make that judgment because it would depend upon the negotiation which the bank had with American Express or Diners Club. So we do not know. The fact that some banks are issuing American Express and Diners Club means that they obviously see an incentive to do it. That incentive is likely to be related to the fact that they just want to be able to offer that product to their customers.

Mr CIOBO—So you are saying there is not a disparity in terms of the playing field between the three-party and four-party schemes?

Mr Hossack—No, I am not saying that.

Mr CIOBO—So you are saying you do not know if there is a disparity?

Mr Hossack—Yes. You asked me about the negotiations between the bank and American Express and Diners Club.

Mr CIOBO—No, I asked you if there was more incentive to issue a three-party card over a four-party card.

Mr Hossack—It is the same thing. It is the same question.

Mr Bell—The evidence seems to indicate that since the reforms there has been an increase—I think 15 per cent is the figure—in the issuance of—

CHAIR—But what about the banks themselves? Has there been a greater issuance of four-party scheme cards since the RBA decision or not?

Mr Hossack—I think the market has increased. What the drivers of that market are, whether it is population or both—

CHAIR—We would be interested to know that, because if you say it is distorting the market then obviously your own figures should be reflecting it.

Mr CIOBO—Would you also advise the committee on this. Say, for example—and I will pluck one out of the air—the NAB issues an American Express card. Is that market share attributable to American Express or the bank? Also, what are your views on the upcoming proposed reforms as to debit payments?

Mr Bell—Is that in relation to EFTPOS?

Mr CIOBO—Yes.

Mr Hossack—The ABA's position and view on that reflects what the banks have been arguing for a long time. The joint study, once it came out, questioned the need for an interchange fee in the EFTPOS system. The banks then went away and said, 'It looks as if the Reserve Bank wants to implement this so why don't we see what we can do to facilitate it?' They then came up with a proposal to set the interchange fee at zero. As you are probably aware, they then tried various mechanisms to facilitate that and in the end those did not work. They were part of a self-regulatory approach. So the Reserve Bank then used its own powers to designate the system. More recently, it has set a cost base methodology for determining the interchange fee. That interchange fee methodology will not result in a zero fee but in a floor of 4c and a cap of 5c per transaction running in the same direction. Collectively as an industry, we would have preferred a zero fee. We can understand why the Reserve Bank has done what it has done, but collectively we would have preferred a zero fee.

Mr CIOBO—You have been talking about market power. Take the example of the Qantas-Amex cobranded card where effectively your only form of payment for an airline ticket is credit card. Is this where you are talking about the surcharge plus lower service fees proving to be a significant boon for retailers, merchants or companies in that situation? Is that the kind of example that you are referring to?

Mr Bell—On the evidence, those organisations that have felt able to impose a surcharge have typically been those with market power.

Mr SOMLYAY—I have a question on ATM reforms. Is the ABA in favour of proposals to introduce direct charging for ATM transactions?

Mr Hossack—The ABA's view reflects that of the banks taken in the self-regulatory process which was established quite a few years ago. You may be aware that that group did come up with a proposal to introduce direct charging. But they ran across some difficulties early on, in that the consumer groups had concerns about direct charging, so I think that reform has lost a little bit of momentum. At this stage that group is still considering the best way forward.

Mr Bell—We are certainly on the record as saying that some of the elements of that reform are positive, particularly if it increases the number of ATMs available, particularly in areas outside metropolitan Sydney, which would have the effect of pushing down prices overall.

Dr EMERSON—You said a moment ago that the interchange fee on credit charges is just a device for allocating costs. Are you saying to this committee therefore that no profit is made on interchange fees and that regulating interchange fees will be of no benefit to consumers?

Mr Hossack—If you look at a scheme such as Visa's or MasterCard's, you see they have got members in that scheme. As to the extent to which the scheme people get the interchange fee set correctly, they look at Amex and Diners Club and other competitive products and then look at their own methodology for determining that fee and make a commercial decision as to where to set it. In effect, they are saying, 'We think it makes sense commercially to set it here and allocate these cost to merchants and those costs to cardholders, because that will grow our business.' To the extent that they get that right, like with all business decisions hopefully that will result in a return. But as to the specific mechanics of the interchange fee, it is what is called 'neutral' in that it just allocates costs.

CHAIR—Thank you very much for your attendance here today. I am aware of at least one piece of information that you have been requested to provide. It concerns four-party systems and the growth in those versus the growth in three-party systems. If there is other information to be provided, please forward that to the secretary of the committee. As you know, you will be sent a copy of the transcript of today's proceedings. Thank you again for coming here today.

Proceedings suspended from 12.17 pm to 1.15 pm

LAWLER, Mr Luke Colm, Senior Adviser, Policy and Public Affairs, Credit Union Industry Association

PETSCHLER, Ms Louise, Head, Public Affairs, Credit Union Industry Association

CHAIR—Welcome. As you know, although the committee does not require you to give evidence under oath, nevertheless this hearing is a proceeding of parliament and has the same standing as proceedings before the parliament. We have received a written submission to this committee's inquiry from you. Do you wish to add anything to your statement or would you like to proceed to make an opening statement? If so, please feel free to do so.

Ms Petschler—Thank you, Chair. We would like to make a short opening statement. To begin with, we would like to thank the committee for the opportunity to contribute to this review. Credit unions in Australia have had a long and active interest in payments reform and we appreciate the opportunity to continue to work with this committee as we raise our concerns. We feel it is particularly timely to have the review today given the finalisation of the Visa debit and EFTPOS standards that the Reserve Bank issued at the end of April. This afternoon we would like to give you a brief outline of the issues that we have raised in our submission as well as some of the areas that we hope to see the Reserve Bank address in its more fulsome review of the credit and debit standards and payments systems reforms that it is proposing for late next year.

The issues that we are particularly interested in relate to Visa debit and EFTPOS. As the committee would be aware, the standards that the Reserve Bank released at the end of April have a number of concerns for our sector. We are particularly interested in three aspects of those reforms. The first one is the reduction in the Visa debit interchange paid to issuers to a proposed average of 15c per transaction as a flat rate, compared with the 55 basis point average that will apply to credit cards under the credit card standards. We are extremely concerned about the removal of the honour-all-cards rule, which is proposed from 1 January 2007. Associated with that is a progressive roll-out of separate identification of Visa debit cards. While we welcome the reduction in EFTPOS interchange from an average of about 20c, paid by issuers to acquirers, to somewhere between 4c and 5c, we are concerned about what we see as a last-minute carve-out of that EFTPOS standard that we think will potentially undermine the benefits from the EFTPOS changes that the Reserve Bank has already spoken about today.

Our view on those standards is that the final regulatory shape for the Visa debit standard in particular is unnecessarily heavy handed. It is inconsistent with the credit card methodologies and it is unnecessarily punitive in, for example: excluding from eligible costs fraud prevention costs, which we feel are legitimate issuer costs; applying a costs basket different from that of the actual issuers of the product; and in differing so widely from the credit card interchange, which we feel creates an incentive for the Visa debit issuers, certainly those that we represent, to move their card portfolio from this product to a credit card portfolio. We feel that the proposed removal of the honour-all-cards rule from the Visa debit product is regulatory overkill. In our view, it is an unnecessary step that is potentially very threatening for issuers like the members that we represent who use Visa debit primarily as their access channel. It gives a really unnecessary competitive boost to large retailers in the market.

In our view, the removal of ‘honour all cards’ at this stage was unnecessary because of the quite aggressive interchange fee reform that the standard already proposes and because of the introduction of surcharging on the Visa debit product. Our argument is that those very strong reforms to the Visa debit product and the potential uncertainty around the acceptance of the card place our credit union and the 1.2 million credit union members who have Visa debit cards as their primary access point at risk of a potential threat that is unwarranted at this stage.

As I mentioned, we welcome the direction of the EFTPOS interchange reforms, but we are concerned at what we see as a very last minute carve-out for cash out transactions associated with EFTPOS transactions. We feel we were not consulted on that proposal and that it potentially undermines the integrity of those very important EFTPOS reforms which should make that product more attractive in terms of price for consumers by passing on the benefits of the lower interchange. My colleague Luke will provide some more detail on those concerns, particularly around the Visa debit standard and the relationship with the credit card incentive that we feel these current reforms will build into the market.

Before we move to that, I want to give a quick update on the credit union sector generally in Australia and to give a quick update on why we see these particular reforms as so important. The Credit Union Industry Association represents most of Australia’s 149 credit unions. We have 127 of those 149 credit unions as our members, which is over 90 per cent of the credit union industry. Collectively, credit unions in Australia have over 3.5 million members and over $34 billion in on-balance-sheet assets—and a considerable amount in off-balance-sheet assets. I am sure the committee members are aware of our background and our history and the role we feel we play in the market in adding competition and choice by our existence, as well as the difference that we feel we bring through a higher focus on customer service and member satisfaction—which is high—because of our mutual structure.

The Credit Union Industry Association is also a division of CUSCAL, which is the key aggregated services provider for most Australian credit unions. CUSCAL is the gateway for credit unions to connect with the payment system in Australia, so we bring that perspective as well. For example, CUSCAL acts as the bilateral interchange partner in the EFTPOS and ATM environments on behalf of credit unions. We are also a principal member of the Visa and MasterCard schemes through which credit unions gain access to those schemes as associate members. So you can see that we have a fairly large stake in the payment system environment.

If you think about those 3.5 million credit union members, we have a high percentage of transaction-oriented members and a high amount of payroll members, so we have a very strong interest in the integrity of the payment system and our ability to connect, both as individual credit unions and a sector, in an effective and competitive way.

Because credit unions operate in that cooperative and aggregated services model, we also have a slightly different perspective on some of the other reform areas, such as ATMs and EFTPOS. We see the central body as essentially acting to aggregate the interests of the industry. As a sector, we are also the largest collective issuer of Visa debit in the Asia-Pacific region. We have among the CUSCAL member credit unions 1.2 million Visa debit cards on issue. That is a significant proportion of our membership base.

You will note that in our submission we point to the historical reasons for our high representation in Visa debit, which really flows back to our inability to join the Bankcard scheme and our search as a sector for a card that would give universal access to the payment system for our membership regardless of the size of the institutions that were issuing those cards, supported as they are by the strong central body in the form of CUSCAL. For us, ‘honour all cards’ has an important ‘honour all institutions’ element that we think has added to the overall competitiveness of the Australian market.

Through CUSCAL, we also operate the Redinet system. We have a very large national aggregated ATM network, the Rediteller network and we have our Redicard product, which our member credit unions issue. We have about 1.6 million Redicards on issue, and they are straight PIN based EFTPOS cards that allow PIN based access to the payment system. To add to that, we also have 149 credit unions in Australia, each of which set their own retail fees for their membership and each of which have their own board and governance. They are accountable to their own members.

Overall, we are very confident in the fee story that we have to sell. Two-thirds of credit union members around the country do not pay any fees at all, and those who pay fees pay, on our estimates, just over half of the average fees that customers of the major banks would pay on their transactions. There are obviously some variances across those 149 institutions.

As I have mentioned, the Credit Union Industry Association and credit unions are extremely disappointed with the final shape of the Reserve Bank’s Visa debit standard, and we have a number of questions about the proposed EFTPOS arrangements and the carve-out on the cash-out transactions. Our disappointment comes from the fact that from our final consultations with the Reserve Bank we had hoped that they might look at adjusting some elements of the Visa debit proposals, particularly to address our concern around incentives that would favour the issuing of credit cards by current Visa debit issuers because of the high interchange differential that will result between those products.

We also felt that we had presented a fairly strong case on the overkill of removing the honour-all-cards rule at this point in the reforms when we had not had an opportunity to see if the very aggressive interchange fee reform and the ability of merchants to surcharge on a differential base would lead to the contestability that the Reserve Bank was looking for in that area of the market. We believe that the Visa debit interchange settings and the removal of the honour-all-cards rule will together act to encourage the smaller issuers of Visa debit, who are predominantly the largest issuers of that product, to move their card base across to credit cards. In our view the natural replacement is and will be a credit card because of the functionality that it will continue to offer to consumers who are currently relying on the Visa debit product. We do not necessarily see that as an efficient outcome for the payment system environment, and we certainly do not see it as being in the interests of the credit union membership in Australia overall.

We agree with the Reserve Bank that EFTPOS is a possible replacement product for Visa debit and we have supported their linking of the time frames for these reforms and the outcomes of the potential substitution with EFTPOS. We feel that the substitution story with the Visa credit card has not been given enough attention and that the Reserve has been too quick to reject what we felt were the fairly strong potential outcomes we will now see in the market. We are also, as I mentioned, quite surprised to find, after what has been a fairly lengthy, detailed and difficult process on EFTPOS reform, a last-minute carve-out for what for us at least is a reasonably significant number of transactions. On our estimate, the number of credit union EFTPOS transactions that involve getting cash out as well are a little higher than the Reserve's estimates. We think that exempting those particular transactions from the significant reduction in EFTPOS interchange will act to reduce the benefits that consumers should be getting from lower EFTPOS fees overall as a result of the changes.

Australian credit unions will adapt to these changes. We have adapted to every other change in the market and we are very confident that we will be able to continue to offer affected products to our members. We will introduce fees on some products and we will pass through savings on others, but we feel disappointed that, at the end of what has been a lengthy reform process, the best interests of an efficient payment system and the overall competitive impacts not just on our sector but on the market overall have not been given enough attention. As a result, we have a range of different methodologies with what we feel is a high potential to lead to market distortions. We have been frustrated by our inability to see a consistent methodology across payment instruments. We have been frustrated by our inability to see any real benefits for consumers generally; it is certainly very difficult to point to that evidence. As well, we have been frustrated by what we felt was a difficulty in having the overall competitive position of the smaller institutions in the Australian banking market being given a reasonable hearing. We feel that that is definitely the case in the honour-all-cards rule, where the potential risk of disruption for our members is much higher than we feel the RBA has given attention to.

I should emphasise that we have never objected to reform. We have not opposed any of the key planks of the Reserve Bank's reforms. We have agreed from the very beginning that Visa debit should have a distinct interchange fee that should be lower than the credit card interchange fees, we have accepted the case for surcharging on Visa debit as a way to resolve merchants' arguments around having to pay a high interchange fee on that product, we have been strong supporters of EFTPOS interchange fees and we are active participants in the ATM interchange fee debates and continue to work with that industry group. But we have argued that we should have fair and proportionate reform with some transparent and accountable principles that would flow across each of the payment instruments. Our concern now is that we have a range of different methodologies in place with last-minute variations on one very important reform process that we feel will encourage market distortions that will not be in the interests of the smaller issuers in the banking sector and, in our view, will not be in the interests of consumers more generally.

We have a mixed bag of reforms where the biggest losers are, in our view, Visa debit card holders, who face a particularly punitive regulatory regime when compared with that applying to credit cards and also when compared with some of the carve-outs that have attached to the EFTPOS regime. The end result, we feel, of the proposals as drafted at the moment will be a push towards credit cards through the regulatory intervention in the Visa debit product and the introduction of the honour-all-cards changes. Visa debit card holders will face higher fees. They will face incentives to move across to credit cards and, should they stay with the card, some uncertainty over their acceptance by a number of retailers.

We are also concerned that a significant number of transactions will fall outside the lower EFTPOS interchange standard, which is an area where we felt consumers might finally see some real and tangible savings from these lengthy payment reform processes in the way of lower transaction fees. I will now pass over to Luke to add some comments about Visa debit.

Mr Lawler—We have spoken to our largest Visa debit card issuers, our bigger credit union constituents, and they tell us they are now forced to look at imposing transaction fees on Visa debit transactions. There are not transaction fees on credit card transactions, so immediately a price incentive is created for members to obtain a credit card. Credit card issuers will continue to be compensated via interchange fees for a set basket of costs, including fraud and fraud prevention costs. Visa debit card issuers are denied compensation for fraud costs and they are undercompensated for processing and authorisation costs.

We cannot say just how rapidly the substitution process between Visa debit and credit cards will unfold. Just as an illustration, if half the Visa debit cards currently on issue in Australia were to be replaced by credit cards you would have an extra two million credit cards in the Australian market. Just as an illustration of the price signals that are now built in, post the RBA's intervention, a cardholder buying a washing machine for $1,000 with a credit card will earn the card issuer an interchange fee of around $5.50, while a cardholder using a Visa debit card will learn that issuer 15c. Adding to those price signals, we have the new uncertainty created by the removal of the honour-all-cards rule as it applies to Visa debit. We face the possibility now of big merchants saying to their customers at the point of sale, 'That card's no good here, but here is an application form for one of our retail brand credit cards,' because big merchants are in the credit card business.

