SUBMISSION 12

Dr Ric Simes' opening remarks to the House of Representatives Standing Committee on Economics, Finance and