Right from the outset of the reform process, as Louise indicated, we have accepted the argument to remove the no-surcharge rule. If retailers want to directly recoup the costs of accepting a particular payment instrument they should be able to. But what the Reserve Bank have done with the removal of the honour-all-cards rule is, as Louise said, complete overkill. They have slashed the interchange fee in a totally arbitrary way, so we have three completely different interchange fee formulas for three different card products. They have removed the honour-all-cards rule, and that exposes cardholders to considerable disruption and creates the potential for a lot of confused and frustrated consumers.

We have supported the reform of EFTPOS all the way through as well. We would have preferred the EFTPOS interchange fee to be zero, as the entire ADI sector and the Reserve Bank originally supported. However, the unexpected last-minute exclusion of cash-out transactions from the new regulated standard for EFTPOS complicates the picture. The potential benefits to cardholders are now considerably uncertain, depending on how many of a particular issuer's transactions do involve cash out. The Reserve Bank estimates that that is about 15 per cent of transactions. It could be quite a bit higher for our members. We do not have the number yet. The removal of cash-out transactions from the standard came completely out of the blue. It was not part of any consultation. It seems to us to be based on arguments that the Reserve Bank has previously dismissed.

CHAIR—Thanks very much. We really appreciate you coming today. You have made some interesting comments. You talk about market reforms, but what you are saying does not quite make logical sense. If you were in favour of the free market environment, one would assume that the concept of choice in terms of the merchant being able to accept or not accept cards would be entirely their call. I would have thought you would support a free market environment. As for incentive, if the interchange fee has been reduced from 40c to 15c, surely that in itself would provide sufficient incentive for merchants to find that particularly attractive and take your card, at the expense of, say, American Express?

Ms Petschler—Obviously, we are going to be spending a lot of time with Visa in promoting the continued acceptance of the Visa debit product. We come at it from a slightly different perspective, because of the size of our individual institutions and the fact that, for the members who use the Visa debit product, it is their access to their transaction account or their savings account. We do not see a valid case at present for potential disruption to the acceptance of that card in merchants. We can see the arguments for the removal of the honour-all-cards rule and we can accept the RBA's theoretical arguments in favour of it. The issue that we have raised is: the evil that you are trying to solve is solved by the capacity for the merchant to pass on as high a surcharge as they may like on that product, in combination with a very aggressive cut in the cost-base interchange for that product.

In our submissions to the Reserve Bank, we have never disputed that, if those reforms do not work, there may be a case to say, 'If you're not seeing the end result that you're looking for in terms of the merchant service fees that are paid by the merchants, then this should be the kind of last-ditch reform you throw into the mix.' We would have preferred to see whether the aggressive interchange cuts, and the ability of the merchants to pass on a particular and specific interchange for Visa debit, would have acted as a solution for that product.

Mr Lawler—I guess it is also worth remembering that the honour-all-cards rule has two dimensions. There is an honour-all-issuers rule: regardless of who issues the card, it will be accepted once you sign up to the scheme. Then there is the honour-all-products rule, if you like, and it is the honour-all-products rule that the Reserve Bank has intervened in and unwound. The honour-all-issuers rule is not totally free-market; people are being bound to accept cards from all issuers if they agree to accept cards from any issuers. So they have picked one aspect of the honour-all-cards rule apart and left the other aspect in place.

CHAIR—So are you unhappy about the reduction in your interchange fees, apart from the fact that the cost of fraud has not been added in?

Mr Lawler—Yes, we are.

CHAIR—You are unhappy?

Mr Lawler—Yes, we are unhappy, because we think that, if the Reserve Bank has decided that certain costs—which underpin services to merchants which are of some value to merchants, which is what they have done in the credit card area—deserve to be compensated, why would you arbitrarily decide that Visa debit card issuers' costs do not deserve to be compensated? We think that does not make sense.

CHAIR—But would your users be able to just use their EFTPOS card, though, in terms of problems of the card not being accepted? Do you see that heading in that direction?

Ms Petschler—That should be the case where merchants refuse to accept the Visa debit component of the Visa debit card, which is a hybrid card in our case and so has EFTPOS functionality. What we are concerned about is the potential disruption and confusion that may come from the visual identification end of the issue.

CHAIR—Have you tested that with merchants and retailers?

Ms Petschler—At this stage all we have to rely on, in terms of what might happen in the market, are the statements that merchants have made themselves.

CHAIR—Saying what?

Ms Petschler—At different points they have said they might switch Visa debit off. So we have to wait and see what happens and we have to work with Visa to encourage as much acceptance as we can.

CHAIR—We will ask that question of the group who are following you.

Mr Lawler—Presumably, since they have campaigned strongly to get rid of the honour-all-cards rule in relation to Visa debit, they would want to take advantage of that. Hopefully they will not but, presumably, that is why they are arguing for it.

CHAIR—It does seem to me to be a free-market question, though; whether it is appropriate is up to the retailer to decide.

Mr CIOBO—I am interested in a couple of aspects that you raised. With respect to Visa debit—and this is my ignorance—is it a signature based system or a PIN based system?

Ms Petschler—It is a signature based system when you are using the Visa debit system—the scheme debit system—and in our case the card also has the functionality of an EFTPOS card—

Mr CIOBO—As a pure EFTPOS card?

Ms Petschler—so it can be both.

Mr CIOBO—So, for a merchant, is the cost associated with using the Visa debit system a higher merchant service fee?

Ms Petschler—At present, it would be included in the merchant service fee.

Mr CIOBO—But under the RBA reforms would that be gone or reduced?

Mr Lawler—Reduced.

Ms Petschler—It would be reduced. And, potentially, there would be some increased granularity because you would be able to break out the costs of different components of Visa debit versus Visa credit.

Mr CIOBO—So the merchants will, say, steer that to a pure EFTPOS transaction, except if you were an online merchant, or something like that, because then you would lose the functionality of being able to accept a payment; whereas if your customers are seeking to have that access, you will say, ‘Okay, the credit unions are going to push them on to credit cards, otherwise they lose that functionality altogether’—the functionality of being able to do online transactions, for example, giving you a number over the telephone and all those kinds of things.

Mr Lawler—Yes. Customers can choose the range of cards they want to use, from three-party cards to scheme debit or credit cards, or EFTPOS proprietary debit cards, but if they want to operate in certain kinds of purchasing space, they need to have a scheme debit card or a scheme credit card. A lot of credit cards also have that dual functionality, of course. You can have an EFTPOS functionality in the piece of plastic that is also a credit card, so that is not particularly unique about Visa debit.

Mr CIOBO—That is peculiar to Australia, though, isn’t it?

Mr Lawler—I do not know.

Mr CIOBO—I think it is. To a certain extent I agree with the chairman on this issue. Surely the sustainability of a card system is dependent upon whether or not there is a value proposition for both the consumer and the merchant. Effectively, is your argument that we are better off in forcing the retention of the status quo because it just becomes a problem for your customers if they have to change to credit cards, and therefore we do not want more credit cards?

Mr Lawler—No—we have never argued for the retention of the status quo. We are quite happy to see a different interchange fee—

Mr CIOBO—When I say that, I am talking about the honour-all-cards rule.

Mr Lawler—Regarding the honour-all-cards rule, we just think that the price you might end up paying, across the various stakeholders but most particularly for the cardholders, and the disruption, the confusion and the loss of access to their account, through their issuer—

Mr CIOBO—That part of it—

Mr Lawler—that is going a bit too far compared to whatever benefit you are getting, because the benefit that you are getting, which is putting some power in the merchant’s hands to be able to put pressure on merchant service fees, can be delivered via the removal of the no-surcharge rule. We have always supported the removal of the no-surcharge rule.

Mr CIOBO—So your point is that they would price it to discourage use?

Mr Lawler—If they think that the interchange fee that they are paying, which underpins the merchant service fee that they are paying, is too high, they can recover it directly by imposing a surcharge.

Mr CIOBO—Don’t you end up in the same situation, though?

Ms Petschler—I guess it is an argument about: is it necessary to remove ‘honour all cards’ at this point in the reforms when we have two other quite significant areas of reform being introduced at the same time? We feel that they really strengthen the incentives for effective negotiations with merchants around those merchant service fees by significantly reducing the interchange fee component and allowing a differential surcharge which, if it were too high, would clearly force a reduction by the schemes for the participants in the schemes.

Mr CIOBO—It would dissuade people from using them. Wouldn’t they end up in the same situation? I mean, if am going to get whacked by 10 per cent—

Mr Lawler—At least you still have a choice: if you want to use that card, you can use that card. It is a scheme card, it has ‘Visa’ written on it, and Visa is widely accepted. If, suddenly, the Visa card were no good, there would be a lot of explanation to do. You might end up doing a lot of education. There are a lot of costs associated with removing that rule, compared to the benefit.

CHAIR—Thank you very much. I appreciate your time today. Obviously we will take your comments on board and we may come back to you over the course of our inquiry. We have one more question.

Mr SOMLYAY—Do the ATM reforms affect the credit unions?

Mr Lawler—Yes.

Mr SOMLYAY—Do you have a view on that? I invite you to make some comments. Strictly speaking, we are talking about the payments system, the interchange fees on credit cards and so on, but I think it would be worth while if you would say something on that.

Ms Petschler—The Credit Union Industry Association represents credit unions on the ATM industry group that has been working on these reforms for a long time. The evolution of the push towards direct charging has included quite lengthy debates about the position of small issuers, like credit unions, that operate an aggregated national ATM network. We are pretty pleased with the acceptance by the other industry bodies and the Reserve Bank of the need for any eventual direct-charging model to accept the continued operation of aggregate networks by the smaller institutions. So, basically, we could continue to operate a national ATM network for credit unions within a direct-charging environment.

The focus at the moment is really around the case for access by new participants. Some of the questions the group will struggle with will be around the sharing of those costs and identifying the true barriers. The ATM industry group, which continues to meet on a very regular basis, with some commitment from all the players in that market is dealing quite proactively with the question of access and keeping the Reserve up to date. We are supportive of those reforms overall. We need a model that will recognise the position of small institutions to continue to participate in an aggregate network. We accept that that will potentially create some tensions around regional banks, but we continue to participate in that in good faith.

CHAIR—Thank you for appearing before the committee today.

[2.22 pm]

HOSKING, Mr Warren, Committee Member, Australian Merchant Payments Forum

ZIMMERMAN, Mr Russell, Chairman, Australian Merchant Payments Forum

PALMER, Mr Barry, Payment System Manager, Caltex Australia

HOWELL, Mr David Geoffrey, General Manager, Financial Services, Coles Myer Ltd

KARAI, Mrs Dhun, Group Head, Financial Services, Woolworths Ltd

TWEDDLE, Mr Rod, Senior Manager, Payments, Woolworths Ltd

CHAIR—Welcome. Although we do not require you to give evidence under oath, I remind you that these proceedings have the same standing as proceedings of the parliament. We have received your written submission and we now invite you to make some opening comments.

Mr Zimmerman—The Australian Merchant Payments Forum represents retailers the size of Coles Myer and Woolworths down to the 12,000 retailers who belong to the Australian Retailers Association—the area into which I, as owner of Sparks Shoes, personally fall. I do not intend to make a full presentation. However, I would like to give an overview and afterwards give the committee the chance to ask questions. As a group, we welcome the committee's interest in the payments system, and I thank you for the opportunity to appear before you in support of our submission. The way fees and charges move and flow has wider implications for merchants, consumers and the wider economy. The timing of these hearings is excellent. We believe they can help the RBA form a solid, cohesive view for the 2007 review.

The AMPF is working closely and will continue to work closely with the RBA to ensure merchants' and consumers' interests are met. We understand the complexity of the RBA task in trying to achieve the most efficient and transparent payments system. However, we as a group believe that the task is unfinished. The AMPF would like the RBA to articulate the objectives and explain the process to achieve objectives and measure success. This would help both this committee and the AMPF in the future in working with the RBA to achieve its stated aims. To date we believe there are inconsistencies. We would hope that the RBA in its 2007 review looks further at the different treatment of credit and debit cards, even though the infrastructure requirements are extremely similar. We also hope that the RBA does not exclude a number of items in the 2007 review. We would see these matters as part of the payments system. We believe that the work on credit cards is unfinished and we have doubts if the RBA's objectives have been met with the EFTPOS review. Certainly the Australian competition tribunal did not support the public benefit in its review. We will also hope that Amex, Diners and BPay would not be excluded in any review of the payments system.

If these reforms are not made correctly to the system, the unwanted consequences could be distorted price signals which would continue to favour credit and charge cards. Credit card interchange fees now account for over $500 million of unproductive costs in the payments system. Given the complexity of the system, the AMPF believes that the RBA and the government should seriously consider abolishing interchange fees for both debit and credit cards. The government may need to consider passing legislation to enable the RBA to either set fees at zero or abolish them completely. Having zero interchange fees would remove any distortion in the payments system and may well avoid a swing to credit cards.

Going forward there will be items and questions that will need to be resolved as we move towards the 2007 review. The AMPF will be pleased to help and work with the government and the RBA to help resolve these matters for all stakeholders concerned—merchants and the consumer—and obviously the wider economy. I once again thank the House of Representatives economics committee for giving us this opportunity today to verbally support our submission. We will gladly now take any questions that the committee may have.

CHAIR—Thank you very much. As Sparks Shoes, you are probably the soft face of the retailing conglomerate. Some of the juggernauts are with you. The question is: what has happened to the money? Philip Lowe has told us you guys are $500 million better off because of less money being forked out in interchange payments.

Mr Zimmerman—I would have to dispute that immediately. The retail environment is so competitive that we all have to get out there and give the very best price. Otherwise we are going to lose market share. So I do not believe we are $500 million better off; I actually believe the consumers are better off.

CHAIR—The interchange fee for merchants has been lowered. Therefore, by definition, you must be better off. Philip Lowe provided that figure.

Mr Zimmerman—Not the retailers—the consumers. Consumers I would agree with, but not retailers, if you are saying ‘you’ being the retailers.

CHAIR—You have been passing it on, have you?

Mr Zimmerman—For a start, I do not think you have had price rises over the last period while this has happened. I would ask David or Woolworths to comment on this, but I think you will find that prices have been stable or have actually fallen in the supermarket area.

Mr Howell—Margins in retailing are wafer thin. Coles Myer’s average margin over the last three years has been 3.2 per cent. That would be one of the lowest margins of any industry around. It is certainly the lowest among many of the OECD countries. Overseas retailers tend to be between five and eight per cent. In Australia it is generally under four per cent. The ability to store away all this good money is great in theory, but—

CHAIR—Coles and Woolworths are hardly struggling. Your reported profits have shifted your share price up to record levels.

Mr Howell—Sure, and we are very proud of that. But we do operate on very thin margins. It is very difficult to be able to illustrate when you have a relatively small amount across such a wide volume of sales—in Coles Myer’s case it is $30-odd billion. The point is that, from where Coles Myer is at least, we are determined to try and grow our market share and do a better job for our shareholders. The way we do that is by lowering our costs and reinvesting that in the customer offer—the offer to our customers—be it price or be it service. Having a better offer out there, hopefully you grow market share. The temptation to keep anything is well and truly overshadowed by the absolutely fiercely competitive marketplace.

CHAIR—So what you are saying it that it is swallowed up in the overall deals you do?

Mr Howell—You reinvest in your offer.

CHAIR—But you cannot prove it to us, can you?

Mr Howell—You cannot prove anything across the whole industry.

Mr McARTHUR—But you are not denying the $500 million savings?

Mr Howell—That has flowed through, certainly.

Mr McARTHUR—Do you accept that figure?

Mr Howell—It is not all Coles Myer. I cannot speak for retailers outside of Coles Myer.

CHAIR—So if it has flowed through and your profitability is up as a result then you would agree with the changes that Dr Lowe has made. Does that follow?

Mr Howell—Yes, and I think that is what Russell said. But the job is part done.

CHAIR—This is a bit of a change, Russell, from last time, isn't it? This was behind closed doors and now you are out in the open. As I recall, unless my colleagues correct me, you thought the change in the interchange fees was totally unnecessary and you did not see the benefit in terms of the merchant services cost and so on. Has this changed?

Mr Zimmerman—We were talking specifically at that point in time about EFTPOS, in which there was a major investment back in the system. We have always stated that on credit cards there was more to go. We do not believe it is transparent any longer. There are costs being hidden. That is why I have made the statement that it should go to a zero interchange.

CHAIR—For debit cards and EFTPOS?

Mr Zimmerman—Everything—debit and credit cards.

Mr CIOBO—What about EFTPOS?

Mr Zimmerman—Same.

Mr Howell—Given that credit cards have come down from there to there, EFTPOS has been really hammered right down. There is not much left to that now. To avoid the distortions and to take away the criticism, why don't we call it zero for the lot as a pragmatic solution?

CHAIR—It will be interesting to follow that up with Dr Lowe when we get him back tomorrow. It sounds quite radical and challenging.

Mr SOMLYAY—If you are saying that the margins have not increased and your costs have decreased, you must have passed the benefit on. Is that right?

Mr Howell—Yes.

Mr SOMLYAY—There was no increase in margin in that time?

Mr Howell—That is right.

CHAIR—That would be hard to prove, wouldn't it?

Mr Howell—When you say no increase in margin, some prices go up and down. If you look at seasonal issues around fruit and vegetables, for example—

Mr SOMLYAY—Bananas.

Mr Howell—they go a long way up and down. You cannot categorically say that there has not been any movements. I guess the point I was trying to illustrate is that there is so much fierce competition, particularly in the supermarket area, you simply compete it away to try to grow market share.

CHAIR—What about the claim from the credit unions about the acceptability of their debit card—that they would be at a disadvantage because of the no preference acceptable cards rule that they do not want changed? What is the story?

Mr Howell—Someone else might want to have a go. I am very happy to give my view.

Mrs Karai—The issue about the honour-all-cards rule is that at least it now allows market forces and the merchants to decide. Until now our hands were tied behind our backs and we had no choice—

CHAIR—I agree with that, but that is not the question.

Mrs Karai—because the schemes had agreements with the acquirers and we were just told what to do as the schemes agreed with the acquirers.

CHAIR—I understand. So you are agree with Dr Lowe about that?

Mrs Karai—Absolutely. You have to. In America a similar case was the famous Wal-Mart class action, which saw the schemes beaten black and blue—

CHAIR—That is not the question. The question is: would you accept their cards?

Mrs Karai—It depends. The competition is so fierce in retailing, it is not easy to make decisions. Take surcharging: none of the large retailers have really been able to surcharge, even though it has been there since 2004.

CHAIR—Their interchange fees are quite a bit lower so, therefore, their cost should be lower.

Mrs Karai—That is right, but the thing is if it is using EFTPOS, it is even lower than going straight through the schemes as a credit transaction. None of us around this table, or even the smaller merchants that you see online, have had it taken off in terms of purchases.

CHAIR—You cannot answer because you do not know yet, or the chances are you will not accept it: is that what you are saying? We try to work—

Mr Howell—It does not need to be as black-and-white as will you accept it or not. Currently you can accept it and the cardholders, by a lot of financial institutions, are encouraged and choose to press the credit button on the PIN pad. If they press the credit button, then the merchant pays the credit card fee—the merchant service fee equivalent to a credit card. The card can still be accepted and the cardholder presses the cheque or savings, and then it goes through as an EFTPOS transaction. It is exactly the same transaction, but with one you pay a whopping fee and the other you do not. You can turn the credit button off and still accept the card.

CHAIR—You are the guys who are in charge of it, so have you made up your mind whether you would accept it or not?

Mrs Karai—Since the final standards have just come out recently, we have not had time to talk to our acquirer. We will be starting to do that, and then deciding.

CHAIR—I can see why they are concerned.

Mrs Karai—No, but that is absolutely true.

CHAIR—I understand you have the choice, but it kind of adds to the weight of their argument.

Dr EMERSON—As usual, I am confused.

CHAIR—He is from Labor.

Dr EMERSON—And honest. You said if the Reserve Bank intervened in the market and regulated away the interchange fee then that would avoid a swing to credit cards. Is that right?

Mr Zimmerman—Yes.

Dr EMERSON—Whereas the Reserve Bank said that by lowering the interchange fee, it has achieved a reduction in the usage of credit cards.

Mr Zimmerman—You are talking about the reduction of the EFTPOS fee there, and it has only been gazetted; it has not happened yet. We have yet to see which way the ball will fall. If you are talking about the EFTPOS fee—

Dr EMERSON—Maybe other committee members can help, but in their submission the Reserve Bank were talking about the slowdown in the use of credit cards and that this has been achieved by a reduction in the interchange fee. You are saying that if we went all the way and got rid of it, we would avoid a swing to credit cards. It seems to be they are going in precisely the wrong direction.

Mr Palmer—The reason for that is that as the interchange fees reduce, the banks increase their charges to credit card users, and that is a pricing disincentive. So if you reduce the interchange yet further, the assumption would be that the banks increase their card fees, interest rates or whatever it may be. This is another disincentive for the cardholder to use that particular product. It is entirely consistent with the RBA figure.

CHAIR—That figures logically, but it is a bit—

Dr EMERSON—Inverse.

CHAIR—Yes.

Mr CIOBO—I assume then you would no longer honour American Express and Diners Club?

Mr Zimmerman—It is going to be for every individual retailer to make their mind up, isn't it? You cannot legislate or you cannot turn around and say retailers should not take this card or that card, but there is suddenly this incentive to take it.

CHAIR—In Sparks Shoes, do you accept Amex and Diners?

Mr Zimmerman—Yes, we do, but, on the other hand, if I have a customer walk into my shop and they can buy the same product at Myer's or David Jones at exactly the same price and those shops take American Express and I do not, I do not want to lose the sale.

CHAIR—Do you put a surcharge on it?

Mr Zimmerman—At this point, no.

CHAIR—But are you planning to?

Mr Zimmerman—I have not ruled it out, but again if you put the surcharge on and the major retailers, or anyone else, do not, then it comes down to a very competitive market.

CHAIR—What about Myer's and Woolies?

Mrs Karai—We have decided right now we are unable to surcharge because of the intense competition that we face.

Dr EMERSON—In a competitive market, how could you reasonably expect the Reserve Bank to set the price of a transaction at zero? I defended you guys earlier about being highly competitive, but it seems to be a bit rich to say, ‘We’re really highly competitive outfits, and what we’d really like the Reserve Bank to do is step in and set the price of the interchange fee of a transaction at zero.’

CHAIR—Somebody is going to pay for that. It is obviously going to be the consumer at the bottom line, so your argument is not heading in the right direction.

Dr EMERSON—Hence my confusion, Chair.

CHAIR—I mean, maximise the profitability of you guys, but you cannot have it both ways.

Mr Howell—The more charges are made to the retailer, the retailer feeds that across all of its products and services and everyone pays a share of it.

Mr CIOBO—Consumers end up paying regardless.

Mr Howell—But is it the cardholder who should pay, or consumers generally? That is the debate.

CHAIR—But don’t you go back the other way? It is the cardholders who will end up paying more through bank fees et cetera, because somebody has to pay.

Mr Howell—Therefore, they are seeing the correct signals of the cost—it is not hidden—of that product across the general price of goods and services.

CHAIR—Surely the merchant who is the beneficiary of the purchase should contribute something towards the cost.

Mr Howell—They certainly do. Merchants have very substantial costs outside of the merchant fees. There is the cost of equipment; there is the cost of time; and there are the operator’s costs. There are quite a number of costs. We have volunteered those costs through to the Reserve Bank, and they are very substantial and more substantial than—

CHAIR—I think we had this debate last time.

Mr Howell—We did.

Dr EMERSON—You are asserting that consumers have benefited to the tune of, I think, $580 million. Roughly, what would that be per person? Are these credit card holders.

CHAIR—It is really a percentage in terms of the total retail sector, which is worth so many billion dollars.

Dr EMERSON—When I divide it by 12 million people, I come up with about a dollar a week. But I do not know if that is a relevant devisor. How many customers are there?

CHAIR—In other words, it is not a big deal.

Dr EMERSON—Yes, that is what I am getting at. We are having an inquiry into a dollar a week!

CHAIR—I think that is an interesting point.

Mr McARTHUR—Could you just help the committee with what the current trend is for consumers using credit card, debit card or cash and what method of transaction will be used by most consumers 10 years out?

Mr Zimmerman—I can tell you what is happening in my business.

Mr McARTHUR—You represent some big retailers. I am just interested to know what is happening.

Mrs Karai—We have seen a slowing down in credit card use as a percentage of spend. Without doubt, that has to do with lower interchange fees, which were paying for most of the reward costs. Issuer banks charging higher annual fees are now making their account holders pay for the reward costs. We are seeing EFTPOS go up steadily. But the biggest change we have seen is in terms of Amex and Diners. Amex and Diners have just gone extremely steep and high in their growth, especially because their merchant service fees are so much higher than the scheme merchant service fees.

CHAIR—You excited us by those comments last time but, when we came back to Dr Lowe, all we found was a two per cent growth in usage in dollar terms.

Mr McARTHUR—Can I get a relativity: cash sales versus on credit card?

Mr Zimmerman—Certainly in my business it is very small. I am fairly unique in my business, I suppose, but 13 per cent is on cash or cheque and the rest of it is on some kind of card.

Mr McARTHUR—What about the bigger retailers—Coles and Woolworths?

Mr Zimmerman—I do not know whether they would be prepared to divulge that. They may not wish to at this point.

Mr Howell—Our cash is less than half of our turnover.

Mr McARTHUR—What is your prediction for 10 years out?

Mr Howell—A little bit will depend on which way interchange fees go. If the credit card ones are not pegged back a bit we might see credit card continue to grow, albeit it has been quite a bit flatter than in the late 1990s and early 2000 years. In our business it certainly has levelled off a little since around 2003 and debit cards have grown.

CHAIR—What type of growth has there been in Amex and Diners cards?

Mrs Karai—We have seen Amex grow to nearly six per cent of the dollar spend in Woolworths stores.

CHAIR—From what?

Mrs Karai—It used to be about three per cent. As a component in terms of our total card dollar spend it is now nearly six per cent, but it has grown to approximately 22 per cent of our merchant service fees.

CHAIR—That is interesting.

Mrs Karai—We have given the Reserve Bank our growth rates.

CHAIR—You factor that in and then calculate its impact on the $500 million that is claimed. So the net cost is something lower than $500 million. Is your percentage similar?

Mr Howell—It is similar.

Mr McARTHUR—What is your attitude towards the customers who have cash versus a credit card? Have you a particular point of view on that, or do you just accept whatever they turn up with?

Mr Howell—Yes, we accept what they turn up with.

Mr McARTHUR—Do you encourage cash customers as in the old days, or are you happy to take credit and debit cards?

Mr Howell—At this point, we have not sought to influence their choice between cash or credit cards or EFTPOS.

Mr SOMLYAY—Many large retailers offer discounts for cash.

Mr Howell—That is because the credit card fees are so high.

Mr McARTHUR—And you do not have a view on that point of view?

Mr Howell—We have chosen not to price differently, if you like, for tender types, at this point.

Mr McARTHUR—In the long term?

Mr Howell—That is simply because of the level of competition. If we were to go out and do something, one of our major competitors might—

Mr SOMLYAY—Do the same.

Mr Zimmerman—They may not do the same and that may cause you cost. That is exactly why I said to you earlier that I do not surcharge for American Express or Diners. If I do—because my competition is there—and they do not, I will lose a sale.

CHAIR—With Coles and Woolworths having 80 per cent of the retail market, if you guys suddenly decide to pass it on then it is a very—

Mr Howell—We do not have 80 per cent of the retail market. We have a higher—

CHAIR—Of the supermarket.

Mr Howell—segment in food, but there is some—

CHAIR—I chaired the inquiry into the retail sector.

Mr McARTHUR—You are talking to the expert!

Mr Howell—You probably know more than me, but there are 30,000 food retailers in Australia.

CHAIR—But you have 80 per cent of the supermarket business.

Mr CIOBO—With respect to investment in new capital, how would you envisage that there would be incentive if there is a zero interchange fee?

Mr Zimmerman—Are you referring to retailers' investment in it?

Mr CIOBO—Correct—and beyond that.

Mr Zimmerman—Firstly, small retailers, generally speaking, use bank equipment. I think you have to look at the smaller retailers. There is not a major investment in the equipment, because we usually rent the terminals from the financial institution.

Mr CIOBO—If there is a zero interchange fee, what would be the incentive for investment in new IT platforms?

Mr Zimmerman—From a small retailer's perspective? I do not think it will change.

Mr CIOBO—What about for a bank? Put yourselves in the banks' shoes for a moment. What is the incentive to invest in better technology and new delivery platforms?

Mr Palmer—The key issue is the ability of the bank to pass the pricing change on to the merchant. For instance, the Reserve Bank currently has reduced interchange on EFTPOS from, say, 20c to 4c per transaction. The acquiring bank simply passes that cost—in other words, it is a revenue stream to the acquiring bank and it simply passes that cost straight back to the retailer, so it is a no-cost game.

Mr CIOBO—The costs are split. With the reduction of interchange fees, we have seen that consumer costs, cardholder costs have increased in large part—

Mr Palmer—In credit card terms or in debit card terms?

Mr CIOBO—No, this is about credit cards for the moment. We have seen merchant service fees fall in cost so, effectively, the cost savings that you have made have been passed on to consumers through lower prices, and the revenue to the banks has been made up by direct charging of cardholders.

Mr Palmer—Yes.

Mr CIOBO—So if there is less revenue flowing into the system by having zero interchange fees, what incentive is there for investment in R&D or new technology or new payment platforms by the banks?

Mr Zimmerman—Can I answer that from a small retailer's point of view: you pay for the cost of that equipment, so I would assume that the cost of the equipment would need to be raised from the retailer. That would be a cost that would be shared back to the retailer for the equipment he has.

Mr CIOBO—In a competitive marketplace it is probably unlikely that there would be much investment in new technology that is going to push up prices for you on the rental cost of that equipment.

Mr Howell—We argued for exactly the same point, that you need an interchange fee to justify or help you meet your investment needs going forward on EFTPOS. We absolutely agree with that.

Mr CIOBO—This was your argument last time.

Mrs Karai—For EFTPOS, absolutely.

Mr CIOBO—How is it any different for EFTPOS from any other form?

Mrs Karai—EFTPOS is PIN based, and schemes are still signature and manual processing.

Mr CIOBO—And probably will remain that way for a great deal of time.

Mrs Karai—The whole issue, in fact, is why has there not been an incentive to move to PIN on credit like other countries in the world to reduce your fraud loss and reduce the misuse?

Mr CIOBO—I would suggest that that is the consequence of low interchange fees.

Mrs Karai—No.

Mr CIOBO—No?

Mrs Karai—It has been here for 20 years and they have not moved to PIN on credit. In terms of EFTPOS systems, on the other hand, the large merchants did all the investment in EFTPOS technology in the PIN pads.

Mr CIOBO—Will you still go ahead and do that on EFTPOS even with zero interchange?

Mrs Karai—We do not have a choice, but it is extremely difficult to justify investment when you are a corporate and you have to justify every project on a returns basis, particularly now with EMV coming on and triple DES and all the investment that is required. Large merchants invest in it to make it easy for the consumers. If you remember in the earlier days when a bank/issuer took out its own EFTPOS, you had to go from your supermarket counter, pull out another bank/issuers terminal and, if it was a Westpac card, you had to go to a Westpac terminal. Merchants saw that you could not have a bank of terminals behind your cash register. Merchants actually invested in EFTPOS technology—end-to-end right until it hit the bank's switch or acquirer—and in all the communications and the PIN pads. Woolworths is right now in the midst of a large and significant investment on its PIN pads to have triple DES security levels. It has been a massive investment. It would have been very difficult to justify in the following year when our rebates will be almost minimised or gone, but we were able to invest in it last year when we still had some revenue flowing in.

Mr CIOBO—Effectively, you have answered my point—that is, that there is basically no incentive.

Mrs Karai—But it is on both sides. It is on EFTPOS and it has been taken away.

Mr CIOBO—I do not dispute that.

Mr Howell—That is why we said, as a pragmatic solution, you look at—

Mrs Karai—On the credit card, just the fraud increase in one year should enable the credit card schemes and the banks to actually upgrade their systems to PIN on credit.

Mr CIOBO—Sure. I cannot talk on behalf of the full committee.

Mrs Karai—There is a huge fraud cost, which does not exist on EFTPOS. You never hear of it. There is nothing. APCA will tell you that fraud on the debit EFTPOS system is not even 0.001 per cent.

CHAIR—Therefore, to have a zero interchange fee does not make sense when credit cards are trying to cover that—

Mrs Karai—You have to be even-handed in both.

Mr CIOBO—I understand that point. With regard to the three-party scheme, you say you have gone from three per cent to six per cent for your charge cards. Under a zero interchange fee basis, given that they are not designated—and rightly, I think—a situation could arise where the issuing banks would do nothing, I suspect, other than issue charge cards and, presumably, it would logically follow that you would be unlikely to accept them or else whack a hefty surcharge on them.

Mr Howell—The differential becomes much greater.

Mr CIOBO—Is that a yes?

Mr Howell—I cannot guarantee that is what we would do.

Mr CIOBO—Is it likely?

Mr Zimmerman—We would certainly think about it as a retailer, yes.

Mr Howell—There would be a more likely chance, yes.

Mr CIOBO—Do you pay any fees on store credit cards? For example, David Jones.

Mr Howell—That depends on the relationship between the provider of that credit card and the retailer. I am not sure that there is a universal position there.

Mr CIOBO—Is there no typical case? If you are Harvey Norman you have a Harvey Norman card, or if you are David Jones you have a David Jones card. Is there no typical position in terms of the way in which that is priced?

Mr Howell—I am not sure there is a typical position. I do not know; I only know Coles Myer’s position?

Mr CIOBO—What is Coles Myer’s position?

Mr Howell—Without being commercially sensitive, we have a very favourable arrangement there which is why we support it.

Mr CIOBO—I take it that under this new no-interchange method you would probably have a strong position when it comes to store credit cards?

Mr Howell—Sure. I think the point about that is that credit cards can exist without large interchange fees. They simply do.

Mr CIOBO—If there had been no regulation on interchange fees—and you may care not to answer this—and if there had just been the upcoming removal of the honour-all-cards rule and the no-surcharge rule, do you believe that the market would be very different to what it is today?

Mr Howell—I think because of the structure of the way those interchange fees have been set over many years and the very extreme degree of competition in the retail market, it is very difficult to engineer a change unless you are prepared to go to the extent of not accepting the card or surcharging, both of which are very difficult to do in a fiercely competitive retail market.

Mr CIOBO—Would it be more likely that you would surcharge if you did not have lower merchant service fees?

Mr Howell—Yes.

CHAIR—We have a question arising from the submission made earlier by the Australian Bankers Association, and I think we found out the answer in between time, but I would like to ask it of you, Mr Hosking. The ABA made a claim of discrimination. It said that interchange fees provide valuable information to competitors and that the Reserve Bank wrote to the BPay scheme requesting publication of its interchange fee. The scheme was willing to publish it only if its competitor, Australia Post, was required to do a similar disclosure. The Reserve Bank saw this as unacceptable and threatened BPay with regulatory intervention. BPay has now published its interchange fee, so Australia Post now has information about BPay's cost base but has retained confidentiality regarding its own costs. Would you like to comment?

Mr Hosking—I was not aware of the full history that you have just recounted.

CHAIR—It has just been presented to us today.

Mr Hosking—Might I say that our service is not a scheme. Our service comprises prices that are directly negotiated with each billing company, so they are based largely around our costs. There is no interchange. There are no other parties involved in the process. So I think we are talking about totally different arrangements. Our prices are commercially set between ourselves and the billing companies.

CHAIR—So there is no interchange fee?

Mr Hosking—There is no interchange fee whatsoever.

CHAIR—So it is not appropriate that you be asked to provide it, if there is not one.

Mr Hosking—I do not believe it is a relevant comparison.

CHAIR—That is interesting.

Mr SOMLYAY—We have had evidence today that our banking system is not keeping up with technology worldwide. Is that affecting business and, if so, how?

Mr Howell—In terms of EFTPOS, when we introduced it we were world leaders in it, and it has been a very good and robust system. There has been no fraud, as Dhun pointed out. We have had PINs for all transactions since it was introduced in the eighties. We were well and truly leading the pack then, so I am not sure that we that far behind.

Mr Zimmerman—In credit cards we might be a little bit behind because Europe, I believe, is 70 per cent or close to a PIN based credit card now. So our credit cards could well be lagging behind the rest of the world.

Mr CIOBO—Are you seeing any increases in fraud on credit cards?

Mr Zimmerman—Personally speaking, no. I am not sure what the other members would have to say but I personally have not.

Mr Howell—I think that is more a question for the card issuers, unless you are talking about merchant fraud.

Mr CIOBO—No.

CHAIR—What about EFTPOS—are there developments there?

Mr Tweddle—No, there has been no increase on fraud on EFTPOS at all.

CHAIR—Do you feel we are falling behind in terms of technology, in relation to the overseas situation, with your competitors?

Mr Tweddle—It is not a technology question, really. We have the opportunity to do PIN based credit today and have had for 20 years. We would argue that that is what we should be doing. As a result we would see similar fraud levels in the credit card arena as we do in the debit card, and that is virtually nonexistent.

CHAIR—I am sure all of you have gone on those familiarisation trips to see what some of the big operators are doing: Wal-Mart et cetera in the States. Do you see a lag behind in Australian technology?

Mrs Karai—Not in terms of America, because it is still heavily cheque based over there and, I would say, behind the times in terms of payment systems. It does not even have a ubiquitous EFTPOS system like Australia does. But certainly, in terms of credit cards, with the UK, Malaysia and a lot of countries going into EMV—and now New Zealand and Canada as well have announced plans to go to EMV—we seem in this country to be dragging our feet on it.

CHAIR—Thanks very much for coming today. We appreciate it.

[3.00 pm]

COATES, Dr Nicholas, Senior Policy Officer, Financial Services, Australian Consumers Association

KELL, Mr Peter, Chief Executive Officer, Australian Consumers Association

CHAIR—Welcome. As you know, although the committee does not require you to give evidence under oath, nevertheless this hearing is a proceeding of parliament and has the same standing as proceedings before the parliament. I invite you now to make an opening statement, which we will follow up with questions.

Mr Kell—Thank you for the invitation to be here. We would like to make a brief opening statement. The Australian Consumers Association has had a long involvement in issues around payment systems reform. I suppose we have tried to make sure that we keep our eye on the overall objective of the reform process, which is ultimately, from our perspective, a more efficient, less expensive and more flexible payments system for Australian consumers. It is a payment system that gives consumers the capacity to transact across a wide variety of situations using their preferred mechanism rather than being effectively forced to use different mechanisms for different situations in ways that may be inefficient and ultimately confusing for consumers.

We have broadly supported the RBA's overall approach and objectives. Again, we have assessed the different measures that they have taken against the big picture objective and so our support has, in certain cases, been conditional upon our view of how consumers might respond or some of the benefits that may emerge from particular reforms. We do think that there is scope for further improvement going forward in the payment system. One simple example is the capacity for consumers to undertake card not present transactions in a wide variety of contexts. We also think this is an area where we have to be careful about how much reliance we place, especially in the short term, upon consumer responses to changes in relative prices in complex markets. It is an area where how it is going to play out can be difficult to work out in advance. We will leave it there for the moment.

CHAIR—Thank you. Are you better off as a result of the changes made by the Reserve Bank, or aren't you? Or, in sitting through today's discussions, are you, like us, confused?

Mr Kell—It is difficult to give a simple answer to that at this relatively early stage in the process. We think there have been savings made through the changes that the Reserve Bank has made and we have seen consumers benefit through lower prices in some areas. We do, however, have concerns about some aspects of the changes—for example, the recent changes to the debit schemes. We think they have the potential, if things go the wrong way, of driving consumers back to more expensive credit card based transactions.

CHAIR—Which changes in relation to the debit schemes?

Mr Kell—The designation of the Visa debit scheme arrangements in such a way that they make that scheme relatively less attractive compared with credit cards. We thought there was scope in the current environment for consumers to be able to undertake card not present transactions using a card that did not involve credit, and we saw the debit scheme arrangements as allowing that. To be honest, in the best of all possible worlds it would be good to see people able to take EFTPOS transactions in that way, but we realise that we are not there yet. In the second best world, if you like, we saw a scope for that card still having an important role.

CHAIR—You were here for our last participants, the Australian Merchant Payments Forum, and you heard their argument for a zero interchange free across the board. Do you have any views on that? Do you think the consumer would be better off under that scheme or do you think that what you gain on one you lose on the other?

Mr Kell—We have not considered a zero fee at this time. We certainly think there is scope for reductions in some of those fees. We did hear your questions about what sorts of incentives that might generate for investment. We have not looked at the zero fee option at this time, but we certainly have been of the view that the interchange fees could come down as part of this overall reform process.

CHAIR—You cannot quantify the benefit to the consumer? We worked out that if the benefit was $500 million a year and if there are 20 million Australians—

Dr EMERSON—There are 12 million customers—lots of kids would not use it. Let us say 12 million; at $580 million it works out at $48 a year—less than one dollar a week.

Mr CIOBO—That is not the net; that is the gross benefit.

CHAIR—That is the gross. Then you look at the change in the credit card mix. If you heard the account from Woolworths and Coles about the greater increased usage—about 15 per cent more in terms of the merchant payment fee—then the net cost is likely to be different. Then you add to that the increased credit card cost and the reduction in benefits on the card, such as frequent flyer points et cetera. Is the consumer better off?

Mr Kell—From a move to a zero interchange fee?

CHAIR—As we are now—the current regime.

Dr Coates—We are a little sceptical about whether the full effect of the reform process will flow on to consumers.

CHAIR—The Merchant Payments Forum has just told you that it all flows on. None of it goes into profit.

Mr Kell—Of course!

Dr Coates—You look at how consumers interface with the payments system through a transaction account, the sorts of decisions they have to make and the marginal benefits and costs of each particular payment mechanism—EFTPOS, ATMs, scheme debits and credit cards. They have to be able to weigh up at the margin which one is best for them, how it suits the particular transaction account, how many free transactions they have and select one that best suits the way they transact. It is not an easy process. You nearly need to be a rocket scientist to be able to work it out as a consumer. For the full effect of these reforms to work, not only must each consumer come up with a system that suits them the best, they have all then got to do that in aggregate for the full interchange fees to be felt right down to the consumer so that they can take advantage of that situation.

CHAIR—The bottom line is that you do not know.

Dr Coates—The bottom line is that we are waiting to find out, but we are not sure.

Mr SOMLYAY—How long do you have to wait? How long before empirical evidence is available?

Dr Coates—Part of the difficulty with saying, 'How long do you have do wait?' is the chain reaction in the way the designation processes occurred. At each stage of designation processes there have been minor distortions in other areas. We are not really certain. What I mean by minor distortions is that other parts of the payments system feel the effects of each designation and we cannot simply pull back in the aggregate and say we would be better or worse off at this stage as a result of that.

Mr SOMLYAY—Do you think consumers are getting smarter and are really thinking about how to use credit cards to their advantage?

Mr Kell—Some are.

Mr SOMLYAY—Is it increasing? I would say it is increasing. I think consumers are getting smarter and taking advantage of the no-interest period and paying off credit card debt with flexible mortgage accounts, reducing the 16 per cent interest rate to 7½ per cent.

Mr Kell—I think the picture is pretty mixed. Clearly, consumers are doing that. Certainly there is now information available for them out there to do that. But there are still a lot of consumers—a sizeable part—who do not behave in that sort of way. Often, they are the less financially experienced and less financially literate consumers who, for a variety of reasons, are not able to take advantage of things. So that leads to that problematic cross-subsidy, which I think has been well recognised, where you have consumers who are often more financially experienced, perhaps with a higher income, who are better able to take advantage of things like that.

Mr SOMLYAY—Is it a function of your organisation to educate people?

Mr Kell—We certainly regularly publish information. Information is on our website at the moment which gives people pointers on both how to try to get the best deal out of credit cards and how to transact in a variety of circumstances in ways that will reduce costs. As Dr Coates said, that can be tricky for time-pressured people in this day and age.

Mr CIOBO—The impression I got was that your starting point was that interchange fees needed to be regulated and that there has been consumer benefit flowing on as a result of that regulation. Why is that?

Mr Kell—I suppose our starting point, in a way, is similar to the system of the Reserve Bank—a system where there were ultimately too many consumers and too many transactions occurring at the more expensive end of the system, if you like, and that there was scope to see that moving towards the less expensive end, which is the EFTPOS end of the system. There were, potentially, benefits to be generated out of that shift. Obviously describing it in those broad terms is fairly simple; it is the process of getting from A to B which is an interesting process.

Mr CIOBO—Couldn't you have done that, though, through the abolition of the no-surcharge rule?

Mr Kell—Given the impact of the no-surcharge rule to date, I am not sure that would have been the process that would get you there.

Mr CIOBO—AMPF said—just prior to your giving evidence—that they are less likely, not more likely, to apply surcharges because of lower merchant service fees. Effectively, what they are saying is that because there are now lower merchant service fees they do not surcharge, whereas there probably would have been a greater chance of surcharging had we not intervened and price capped interchange fees.

Mr Kell—We have not really had the opportunity to test that argument. I would have to say that on the face of it—

Mr CIOBO—That is central to what this committee is looking at, or part of what this committee is looking at: whether or not this regulatory intervention is warranted. It seems to me a fairly big statement for the ACA, as a starting point, to say, 'We think there should have been regulation of interchange fees,' but then to say, 'We do not see any evidence of the benefits that have flowed from that and we are not really sure whether in fact that is what we should have done.' I am just trying to get to the bottom of what lies behind your statement.

Dr Coates—To clarify that, we see that certainly the formula mix for the setting of interchange fees has been important. It has been important because at least someone is in this space. Our prior experience was seeing the costs of transacting in the payments system for consumers increasing significantly. We express some scepticism as to whether the full effect will be felt, so I guess it is a case of: this is working a little bit, and that is better than nothing.

Mr CIOBO—Do you think there is more or less incentive now for new issuers to come into the credit card market?

Mr Kell—There seem to be some coming in—

Mr CIOBO—I think we have had evidence of one.

Mr Kell—and advertising fairly widely.

Mr CIOBO—There were significantly more previously.

Mr Kell—I suppose we would be looking at it almost at the other end and saying, 'Where are some of the changes that are hopefully driving reforms for consumers at the EFTPOS end of the market?' Now that we are seeing some changes there—they are obviously relatively very new—we will be very interested to see how that plays out. The credit card market is one where, to be honest, a lot of competition has been around the bells and whistles rather than the price. Over a long period of time, a lot of the competition has been around the fluff, the loyalty schemes and whether your card is gold coloured or silver coloured. For us, that is not particularly meaningful competition.

CHAIR—Is that meaningful, though, in terms of the bottom line as a consumers association, in that you work out whether the consumer is better off under the change in the interchange fee and/or under a system where the interchange fee is lowered and you have these higher charges on having credit cards? Because there have been substantial shifts upwards in the cost.

Mr CIOBO—Your position must inherently be split, because consumers overall are arguably better off in aggregate, but cardholders are definitely worse off, aren't they?

Mr Kell—Some cardholders, depending on their usage of the card.

CHAIR—Have you done any analysis of that?

Mr Kell—We have not done a share analysis of that. We have been, I suppose, looking to the Reserve Bank and asking to do that.

CHAIR—Wouldn't that be a starting point?

Mr Kell—We have been seeking—

CHAIR—It seems as if, while people have been focusing on this one, the prices of the cards have been going up rapidly. That is what we want to get a handle on.

Dr Coates—That is an interesting point that we will have to take into consideration.

CHAIR—Okay, that is fine.

Mr CIOBO—You are in general terms opposed to the abolition of the honour-all-cards rule. One of your summary points was that, with respect to phone and internet transactions, the 'ACA does not support measures that shift consumers from debit card to credit card products'. Why is that?

Mr Kell—I suppose our position on the honour-all-cards rule needs to be seen in the context of the relative attractiveness of the debit scheme versus both credit and EFTPOS. We understand what the Reserve Bank was trying to achieve there, in terms of increasing the relative attractiveness of EFTPOS in the overall scheme of things as the cheapest mechanism. But, as I said, we saw that in the current environment—where especially you have a situation where, for most consumers, the ability to undertake transactions over the internet and whatnot is really only available through either a credit card or the Visa debit or MasterCard debit arrangements—many consumers would like to have the option of doing that without using a credit based facility. Therefore, introducing a measure that was going to reduce the attractiveness of the Visa debit or MasterCard debit could raise some problems there, some perverse outcomes. Down the track, we would like to see an outcome where EFTPOS can operate in that environment, but we are not there yet.

Mr CIOBO—So you are happy for that cross-subsidy to exist in the short term?

Mr Kell—We have been honest about it. There are some short-term and long-term issues here—

Mr CIOBO—Sure.

Mr Kell—and you do not achieve exactly where you want to go overnight, so we have been open about that.

Mr KEENAN—On the honour-all-cards rule—that is, the issue that has just been picked up by Mr Ciobo—might there be some consumer benefit in merchants directing consumers to a payment system that they prefer because it has a lower cost base, in that ultimately that saving might be passed on to consumers? Just to give you an example, we have credit card facilities at our own offices, and we always try and discourage people from using Amex or Diners because it is just a lot more expensive for us. Couldn’t you make the case that consumers would be better off, assuming that merchants would ultimately pass on those savings?

Mr Kell—Under the scenario that you have just talked about, yes, it would be useful for merchants to be able to give a signal to consumers, but a lot of them do not seem to be doing that at this point in time. We are taking that reality into consideration as well. It is an interesting question as to why that is not more widespread as yet. I suppose we would like to see that becoming more widespread.

Mr KEENAN—At the end of the day, I suppose you could make the case that people who are using Diners and Amex get higher benefits, through reward points or something, for using those cards. They are making the whole system slightly more expensive, I suppose.

Mr Kell—Are you asking us about the Diners and Amex issue—our views on why they are not designated?

Mr KEENAN—They are really making the system slightly more expensive for everyone, I would have thought.

Mr Kell—Our view has been that, while we do not see it as a first order issue, Diners and Amex should also be captured under this regime for the purposes of regulatory consistency.

Dr EMERSON—I wonder whether you might be able to, later, provide some estimates of the maximum consumer benefit that could be obtained out of going all the way to zero. Chair, I might ask the Reserve Bank to do the same thing. I hasten to add that I am not suggesting that the interchange fee should or should not be zero, but that is the limit. If going from 95c to 55c achieves $580 million of savings which bob up somewhere and are shared between different players in the whole area, including consumers, if you then went from 55c to zero we would have at least an estimate of the maximum impact that could be achieved. I am interested in any comments that you might have as to who ultimately gets those benefits. That is the first point. I am not really seeking an answer but am just wondering whether you can do that.

The second, related, point is the reward schemes. As I said earlier, they are designed more to confuse than to reward. People try to attract customers to different cards by these reward schemes and they become very difficult to compare. Is there an issue in terms of not only transparency but information overload, whereby consumers just cannot make rational decisions? In order to make a rational decision you would have to spend so much time—which has a cost associated with it—evaluating everything that you might just throw up your hands and say, 'This is too complicated; I will just go with a hunch.'

Dr Coates—We suspect that there is a class of consumer out there, small in number, that is extremely savvy and makes the reward schemes work for them very effectively. I cannot give you exact figures, but there is a larger group that does not quite understand how to use them to make them work for them. They often do not repay the outstanding amount by the end date, so they end up paying interest. That effectively makes any rewards that they earn—

Dr EMERSON—It wipes them out. It obliterates them.

Dr Coates—It wipes them clean. Similarly, a lot of them do not weigh up the administration fees that they pay on their credit cards against the cost of the reward schemes. When we have looked at this in the past and done research on it, we have found that a lot of the cards are not as great as they look when you factor in the administrative fees and charges.

CHAIR—Not only do Diners cardholders pay the late fee but they also lose their frequent flyer points entitlement.

Dr EMERSON—So one impact of the reduction in the interchange fee has been a reduction in the attractiveness of the reward schemes. Is that necessarily a bad thing—that is, are reward schemes so terrific that the reduction in the attractiveness is a big cost to consumers? Taking into account all the information gathering problems, is that such a sad loss?

Mr Kell—No.

CHAIR—Thanks very much. That was interesting. We really appreciate you appearing before the committee today.

Proceedings suspended from 3.25 pm to 3.37 pm

MANSFIELD, Mr Bruce Andrew, Executive Vice President, Australia and New Zealand, Visa International Service Association

MEAGHER, Mr Bruce Michael, Head, Public Affairs, Asia Pacific, Visa International Service Association

STOREY, Mr Gregory, Head, Products and Strategy, Australia and New Zealand, Visa International Service Association

CHAIR—Welcome. We do not require you to give evidence under oath, but we certainly ask you to respect the fact that these proceedings should be treated in the same way as proceedings of the parliament. We have received a written submission from you. Do you wish to make an opening statement—as if I don't know the answer!

Mr Mansfield—Thank you for the opportunity to address this forum and answer questions on what I believe is a very important matter. As you have said, Chair, the committee already has a copy of our submission, so I will not go through it in specific detail here this afternoon. Rather, I would like to speak briefly about the way in which we believe the committee may wish to proceed to overcome the problems that have clearly been thrown up by these regulations.

Firstly, let me emphasise a point that has already been made here today: it is no surprise that consumers are paying more to use their credit cards. This was the intention of the Reserve Bank all along. In the bank's view cardholders were being subsidised to use their cards, and thus the wrong price signals were being sent out. However, I believe there have been two unintended consequences relating to the shift in costs within the system. The first is that, even though consumers are paying more in fees and charges, they are also paying more when they use their cards because of surcharging and other cost pressures out there. What is more, another point acknowledged here today is that there has been no discernible benefit passed on to consumers from merchants, who are now paying significantly lower merchant service fees. In essence, consumers are paying more for their cards and they are also paying more at the cash register. I would also observe, and I think this has been mentioned on a number of occasions this afternoon, that there is no evidence that consumers that use cash have actually received any benefit otherwise from any reduced prices at the cash register.

The second unintended consequence is that, by failing to include American Express and Diners Club in these regulations, the RBA has achieved a somewhat perverse effect of driving up the use of products that it has already identified as the most expensive in the system. According to the RBA's own data, Amex have achieved already around a 20 per cent lift in its market share since the regulations were enacted. Again, a number of submissions presented to the committee identify that this alone is more than a $4.3 billion increase in revenue alone. What is more, it is further $40 million to $50 million increase in merchant service fees, which in some respects are eroding some of the benefits that the merchants have enjoyed from the significantly reduced merchant service fees for Visa and MasterCard. I say to the committee that, as more and more of these new Amex cards are issued to take advantage of what I believe is a regulatory opportunity—of which the recently launched American Express card with Qantas is a classic example—this situation will only worsen in the months and years to come.

We have heard objections raised about how hard it is to regulate these so-called three-party schemes as opposed to the four-party schemes, such as ours. We therefore believe that the ultimate answer is not to prescriptively regulate the three-party schemes at all but, more importantly, to move to a more light-handed but competitively neutral system of regulation of all payment schemes in Australia. However, I believe that there is a very good case in the meantime for the RBA to conduct an inquiry into why American Express's merchant service fees are twice as high as those charged by Visa and MasterCard in Australia. As a consequence of these regulations, the relative difference between merchant service fees for different schemes has widened. Asking three-party schemes to justify the difference probably would be an exercise worth undertaking. Shining a light on this issue might help bring prices down for consumers.

My second major point relates to the recent decision to remove the honour-all-cards rule, which has been spoken of in earlier submissions. We believe that this is fundamentally bad policy. It is bad because it gives merchants the right to discriminate and limit consumer choices. It is bad because the people who will be hurt by this proposed new regulation are the four million Visa debit card holders, most of whom are the low- and middle-income earners of today or the children of parents who do not want their kids to have access to credit cards but who recognise there is an increasing need for such cards to be part of their kids' daily lives. It is bad also because any harm suffered will fall disproportionately on the smaller financial institutions—the building societies and credit unions, which fundamentally issue the majority of those four million Visa debit cards that are in circulation today.

My third point relates to surcharging. I have said already that the combination of regulating interchange fees and allowing for surcharging is a double hit for cardholders and consumers. It gets worse when merchants are allowed to surcharge whatever amount they want, with no reference to what it costs them to accept the card. There is no cap on surcharging. At the same time, this also occurs when surcharging is a blended rate: where merchants elect to use one fee that averages out the different costs of the schemes—the four-party schemes versus the three-party schemes. Effectively, in this case, Visa cardholders are subsidising the use of American Express and Diners Club cards at other merchant locations. Clearly it is worse in the case of merchants who seek to make a profit by surcharging and effectively gouging cardholders, some of whom may have no choice but to use cards in that distribution channel.

In summary, it is inappropriate to permit surcharging where interchange fees are strictly regulated. But, even if surcharging were to be permitted, I would encourage this committee to consider that merchants should not be able to do more than recover the actual costs related to accepting the cards that are being used.

In conclusion, I would like to suggest a way forward. We do not believe that the current framework and approach are sustainable going forward. We cannot imagine that anyone thinks that in three, five or 10 years time the RBA should still effectively be fixing the charges that apply to the payments system. There must be an exit strategy, and the RBA should be asked to outline what that is and over what time frame it will occur. It is our hope that the RBA, in suggesting the possibility of Visa and MasterCard offering voluntary undertakings to comply with its proposed standards on debit interchange, is in fact moving in the right direction. However, it is only a very small step and we are still being asked to comply with two very prescriptive standards relating to Visa debit.

A better approach has been suggested in our submission. We have recommended a principles based approach to interchange regulation that is light handed and relies on transparency rather than on prescription. This approach also has the virtue that it can be applied in a neutral manner that overcomes the competitive distortions that currently exist in the market. Furthermore, it is in line with the light-handed approach suggested by the Wallis report and endorsed in the recent Banks report called *Rethinking Regulation*. Importantly, the principles we recommend will recognise the need to encourage investment in the payments system. The current regime does not do that and, as we have commented in our submission, this puts at risk the capacity of the payments system in Australia to deliver on the needs of the community and policy makers, especially in the area of protection of personal financial information and reducing fraud. Once again, thank you for this opportunity. We are happy to answer any questions.

CHAIR—Thank you very much. I am a little curious. Your presentation is made on a couple of levels—it is market related at one level and it is not at another. You argue passionately about the merchant services charges that are twice those that other cards charge and yet you object to the ability of merchants to surcharge. Surely that fixes it. If you have an excessive merchant services charge, you let the merchant pass it on, if they wish. What is the problem with that?

Mr Mansfield—The line of argument you run about allowing merchants to surcharge as a consequence of these regulations is a substantive one. Clearly what we do not like to see is the opportunistic approach taken by specific merchants where they have concentration in their distribution channel and cardholders and consumers have no choice. I would make the point that our regulations globally state quite simply that if local law requires surcharging to occur in a market we are supportive of that. However, we believe it is good public policy to put a cap on it to ensure that gouging does not occur. Again, in those specific segments where a consumer may have no choice but to purchase, for example, an airline ticket over the internet, which therefore limits their choice, we would not want to see merchants having the ability to profiteer from those regulations.

CHAIR—Or to use some other kind of card, such as EFTPOS.

Mr Mansfield—In some instances, you clearly do not have any choice. I draw the parallel of the move we are seeing not only in this country but globally of consumers wanting more from their debit products than they can get from them at present. One of the limitations is that proprietary debit cards—the EFTPOS cards we have today—are online PIN based cards. Globally, we are seeing consumers asking for more in relation to their debit services; therefore, we are seeing products like Visa debit coming into the market here. Consumers have the ability to use those cards where they cannot use their EFTPOS card, such as over the phone and across the internet.

Again, it comes back to my comments on Visa debit. Over the last 30 years, four million Australian cardholders have elected not to take an EFTPOS card. They see the benefits in using products like Visa debit. Primarily, lower- and middle-income earners do not want credit facilities and prefer to use their own money. With these regulations, I am concerned that, if the RBA proceeds with dismantling the honour-all-cards rule, we will see those cardholders turned away when buying their groceries—and that is not a good outcome for anyone.

CHAIR—You have expressed concern about the rising market share of Amex. Amex operates within a different demographic market, doesn't it, to that of other card providers? Its fees and benefits are high. It charges a premium because it is looking after premium consumers, in terms of demographics. Should that be of concern to the cardholders operating at the top end of the market?

Mr Mansfield—I do not think we can dismiss a 20 per cent increase in market share by one competitive payment system.

CHAIR—According to the figures provided by the Reserve Bank, during the last 12 months they have only increased their market share by two per cent.

Mr Meagher—Two percentage points. But they have gone from 14 to 16, which is about a 20 per cent increase in their market share, if you look at it that way. It is a question of description, but—

CHAIR—It sounds like good spin.

Mr Meagher—From their point of view, they would go to their bosses in New York and say, 'We've had a 20 per cent increase.' They see it that way, I am sure.

CHAIR—But on their bottom line they have also had a reduction in their merchant services fee, which has come as part of that. They have their quid pro quo on that.

Mr Mansfield—It is obvious certainly to the consuming public that there is a great deal of promotion around American Express as a payment product in this market.

CHAIR—You cannot walk through the airports or shopping centres without seeing its advertising boards.

Mr Mansfield—Yes. Fundamentally, it is driven—as you say, Mr Chairman—through the appetite of cardholders to accumulate reward points. You will see many offers out there where you have double, triple or quadruple points for a period of time. For the segment of the population that is looking to that, that is a very compelling offer.

I think you will also find over time that, as their success grows in that high-end upper-income segment, they will continue to leverage their product further down the value chain. We are already seeing, for example, a move to offering credit facilities rather than charge card facilities and to risk based pricing where they are offering a different range of interest rates, depending on how good you are at paying them back. Therefore, certainly I am of the view that their regulatory arbitrage is leading to a competitive imbalance such that they will leverage it more and more over the years to come and they will bring the appeal of their product further down into the middle-income segment. The outcome will be that cardholders will pay more and, at the same time, where merchant service fees are, the small- to middle-merchant segment will also pay more. Clearly, the large merchant segments are able to negotiate competitively in relation to their merchant fees, but the average is still quite high because the mass-market merchant population does not have that ability to negotiate.

CHAIR—As I understand it, their latest offering, which has been highly publicised, is about $400 per cardholder. That is hardly moving down into the lower end of the market, I would have thought. Isn't this the marketplace at work? They have aimed at the premium market, pitched accordingly and charged appropriately, and they have charged their merchants a higher amount. It is the Gucci end of the market.

Mr Meagher—Yes, but at the same time other players in the market are being told, 'Even if you wanted to, you couldn't make those choices, because the Reserve Bank effectively surrounded your pricing structure with regulations.'

CHAIR—You could increase the cardholder fee for a premium card, if you wished—gold, platinum, triple-plus or whatever it may be.

Mr Meagher—That is true. But you have to remember that, at the end of the day, essentially this is about allocation of costs within the system, and the Reserve Bank has made some judgments about that—that the costs, whatever they may be, will be moved to the cardholder and away from the merchant. Our point is that interchange, when it is allowed to be set in a market context, seeks to balance those things out, recognising the benefits that merchants and cardholders receive—the benefit to the merchant being as many people as possible with cards spending on them. That is how the market mechanism of interchange is supposed to work. As I said, the Reserve, in this instance, has intervened and said: 'We do not think that is right. We have a view, and so we are going to push people one way or the other.'

CHAIR—Yes, but if Amex and Diners were not involved—particularly Amex—then you probably would not complain at all, would you? Or, alternatively, if there were no change on the interchange fee, you would be up and into the same market, would you not?

Mr Mansfield—I think there are too many. It comes back to, I suppose, the fundamental rationale as to why you regulate anything. Most of us have the view—and I am sure the committee does—that regulatory intervention is only required when there is market failure. I still find it hard to identify where there was market failure in the payment system prior to the regulations being in force.

CHAIR—We asked an economist that this morning.

Mr Mansfield—If there is no market failure, there is no prescriptive need for regulation. We have regulation, and the consequences of that regulation are unintended and very hard to predict. Clearly, we have an impact at the top end, with a regulatory arbitrage happening in terms of the charge card products. We also have some regulatory challenges at the bottom end. All the signals that we are getting from the Reserve Bank are that they would like to encourage the Australian community to move to using debit cards or EFTPOS cards, and therefore they have got themselves involved in setting prices for the relative payment products.

Dr EMERSON—It seems that there is a fair bit of predictability in the various submissions that we are receiving today. The merchants say, with hands on hearts, that $580 million has flowed directly to consumers very quickly. A study that you have commissioned says:

... most merchants report ...that they are increasing profits rather than passing the lower costs through to consumers ...

It also says:

> ... despite the lower fees for merchants, the net impact of all the changes appears to have increased consumer prices slightly.

I could have written that submission; it is a bit disappointing when one could write the submissions for the various players. We know where you are coming from. We know that you are on that horse called 'self-interest' and that it is trying really hard. Frankly, it is not necessarily helping us to have polar positions set out where the merchants say that $580 million has gone straight into the pockets of consumers and you guys say: 'That is not right. None of it has and, in fact, these changes have led to them increasing their prices. Consumers have been screwed.' I implore you to help us out by a little bit more than just flogging that horse called 'self-interest'.

Having said that, you asked where there was evidence of market failure. The Reserve Bank this morning gave us a submission which said:

> ... various restrictions imposed by the card schemes on merchants were effectively eliminating or dulling price signals to cardholders.

I think another term for that is 'market failure'. They, as you know, refer to the no-surcharge rule, the honour-all-cards rule and the no-steering rule. Are you saying that they are not signs of anticompetitive behaviour and do not constitute evidence of market failure?

Mr Meagher—We do not believe that they necessarily are. Obviously, you have to take the market in its whole context. For example, if you take something like the honour-all-cards rule, the case that was made by the credit unions is an important one, which is that it is, if you like, a maturing product. The Visa debit product is fairly widespread but is still relatively immature. It tends to be supported by smaller institutions that have less market power. In a sense, we would argue that that rule protects the system and helps it to grow. There may be a point at which the system is sufficiently mature when you would say you do not need that rule anymore.

Similarly, if you take the no-surcharging rule, it may also be the case that in some markets no surcharging is not necessary anymore, because the market is sufficiently mature. We are not sure whether Australia has got to that point or not. These rules all have a purpose, and their purpose, at the end of the day, is to help the system to grow to the benefit of both sides.

Dr EMERSON—It sounds like the old infant industry argument of the 1960s justifying high tariff levels.

Mr Meagher—We certainly would not use it quite like that, but we do see that these rules have a purpose within a very complex system where different parties have quite a lot of market power. Take, for example, protecting small institutions and their small bases. We believe there is some public policy benefit in allowing that sort of thing to happen. We do not see that necessarily as contributing in any way to anticompetitive behaviour or market failure.

Dr EMERSON—But, if you are protecting small institutions against big institutions that sounds to me a bit like the petrol industry, where people say, 'We've got to protect the small independents against the big guys so that the small independents can charge more and stay in the market.'

Mr Meagher—In this case the smaller independents actually charge less and they provide a more personal service, a more direct service, to their customers, and they are valued by their members.

Dr EMERSON—But if there is no market failure—and one example of that is monopolistic behaviour, the exercise of market power over others—then what is the need for the protection?

Mr Meagher—I think the problem is that the market is so complex and there are so many different players that the small ones do actually need to be protected until they get to a point where they can become more self-sustaining and where that product is sufficiently sustaining.

Dr EMERSON—I just do not know any other industry where there is an argument for protecting small guys by big guys, sitting alongside the argument that there is no market failure. If the big guys are able to engage in predatory pricing effectively—now I am talking more generally—such as to keep small players out, that itself is evidence of market failure and therefore an argument for—

CHAIR—Big guys in credit card terms?

Dr EMERSON—Yes.

CHAIR—These are the big guys.

Dr EMERSON—I understand that.

Mr Mansfield—We have spent some time talking about the impact of the smaller institutions on the larger ones. I would also say that, with the honour-all-cards rule, clearly we have had a very successful business for 30 years. We have developed what I believe is one of the more successful joint venture franchises in the world. It delivers wonderful public good across the communities. One thing the honour-all-cards rule does is encourage innovation. We are consistently trying to build new products and services. The guarantee that cardholders have that, if they take their Visa branded product to merchants around the world, they will gain acceptance and utility is a powerful proposition. I think what is often missed in this discussion is the fact that we are running a payment system, as are our competitors, and we are running it on a commercial basis to ensure it delivers value to all parties involved.

You mentioned in the discussion with the prior group the concept of zero interchange. Again, that is clearly something you would expect from the retailers' submission. I would come back to the committee and say: this is not public service here, in the sense that we are providing it at no cost. We have to encourage the lively development and richness of a payment system, because it is what a country needs. If you do not have that, you are going to see the Australian payment system move from what I believe was a world-class system. It was very much world class in the eighties and nineties. We were viewed as leaders in the payment system. We are not seen as that now because there is a disincentive to invest and a disincentive to innovate because there is uncertainty. If the bank moves forward on things like 'honour all cards', there will be further disincentive and dismantling of products that are already quite well utilised by consumers today. So my fear is that, if we continue with further prescriptive legislation and regulation in the coming years, it will further impact on things like investment, protection, protection from fraud, and the encouragement of innovation in the market—and 'honour all cards' is fundamental to that.

Dr EMERSON—You go on to say that maybe the ACCC should be given the job of overseeing this industry, just like it oversees any other industry.

Mr Mansfield—We have had that view all along.

Dr EMERSON—How would that apply? What would be dismantled in the current regulatory regime to get to that point where the ACCC could use its legislation, the Trade Practices Act, and step in and say, 'That is anticompetitive behaviour; we are going to take you on'—getting the Reserve Bank out of it altogether, getting no regulation of interchange fees and so on. Is that right?

Mr Mansfield—As I said in the submission, if we move the responsibility away from the payment systems act to the ACCC to monitor and the Reserve Bank still has a role to play, which is basically to outline certain principles that it wishes the payments system to embrace and move towards, clearly market forces should demonstrate to the ACCC if there is any failure or move that is going in the wrong direction. When this journey first commenced back in 1999, it commenced with the ACCC investigating the issue of interchange and how it was set. As a consequence of the core proceedings between the commission and the National Australia Bank, which we joined, the commission elected to move that responsibility to the bank under the arrangements that were in place. We again believe that bringing it back to the commission where it should rightfully be and allowing them to monitor it and take action under the Trade Practices Act where necessary is the most appropriate mechanism. That has been considered in other countries as well and it does seem to work.

Mr SOMLYAY—Mr Mansfield, Craig Emerson said today that we have got the answers we expected from everybody. You are different in that you are the only ones who have tried to substantiate your view by professional research. I would like you to run us through that research.

Mr Mansfield—I love being put on the spot, Mr Somlyay, thank you. Let me say that, since this journey began, one of the things we have done consistently since 2002, in all of our submissions to the Reserve Bank which are on the public record, is substantiate our views by using external economic research. Interestingly enough—and, again, this will be no surprise to the committee—the majority of things that we suggested and had supported by external economic research have come about. So there are no surprises here as to what has actually happened as a consequence of the regulation. To do it justice and go through all of them, I suggest that we can once again table with this committee much of that economic work that we have done. I think you will find that it actually confirms what has happened in the market. Again, as to Dr Emerson's point, rather than come to the committee and once again run a line of argument that you have heard and seen often, we have made what I believe to be some concrete suggestions as to a way forward. I would rather see a way forward than come back and consistently argue the same points of view. As I said in my opening comments, none of us want to be here in three years time arguing about relative pricing of various payment products in the market. Again, I am very happy to get the right people to come to the committee with the necessary information.

Mr SOMLYAY—I would have thought that, having done the research, the views you have given in your submission have to be more credible than some other views we have heard.

Mr Mansfield—It is kind of you to say that. We believe so.

Mr SOMLYAY—That is why I asked you to run us through the research.

Mr Mansfield—I can go back to a number of our submissions. For example, our submission to the bank in March 2004 went through all of the issues around why we felt that moving forward on designating another payment system was inappropriate. We put into the submission to the committee some NECG research on how the market has responded to the RBA regulations. If you would like us to walk through the executive summary on that, we are happy to do so.

Mr SOMLYAY—Just those dot points that you had in your submission.

CHAIR—We are on your submission, which says:

Research conducted for Visa International in Australia by the Network Economics Consulting Group in 2005 ...

If you do not have the research today—

Mr Meagher—We have the information here. Essentially what we have tried to do at different points is pull together as much of the data that was publicly available as we could. A lot of that is Reserve Bank type data and some of it is produced by groups like Canex that is either proprietary or public record. Where there were gaps, to the extent that we could, we commissioned data and research from different groups, including some specific stuff from Canex and work by UMR at the consumer level and various others. As is stated in our submission, the essential findings that came out of all of that are:

- merchants are paying substantially lower bank fees in relation to the regulated schemes but only marginally lower fees for the unregulated schemes;

CHAIR—We are asking for the evidence you have for that.

Mr Meagher—The evidence for that is from the Reserve Bank’s published data. That will show you that the merchant service fees have fallen pretty much exactly in line with the reduction in the interchange fees, as per the regulations; whereas the merchant service fees that the Reserve Bank publishes in relation to the three-party system have fallen marginally but not anything like the same. When you consider that they started at a higher point, the margin spread between the two has actually got greater. There is now a greater differential in those fees between the regulated and the unregulated schemes.

CHAIR—So that is not necessarily research conducted for Visa International; it is just information drawn out of the Reserve Bank report?

Mr Meagher—It is research conducted and supported by the subsequent data released by the Reserve Bank. This research report in a way pulls together published data and our proprietorial commissioned research.

Mr SOMLYAY—And the next dot point?

Mr Meagher—The next dot point is:

- most merchants report that the reduced fees have either not resulted in a change to their operations or that they are increasing profits rather than passing the lower costs through to consumers.

That was a Canex survey that we had conducted last year.

Mr SOMLYAY—That is the opposite of what the merchants told us today.

Mr Meagher—That is right. That was what was reported when merchants were asked—

CHAIR—Was it qualitative or quantitative?

Mr Meagher—It was qualitative research. It was a survey conducted—

CHAIR—I understand, but what kind of survey was it? Is it survey that you can show to us?

Mr Meagher—I am sure that we can find it for you.

CHAIR—If it is qualitative, was it a group of merchants in various places jawboning about it?

Mr Meagher—I would have to recall the exact methodology. They interviewed merchants and, in order to try to find out what the movements were in merchant service fees, they asked the merchants to pull out their bank statements—and it was actually quite difficult to get a lot of them to do this, particularly the small ones—so that they could report on what was in fact happening in their merchant service fees. They then said, 'In light of this evidence'—when they found that their merchant service fees had gone down—'what have you done about that? Have you reduced your prices?' The majority said no, and a small number said that they had actually increased their prices. Whether that was due to one force or another, it is very hard to tell. Obviously, there were lots of things going on in the market. But what did not emerge was merchants saying that they were reducing their prices.

Mr Mansfield—The three or four most public sources of information on what is happening on the merchant side of the business clearly come from the RBA's tracking, which I think we have all referenced. It clearly says that there has been a shift of about $500 million in reduced merchant service fees. There is the Canex report that we undertook ourselves as a consequence of us wanting to understand what is happening out there in terms of where that $500 million has come from. East and Partners also do research on a regular basis for the industry, and we have attached some of that to our submission. There is also the RBA itself and its ongoing tracking of the merchant service fees. I think the bank would have said to you that an agreement was reached that they would monitor and publish—I believe on a monthly basis—the merchant service fees of the four-party versus the three-party schemes.

Dr EMERSON—But if a business has lowered its costs, it is just completely counterintuitive that, as a consequence of that, it would raise its prices in anything like a competitive market. I think you were saying, Mr Meagher, that there could be other factors that have caused the price rises.

Mr Meagher—Yes.

Dr EMERSON—I do not know that this proves anything. There could be general price increases in the economy.

CHAIR—Fuel costs, for example.

Dr EMERSON—Yes, or a flood in North Queensland affecting banana prices or whatever. It does not actually prove your case that—

Mr Meagher—Our conclusion was not that the world had gone to hell in a hand basket as a result of these reforms. Our conclusion was that you could not demonstrate any positive impact, but you could point to a number of direct negatives for some people—such as cardholders, in particular—whose costs had gone up in various ways and whose benefits and rewards had been reduced. What you could not then show on the other side was that either cardholders or people who purchased by other means had received any benefit. So, at best, you could say, 'We can't tell what the outcome of this has been.' And then, if you go back to Mr Mansfield's point at the outset, if you are going to make a regulatory intervention then presumably you would hope there would be a net public benefit. Our conclusion is just—

Dr EMERSON—But there might be. I am just trying to think of an analogy as a result of a regulatory or deregulatory decision. You could say that unless the price of something went down then it could not be good, but it may be that the price went up by less than it otherwise would have.

Mr Meagher—That is entirely possible. As I said in answer to your point before, we are not trying to say that the world has fallen apart. We are saying that we have quite an intrusive regulatory regime that imposes costs on our business and is very complicated for us and for our members, and that to date we cannot demonstrate to you the benefits. However, we can say—and I think this is one of the things that Bruce would probably like to talk about—that it does put up significant barriers for us in terms of investment in the network. For example, there is not an allowance in the interchange mechanism now for a return on investment in any form. We think that will cause great problems for the system in the future. They are our points.

Dr EMERSON—I understand.

CHAIR—We will now go to the last dot point.

Mr Meagher—It says:

- the regulations have provided American Express ... with a clear competitive advantage ...

And on the next page there are a couple of others. The first says:

- a small but growing number of merchants surcharge ... leading to a further increase in costs ...

That is demonstrated through the East End Partners studies, and I think there are some other studies in the marketplace on that. Consumers do not feel that they have benefited from the regulations. We commissioned our ordinary market research company, UMR Research, to do the research, and they found that consumers certainly do not believe that they have benefited. That is a perception thing, if you like. The next dot point says:

- Despite the lower fees for merchants, the net impact of all changes appears to have increased consumer prices slightly.

We would say that there are a number of reasons for that. They may not necessarily be related to this, and we are not—

CHAIR—That is a pretty dicey one: 'the net impact of all changes appears to have increased'. With quite a number of the other ones you are on stronger ground than you are with that one.

Mr Meagher—Well, we will let you draw that conclusion.

Mr SOMLYAY—I am happy with that, because at least someone is looking at it scientifically. The answer is that no-one knows, but at least you are trying to find out.

Mr Mansfield—I will make one other comment. The committee is fully aware that, when the governor has appeared before this committee on numerous occasions over the last three years, questions have been raised about whether there would be a reduction in consumer prices. I believe that, when we embarked on this journey again, there were suggestions that prices would fall. Our point is that we are all still trying to quantify that and wondering whether it will actually ever happen.

CHAIR—I think Dr Emerson has tried to quantify what it means to the average family, and it is not much.

Dr EMERSON—And that is why, even in the best of circumstances, they would not have noticed something like a dollar a week.

Mr Mansfield—What they have noticed is the significant shift in fees to consumers, to cardholders. Again, I come back to the point that there was an intended consequence of the regulation. The Reserve Bank took the view that they wanted what they believed were hidden costs within the system to be moved across and for it to move to a user-pays principle. We wait anxiously for the next report on bank fees from the Reserve Bank, and once again I am sure it will demonstrate an increase in fees on the consumer side of the business. But, again, I would come back to this committee and say that that was what was intended in the first place.

Mr Meagher—To some extent, in this debate we have not actually looked at the benefits to merchants either. A lot of this debate focuses on consumers paying because they derive the benefit. There is very little discussion about how merchants benefit from the existence of the payment system and why access to relatively cheap, relatively low-risk credit, is good for their businesses. The fact that interchange is about sharing those costs and benefits is lost.

CHAIR—I am surprised that you have not tried to quantify, as the merchants did, what they say the increase in the merchant fee for Amex is costing. They say that the cost has gone up substantially. It is now, I think, $60 million extra.

Mr Mansfield—Over the last week, I have been heartened in reading the submissions on the committee’s website. Various numbers have been quoted. I think we started at $44 million, the retailers put $60 million, and one of my competitors also put a number out. The uniform view is that merchant fees are going up because they are accepting more American Express cards. That is substantiated in all of the submissions you have seen. One thing that I often also ponder about is the issue of relative payment costs, in terms of our payment product versus other forms of payment that merchants are accepting. What is often lost is the fact that it is a very efficient payment system that merchants enjoy significant benefits from.

We are often asked, as I am sure the committee has been asked: what is the cost of accepting cash and cheques? We saw the research that was presented to the Melbourne Business School recently. With all the research we do, I am pleased to say that I think we are on strong grounds in terms of the efficiency of our product versus other payment products but also in terms of the efficiency of our product versus non-electronic payment. What does it cost merchants to accept cash and cheques? This, we believe, is a more efficient way in which consumers and merchants can do business.

Mr CIOBO—Surcharging for cash.

CHAIR—It is perhaps not that crazy.

Mr Mansfield—The cost of cash is an interesting question.

Mr CIOBO—I want to tease out two issues. One is the principles based approach that you outlined. Interestingly, you have come to the committee with a proposal about winding back interchange fees on credit cards. I am interested. You do not go into a lot of detail of what we have in front of the committee. When you say ‘a principles based approach’, does that incorporate ROI, for example? Could you tease that out a little bit further?

Mr Mansfield—Clearly, we have a very prescriptive cost recovery based approach to interchange, which is being regulated. What we are looking for is an approach whereby the industry can have an open and frank dialogue with the bank to identify a range of issues that are important—above cost recovery: to ensure that the network is well balanced, to identify future challenges in terms of investment and to bring in a range in terms of potentially acceptable interchange rates. If those principles were then worked upon and we had dialogue as opposed to regulation, we could come to a conclusion and, as an industry, set interchange effectively. One of my big concerns—and I think it is a uniform concern of everyone involved—is about the need for more investment in the system. Even the government has moved recently in relation to smart cards. They are a great example of that. We are moving from the existing magnetic stripe technology to more robust technology.

Mr CIOBO—This is the second issue I wanted to tease out. I might get onto that in a second. There is regulatory neutrality as well.

Mr Mansfield—A range of things above cost needs to be considered in setting out the principles. In that way, there can be a return on investment, protection of the system going forward and maintenance of the system going forward, so we can all enjoy a healthy and robust payment system.

Mr CIOBO—I take it that regulatory neutrality is crucial.

Mr Mansfield—And regulatory neutrality, of course, is only fair.

Mr CIOBO—Regarding the point that you were just alluding to, I spoke to Dr Lowe this morning and he said that he did not see a strong connection between the regulation of interchange fees and investment in R&D et cetera, in terms of different platforms. In your submission, you say:

Visa International believes that the regulation is also contrary to good policy principles because it dampens incentives to invest by not allowing ... an adequate return on investment.

Could you go into more detail on that—the cost of fraud and those types of things?

Mr Mansfield—Let me focus on that one example, which I think is probably the most illustrative one at the moment. Clearly, we have a business that consistently requires us to stay one step ahead of fraudsters. I am pleased to say that over the years this country has performed very well in relation to fraud mitigation and management. I think we do that well as an industry. We cooperate with law enforcement well and we cooperate with our competitor well, because it is a non-competitive issue to stay one step ahead. Universally, we are seeing a move to chip technology. That involves a significant capital investment. The government is very much aware of that, given its considerations of that. It is an investment of many hundreds of millions of dollars. Our issue is where the majority of the costs lies. Our people are somewhat constrained in terms of their return on investment and return on assets. They are somewhat challenged in terms of getting the capital expenditure of many hundreds of millions of dollars approved, particularly in an environment where there is still further uncertainty as to where interchange is going. The bank has clearly identified its desire to do a review in 2007 and set new interchange rates in 2009 which will include less costs. There has been some discussion as to whether the cost of fraud should be included in the interchange rate going forward. If you take that out, there is the classic question as to how you can invest in fraud reduction techniques and what the appropriate investment in that area is.

Mr CIOBO—Are we in Australia falling behind when it comes to fraud detection and prevention relative to other payment systems overseas?

Mr Mansfield—In overall terms, yes. I think that the banks do a fantastic job on both sides of the business, but I am worried about the weakest link. Clearly, as more and more markets move to chip technology—those of Japan, Korea, Malaysia, Taiwan and Singapore—we will be the weakest link and what we will see will be the migration of fraud and criminals to this country.

Mr CIOBO—It is the path of least resistance.

Mr Mansfield—Yes, it is the path of least resistance. A year ago there were views in the market and industry that an ATM card or a PIN was more secure than a signature, because you could not get someone's PIN. Clearly, we are now seeing ATM compromises in this market where consumers are putting their cards into ATMs and having the magnetic stripe and the PIN compromised and funds have been taken away from their transaction accounts. I have no doubt that the long-term outcome has to be investing in technology to further reduce fraud and increase chip use. I am concerned that having a prescriptive interchange regulation that is going down in terms of its value will stifle that.

CHAIR—As there are no further questions, I thank you very much for coming today to give us your input. Thank you for your input on this and several other occasions.

[4.31 pm]

CLAPHAM, Mr Leigh Brian, Senior Vice-President and General Manager, Australasia, MasterCard International

NAFFAH, Mr Albert, Business Leader, Business Planning and Corporate Affairs, MasterCard International

CHAIR—I welcome representatives of MasterCard to today’s hearing. We have received a written submission to this inquiry from you. Do you wish to make any additional comments or would you like to make an opening statement so we know MasterCard’s view? We have the submission here.

Mr Clapham—Yes, we have a statement. Good afternoon, ladies and gentlemen. We are delighted to have the opportunity to address this committee. At the outset we want to make clear that we do not believe that the Reserve Bank’s regulations have achieved their objectives to create a fair payments environment. Specifically, we believe that the regulations have failed on two fronts. Firstly, they have been demonstrably detrimental to consumers and, secondly, while they may have delivered an immediate financial windfall to some merchants, in the medium to long term merchants may well be worse off. In addition, the regulations have created a bias in the marketplace clearly in favour of the three-party schemes. Because of these reasons, we believe that there is a compelling case for the Reserve Bank to remove price-fixing regulations that apply to credit cards, implement controls on surcharging so that consumers are protected and halt the introduction of regulations relating to debit cards. This will result in consumers paying less for using the payment card they choose to use.

Let us have a look at how the payment system works in this country. In your handout there are two diagrams. One gives a quick snapshot of the four-party system, such as the MasterCard and Visa systems, and the alternative three-party system, which is along the Amex lines. Let us look at how the Amex system works. Traditionally Amex, as the operator of the scheme, is responsible for signing up both cardholders and merchants, setting the prices for both of these end customers as well as developing and delivering other benefits, terms and conditions. The revenue it earns from both cardholders and merchants alike is pooled in one bucket and can be used to create a marketing advantage in an intensely competitive industry. There is no need for an interchange fee in this system, as there is only one bucket—that is, the issuer and acquirer are the same entity. This system in Australia today is unregulated.

Let us now turn to the four-party system diagram in your handout. The four parties are the cardholder, the merchant, the issuing bank and the acquiring bank. The issuing bank and the acquiring bank are licensed customers or members, if you like, of either MasterCard or Visa. In some instances the issuing bank and the acquiring bank are one and the same. However, unlike with the three-party system, the revenues from the merchants and cardholders do not end up in the one bucket. Also, unlike the three-party system, in our system if a merchant decides it is in their commercial interest to accept MasterCard cards, they have a choice of up to 10 banks which will provide them with a merchant facility. But unlike three-party schemes, there is a need for an interchange fee to ensure that costs are properly shared and the system is robust, secure and operates seamlessly.

That brings us to the crux of the matter. The interchange fee facilitates choice of payment preferences—choice for both consumers and businesses alike. It does not matter if you are running the business or buying from the business, choice is critical. There is no question that the four-party system is an important part of the mix—the Reserve Bank has acknowledged this and indeed supported it—but what underpins the success and viability of the four-party system is the interchange fee, and this is under threat. Setting the interchange fee at the right level is a fine balancing act. It cannot be set too low, but also it cannot be set too high as cardholders and merchants will desert in droves, bringing the whole system undone. It is in our best interests, more so than anybody else's, to get the interchange fee right. If it is too low, our cardholders walk; if it is too high, our merchants walk. To operate successfully, we need both.

Nor are we operating in a vacuum; we operate in a vibrant, highly competitive and increasingly informed, questioning and commercial environment. I said at the beginning of this submission that cardholders are demonstrably worse off. On average today, an average cardholder, Jane Smith, pays at least double the annual fee she paid on a MasterCard in 2002. She gets fewer interest-free days and, to add insult to injury, she gets half as many rewards points, which are now capped at an annual level for the first time. These figures I am quoting are from a Roy Morgan survey commissioned for us by Ernst and Young, which I am happy to share with you. It is a quantitative study of 1,000 consumers and 300 merchants, and we have done the study five times in the last three years.

CHAIR—That would be very useful. You can send it to us.

Mr Clapham—In addition, Jane faces paying a surcharge at the till, but without the promised reduction in the general level of prices. It is a key failure of the RBA reforms that any reduction in interchange fees is not passed on to the consumer. Again, from the same study, of the 300 merchants we surveyed, the majority were unaware of reduced merchant service fee pricing. So it is very hard to expect them to be passing on something they do not even know they are getting. In no way is Jane better off today than she was before the Reserve Bank introduced legislation on the interchange fee, unless of course she operates through a three-party system like Amex, and then the tide turns on the merchant. If Jane acquired an Amex card today, on which the annual fee is no higher, and indeed sometimes less, than it was in 2002, she can get twice as many points and a full 55 days interest-free.

CHAIR—Are you sure about the Amex fees? The figure I have seen for the much-touted new card that is being marketed is $400 per annum.

Mr Clapham—There are three cards in the mix. They are all targeted at a different level of the community and they all have a different annual fee. The fee for the premium card is $400, but there are cards at a lesser price.

CHAIR—But with lesser benefits as well?

Mr Clapham—It is still higher than the four-party cards issued by the banks.

CHAIR—But it is not much, is it?

Mr Clapham—It is significant enough for a consumer to notice the difference. So here is the catch: that will end up costing the merchant almost 2½ half times more than accepting a MasterCard. So while the Reserve Bank heralds a $700 million benefit to merchants to demonstrate the success of its regulations—I thought I heard Dr Lowe say this morning that the benefit passed on to merchants is $700 million, but I know that Dr Emerson talked about $580 million; wherever we sit, it is a hell of a lot of money—if the current trend of three-party schemes growing their market share continues, these benefits will eventually erode, and then some. We have already heard that 15 per cent of Woolworths' total merchant service fees go to Amex and Diners Club. In effect, the Reserve Bank has taken from Peter to pay Paul. That is not sustainable, as merchants will end up paying more—and more in the three-party system.

CHAIR—If I can correct you there: unless I remember it incorrectly, I thought they had six per cent of the market but that it had grown 15 per cent.

Mr Clapham—It is six per cent for Amex. I do not know what it is for Diners Club these days.

Mr Clapham—As I understand it, Dhun Karai said that previously six per cent of their merchant service fees were represented by American Express and Diners and now that has moved. Of their total merchant service fees that they pay, 15 per cent is now represented by Amex and Diners—a 150 per cent increase.

CHAIR—That is a very interesting point.

Mr Clapham—More worrying still, perhaps, is the Reserve Bank's preferential treatment of and bias for the three-party scheme. Since the regulations were introduced in 2002, the combined market share of American Express and Diners Club has grown substantially. With merchant fees more than double of the four-party scheme this is only likely to continue, particularly with the three new Qantas cards that have just been released. On a brighter note, however, I can say that MasterCard has always supported the measures implemented by the Reserve Bank, which promote greater transparency and provide for greater access to the credit card industry. Those measures include the use of a cost based formula in the setting of interchange—even though there may be some disagreement in the actual components of the formula—and the establishment of a new type of banking licence in the form of a specialist credit card institution, albeit we have only had one new entrant in three years. In fact, MasterCard has been operating under these sorts of principles for many years, well before the introduction of the regulations.

While we believe abolition of the no-surcharge rule is anticonsumer and exposes our card holders to be gouged, particularly in noncompetitive retail segments, we can live with it if reasonable consumer protections were enshrined into the regulations. MasterCard believes that these protections should include amongst other things a requirement that any surcharge applied by a merchant should not exceed the actual merchant fee and associated costs incurred by that merchant for accepting a credit card payment. In addition, recognition of the costs of other payment instruments, including cash, should also be considered because, after all, cash handling by a merchant is not an exercise free of cost. PricewaterhouseCoopers did measure the cost of cash to be on average 2.3 per cent of a transaction value back in 2002. Perhaps there is a case for surcharging cash payments, which was mentioned earlier.

CHAIR—I would not push that too hard.

Mr Clapham—In terms of regulatory reform, the Australian experience is clear: less not more. Less regulation results in the best outcomes. Australia did not follow the draconian Sarbanes-Oxley laws—a decision that now looks totally justified in retrospect. We all know that by trying to address the shortcomings of the current payment system regulations, introducing another convoluted layer of regulations will only exacerbate the problem. We all know that further regulation of the debit card system will only result in more pain for consumers and merchants alike. By slashing interchange fees on scheme debit cards and not fully recognising the costs associated with issuing such programs, issuers will be forced to charge card holders higher fees for the privilege of accessing their funds while shopping over the internet, over the phone and with more than 24 million merchants. I think the denial of costs related to fraud reduction seem to be counterproductive, particularly in the debit interchange formula that the bank is proposing.

Our solution is simple and one that this government and its predecessor are all too familiar with. While recognising that some of the regulations have added value and benefited the entire community, MasterCard believes that there is a compelling case to preserve the integrity of the current system and deregulate those parts of the payments industry that work against the best interests of card holders and merchants alike. Unfortunately, we have not been flooded with new entrants taking advantage of the praiseworthy amendments to the Banking Act, which have created a new class of ADI in the shape of a specialist credit card institution. Potential SCCIs have acknowledged that the current regulations significantly impact on the profitability of credit card issuers and have ensured that they stay away. MasterCard’s experience from operating in 210 countries and territories tells us the interchange fee regulations have scared away any new entrant that may have been considering the Australian marketplace. The ongoing absence of comprehensive credit reporting also plays a role here, but this is a debate for another time and place.

I think it is also relevant to mention at this point that MasterCard will list on the New York Stock Exchange under the ticker of ‘MA’ in the coming weeks. The listed entity will be 49 per cent owned by institutional investors, 10 per cent by an independent philanthropic MasterCard foundation and the remaining 41 per cent will be non-voting shares and will continue to be held by MasterCard customer banks.

As you will appreciate, this will dramatically change the way that MasterCard is governed and managed globally. Listing on the New York Stock Exchange is not a walk in the park, but satisfying onerous SEC regulations will only make us more disciplined, more transparent and more accountable to the world at large. What it also does is confirm that MasterCard is independent from its financial institution customers from an ownership and governance perspective. That should allay any unfounded concern that any of our practices are collusive or anticompetitive. My colleague Mr Naffah will take us through some points raised by Dr Lowe this morning.

Mr Naffah—We thought it might be appropriate to answer some of the points raised by the Reserve Bank in their submission this morning.

CHAIR—That is good. You are the first to do so.

Mr Naffah—It is the benefit of presenting at the end of the day. Firstly, the Reserve Bank argued that the interchange fees are not subject to normal competitive conditions in Australia or anywhere else in the world and it cited several countries as examples of where regulators have intervened. What the Reserve Bank failed to mention is that interchange fees have not been found to be illegal in any country in the world and proceedings in the countries mentioned are in their preliminary stages. Indeed, the Reserve Bank itself has acknowledged the need for and legality of interchange fees.

Furthermore, as we stated earlier, the setting of the correct level of interchange fees is a delicate commercial process. We have seen that, in many countries throughout the world where interchange fees have been set too high, merchant acceptance is often affected. In Australia, even before the Reserve Bank's intervention, interchange fees were amongst the lowest in the world. MasterCard conducted a number of cost studies in accordance with its methodology employed globally for the last 40 years and each time the studies suggested that the average interchange fee in Australia was either below or at the measured cost. This is the primary reason for the relatively high levels of acceptance in the Australian marketplace and healthy levels of penetration amongst consumers. The fees were at about the right level prior to the regulations.

The Reserve Bank also argued that credit card holders were being subsidised by merchants. However, its own data contradicts this. According to the bank's joint study with the ACCC in 1999, the vast bulk of costs and revenues are incurred at the issuing side of business and not the acquiring side of the business. The credit card system is a network with two different types of end customers. Merchants typically behave in a uniform manner. They offer credit card acceptance in order to attract more customers and grow their sales. The price they pay for a credit card facility largely depends on the size of the business and their particular risk profile.

Cardholders, however, can be very different to each other. Some cardholders choose to use a credit card because they need borrowed funds to pay for a particular requirement that arises at that point in time. Other cardholders are very savvy and take advantage of a short interest-free period, while others like the convenience that a universally accepted payment instrument offers them. They can use the one card to make purchase online, over the phone or face-to-face, either locally or overseas. They get a comprehensive statement every month and then decide how much they pay off and how much they revolve. What is more, they have a choice of at least 200 different offerings from dozens of issuers in Australia alone.

All of these customers are valuable to the issuer, admittedly some more than others. Inevitably, however, because of the varied behaviour these cardholders engage in, some will pay more for their credit card than others. Some may even enjoy a positive price benefit through rewards points. However, the absolute vast majority are paying fees and/or interest for using a credit card that exceed the value of the rewards they may earn. That has always been the case. They do this because they acknowledge the benefits they derive from that card. Therefore, to introduce regulations that require credit card issuers to raise a further $700 million or whatever that number might be from cardholders without any certainty that consumers at large are to receive any benefit is bewildering to us.

Furthermore, the Reserve Bank seems to be taking credit for the introduction of low rate credit cards into the Australian market. A simple glance at overseas markets like the United Kingdom and the United States would have allowed any reasonable observer to understand that the introduction of low rate programs into Australia was simply part of a natural evolution of the payments marketplace. Arguably, interest rates and annual fees could have been even lower today than they would have been had interchange fees not been regulated. The growth of the low rate segment has not been a result of the regulations but, rather, in spite of the regulations. For the Reserve Bank to claim that American Express's ability to offer more generous loyalty programs than those offered by issuers of MasterCard and Visa has nothing to do with interchange fee regulations cannot be left to stand.

The bank supports this claim by the most tenuous of cause-and-effect arguments: that the higher merchant fees charged by American Express allow it to fund richer loyalty programs, and not the other way around. To ignore the proposition that American Express purposely charges higher merchant fees in order to fund a richer loyalty program simply ignores basic commercial reality. Additionally, we believe that not even the most naive of observers would believe that removing $700 million per annum from the system could have no effect on the technological development of the system. Countries across the globe, both more and less sophisticated than ours, have adopted technologies like chip and EMV over the last three to four years, and the United States is quickly adopting contactless payment solutions. One would have to ask whether Australia would also have moved in that direction but for these regulations.

Finally, while we understand the textbook theory promoted by the bank that by reducing a merchants' cost base prices will eventually also fall, I will simply echo the banks' response to MasterCard and industry every time we made a proposition based on our own experiences: please show us the evidence. We cannot allow our consumers to be hit with an additional $700 million in fees every year in the hope that the theory might be true. We increasingly live in a world where we have less and less control of more and more things: fuel prices, interest rates and the cost of other consumables have skyrocketed because of events that we have absolutely no control over. Yet here we have a case where the government and industry have the power to influence how much or how little our consumers and your constituents pay for their payment cards. Let us not leave it to the chance that economic theory may indeed prevail. As we said at the onset, MasterCard does not believe that the Reserve Bank's regulations have achieved their objectives. They have been demonstrably detrimental to consumers and in the medium to long term merchants will also be worse off. The only way forward is to remove the price-fixing regulations that apply to credit cards, implement controls on surcharging so that consumers are protected and put a stay on the introduction of regulations relating to debit cards. We thank you for your time, and we are open to any questions you may have.

CHAIR—Thanks very much. It was fairly hard hitting and obviously had some degree of passion. I hope you return tomorrow and find the return of serve from the Reserve Bank.

Mr Naffah—I am looking forward to it.

CHAIR—Before we move on, it is the wish of the committee that the additional submission by MasterCard of 15 May 2006 be accepted as evidence and authorised for publication, as moved by Mr Somlyay. I will start off with a few short questions and then my colleagues will ask theirs. How much market share have you people lost since the changes by the Reserve Bank?

Mr Clapham—During the 2½-year period, we have increased our market share in comparison to Visa and remained about the same with American Express.

CHAIR—Okay, so it has not been all bad as far as you are concerned?

Mr Clapham—We would argue that commercial arrangements with some of our financial institutions have driven that, as has the fact that we have been prominent in the launch of a number of low-rate cards which have been quite successful.

CHAIR—That has been mainly four-party cards?

Mr Clapham—They have all been four-party cards.

CHAIR—Right. While you have mainly taken a deregulationist approach, in your submission you said that some of the regulations have assisted you. Would you say that accepting more cards was acceptable to you? And what about the streaming issue? Or were there other regulations that you supported?

Mr Clapham—I think we have broadly supported the majority of the reforms—

CHAIR—But not surcharging, is that right; or surcharging with a cap?

Mr Clapham—Surcharging with a cap. We are disappointed with some merchants' behaviour in the surcharging space, where they do have market power. Particularly in—

CHAIR—Is that large merchants?

Mr Clapham—Yes, I mean large merchants, where they had a business that was taking payments online and there was always going to be a credit card payment in that space. I am not naive enough to believe that they did not build in cost of card acceptance while pricing that product, but now we find that they are surcharging the previous amount. So there has got to be some evidence in that, that they are taking advantage of the situation.

Dr EMERSON—To be even-handed, I will make the same comments in relation to MasterCard as I did in relation to Visa and the other players in the industry. I think your arguments happily coincide with your self-interest. I do not mean to be nasty about it, but I do not hear any of the industry players saying, 'Despite our self-interest, this is the position that we hold.' I will give an example of that. It seems to me that in the presentation you have just given and in your response to the Reserve Bank you asserted that the credit card industry is competitive but that the merchant industry, namely the retail industry, is not. You said that the merchants will not pass on the benefits of those cost reductions but that you operate in a very competitive industry, and I do not see any evidence of that. I am not saying your industry is not competitive at all—I am not asserting that—but I do not know how you arrive at those conclusions.

Mr Clapham—I thought we were calling for greater transparency—some form of measuring how the $580 million or the $700 million is passed on.

Dr EMERSON—We had that discussion a while ago and it is very difficult to control for cyclones in North Queensland and petrol price rises. If the proposition is that this cannot be any good unless it is measured, then I do not think that that holds water and I do not believe that there is any evidence that the retailing industry in Australia is uncompetitive. If it were, then the ACCC would be in there like a rat up a drainpipe, and so I am arguing that the price reduction should be passed on.

Mr Clapham—If there was an impression that we were claiming that is was uncompetitive, that is certainly not the case and not our belief. Our desire is to find out what happened with the $580 million. To quote you earlier: the $580 million 'bobs up somewhere'—your exact words. It is not good enough for $580 million to $700 million just to bob up somewhere in the system when it has been taken from our issuing banks and we believe that there is a legitimate case for them to recover their costs. It is often referred to as revenue. We are adamant that it is not revenue; it is cost recovery. All the services that the issuing bank provides to the cardholders and the merchants in the four-party scheme are about cost recovery. If you do not recover all your costs, then it is very difficult to invest in the business.

Dr EMERSON—That sounds like an industry argument. It sounds like: 'We need some sort of protection so that we can use the rents to invest or reinvest in the industry.'

Mr Clapham—Do you know what it is? It is actually an argument about an industry that was performing adequately in interchange in the first instance. At 95 basis points, that had come down several basis points over the last few years with the movement towards a higher percentage of electronic payments. We all know that payments are moving towards being electronic. Electronic transactions at that time, in 2001 and 2002, were at 80 basis points, as that percentage was moving higher. There were calls earlier: 'Why wasn't interchange going down?' It was going down. If anybody is uncertain of that, let me make that case now. Interchange was declining as there was an increase in electronic payments and moving towards a payment of 80 basis points.

Mr CIOBO—Do you have evidence of that? The assertion has been made that this market does not operate like any other market and that competition forces the prices up.

CHAIR—We would be interested in the historical data you have on that.

Dr EMERSON—I thought you said during your oral presentation that you supported a cost based formula.

Mr Clapham—We do, and I made the point that our issue is: what are the component parts of the cost based formula?

Dr EMERSON—But, if it is a competitive industry, wouldn't you be better off not having that sort of regulation at all? I am arguing the pro-competitive case. If you assert that it is a competitive industry, if you assert that you believe in less not more regulation, wouldn't you be better off saying: 'We don't want any cost based formula. We'll just compete in the marketplace and, if we're doing the wrong thing, the ACCC will come and get us'?

Mr Clapham—The reality is that we actually support a cost based formula globally. So, in every market of the world, we measure the costs of issuing MasterCard cards and, in most of those markets, that is the basis upon which the interchange fee is set.

Mr Naffah—I can provide a bit of background to that. I think you have to remember that our end customers are not just cardholders; they are the merchants as well. We owe it to them to explain to them how we come about our decisions, including things like interchange fees. In the best world model, you would be right: the market would dictate the interchange fee. In order to create some transparency there and help people understand how we come about our interchange fee, we look at what our business had evolved from 40 years ago. Our four-party system evolved from the three-party system, like Amex and Diners, and that had evolved from the store card model. Stores at the time, when they created their own cards, had certain costs that they incurred as a minimum in order to offer their customers a particular service. And they acknowledge the benefit of that in the stores by incurring those costs. So we have taken some of those costs as a minimum and said: 'Okay, merchants. You would be happy to pay these because you would be paying them anyway—and probably more—if you were to offer your own store card model, but we will give it to you at a discount, given the global scale we have and the greater number of cardholders.' So it is a proxy for what really should be a market determined transfer price.

Mr Clapham—We certainly are not paying the Reserve Bank lip service in that formulaic approach; we actually do believe in it. We would just like to argue some of the components. You also mentioned that our presentation was somewhat self-serving. I would like to think that we very much have the consumer at heart. In fact, I take the ACA to task over their belief that things are working. Speaking as a consumer in Australia, the problems are the fact that seven per cent of merchants are surcharging my transactions, the fact that my overall annual fees have increased, the fact that there is no real evidence of lower prices, the fact that there are dramatically fewer rewards for credit card holders—and this is not a small segment; 1½ to two million Australians are being impacted by this—and the fact that there is no evidence of greater competition. This is in an environment where—if the ACA needs evidence that people do want credit cards—we currently have 8½ per cent growth of new accounts in Australia, which is the highest growth rate in 13 years, which has largely been driven by the increase in American Express issuing credit cards and the conversion of store cards into scheme branded cards. I am not certain how the ACA can say that these reforms have been beneficial to the consumer when everything seems to be going against them.

Dr EMERSON—I thought that this was a very slow rate of growth, according to the Reserve Bank this morning.

Mr Clapham—Expenditure on the cards is at a slower rate of growth. It is slowing quite quickly. Growth in account numbers—people wanting a credit card in their wallet—is the highest growth rate in 13 years.

Dr EMERSON—By the way, it looks like that $700 million—we did hear that it was $540 million—

Mr SOMLYAY—$500 million per annum.

Dr EMERSON—It was $540 million, I think. Anyway, we can clarify that later. The point is that spending on credit cards over the year to February was around eight per cent higher than the previous year and around the slowest since the Reserve Bank started collecting data. You are talking about—

Mr Clapham—So we have a dichotomy. We have the accounts growing at the fastest rate in 13 years and we have expenditure growth at the lowest level in 15 years.

Mr CIOBO—Perhaps it is unsurprising that your position is similar to Visa's with respect to a principle based or some kind of formulaic framework on interchange pricing. I am interested in your comments in response—and I assume they are going to be similar as well—to return on investment and the encouragement or incentive to invest in more robust technologies and new platforms.

Mr Clapham—We are very fortunate because we are a global business, and the majority of the investment that is going to benefit this market is probably taking place in North America or Europe, as we speak. In fact, we are currently in test market with the Commonwealth Bank for a new contactless payment product, called MasterCard PayPass, which is at the cutting edge of what is happening in the Northern Hemisphere. So, from that point of view, I think we are hugely benefited. If we had to drive it ourselves here, it would be incredibly difficult to justify the investment in developing that technology.

Mr CIOBO—Is that a PIN based system or is it signature based?

Mr Clapham—It is contactless without a signature up to $35.

Mr CIOBO—That is what I thought. But it is not PIN based, is it?

Mr Clapham—No, it is not PIN based.

Mr CIOBO—Why is that? You probably do not want to go into it, but—

Mr Naffah—It can be. Below $35 is for convenience. There is low risk, it is a small value and it provides speed for both the merchant and the card holder. PayPass can be chip as well and you can have PIN—

Mr CIOBO—Is it PIN based in Europe or North America?

Mr Clapham—I believe in the market it is being tested in it is chip based and I think it is PIN. In North America they do not have chip, so it is a signature based produced and for over $35 you still sign.

Mr CIOBO—As I understand, our platforms do not allow for PIN based credit card systems here. Is that right?

Mr Clapham—That is correct.

Mr CIOBO—Is that part of the reason that you are not adopting a PIN based system?

Mr Clapham—That is entirely the reason.

Mr CIOBO—Do you have any comments on some of the other proposed reforms with respect to EFTPOS and the regulation of ATM fees? Do you have any views on that?

Mr Naffah—Not really on ATM fees. With EFTPOS, we think there are some basic principles along the lines of what Visa were saying on how interchange should be determined and how that sometimes may result in a negative interchange fee or a positive interchange fee depending on the dynamics of the market. We believe there is still not a strong case in this market for a negative interchange fee for a retail based payment card network. That is based on the costs associated but also the basic economic state. There is incredible competition within the payments market. We define the payments market—and it has been upheld by courts around the world—as not only cards or credit cards but also cheques, direct entry, cash and basically any payments instrument. When you look at it like that, our share is very small and we are competing very strongly to grow that share. Therefore, the card holder needs to be encouraged to use that card. Imposing a fee on their bank really does not achieve that purpose.

Mr CIOBO—Do you have a view on whether the honour-all-cards rule should remain or be abolished?

Mr Naffah—With the honour-all-cards rule, again, I think in this market scheme, debit is in its infancy. For MasterCard, we partnered with BankWest late last year to launch the first MasterCard debit card in Australia—though we do have many throughout the world. Our fear is that, if the honour-all-cards rule were removed, it would potentially impact on our cardholders in the sense that their card would just not be accepted, in favour of credit cards.

Unfortunately, EFTPOS is not at the level of acceptance that credit cards are or scheme debit cards are. As people have commented throughout today, it is not accepted online and there is very limited acceptance overseas. So the real alternative is credit cards. If the government and the Reserve Bank and issuers are happy for people to offer a credit card instead of a debit card when in fact a debit card might be more appropriate, you could do away with the honour-all-cards rule. But I do not think that is the objective of this community at the moment.

Mr CIOBO—I have one final question. Back on the signature and PIN based systems, obviously PIN based fraud is significantly lower than signature based fraud. Are you basically just pricing in the cost of fraud on signature based systems, such as the rollout of this new technology?

Mr Clapham—Obviously whatever the fraud levels are at the moment they are included in the interchange formula. So it is priced in there. If there is a move that diminishes the level of fraud in Australia, at the moment all the merchants will benefit with a lower interchange fee.

Mr Naffah—About four years ago there was a fully-fledged project across all brands in all banks to bring PIN to credit card transactions at point of sale. Because of the uncertainty at the time with the regulatory environment and the significance in the investment required to bring that, the industry—not the schemes but really the issuers and acquirers—decided that, because of that uncertainty, they would put that on hold. That has not been re-established—

Mr CIOBO—So, effectively, when it comes to fraud, we are getting the rollout of a substandard payments platform because there is not an adequate return on investment to warrant the rollout of a better system? Did I hear that correctly?

Mr Clapham—But the reality is that fraud has not increased dramatically here.

Mr CIOBO—What about arguments that show that it is the path of least resistance? I have heard from a number of people that, if markets all around us are going to PIN based systems with much tighter fraud control and Australia remains in South-East Asia as the sore thumb, that will attract organised crime et cetera.

Mr Clapham—That is a very reasonable concern. A lot of the Malaysian fraud has moved to Spain—of all places—because they were vulnerable. We would consider ourselves vulnerable here.

Mr CIOBO—So is there a link back to investment?

Mr Clapham—Yes.

CHAIR—The Australian Merchant Payments Forum advocated a zero interchange fee across the board. What would your view be on the imposition of a zero interchange fee?

Mr Clapham—I do not believe it respects the investment that has gone into building the network both domestically and globally by MasterCard and our customers. So I think it is highly inappropriate.

Mr Naffah—Also, I do not think it recognises the benefit that merchants receive from card based payments. The whole purpose of the interchange fee is to share the costs.

CHAIR—I am interested in the survey that you have done. Obviously the points you made with respect to whether the consumer is better off in terms of the additional costs that are allocated—the seven per cent surcharge, the additional costs of the card and benefits being reduced et cetera. You have not attempted to quantify all of that, have you?

Mr Clapham—In terms of how much it might be costing—

CHAIR—The bottom line—the net benefit. I presume that, because you cannot prove the bottom line in terms of the lowering of costs to the consumer in the goods they buy, the net cost is going to be greater.

Mr Clapham—We believe so.

CHAIR—Some objective basis to measure that would be useful.

Mr Clapham—We could have a go. It is possible but there will be some hypotheses in it.

CHAIR—In terms of the regulations, do you accept the honour-all-cards rule, the surcharging with the cap on it and the streaming?

Mr Clapham—Yes.

CHAIR—Thank you, gentlemen, for appearing before the committee.

Resolved (on motion by **Mr Somlyay**):

That this committee authorises publication, including publication on the parliamentary database, of the transcript of the evidence given before it at public hearing this day.

Committee adjourned at 5.13 pm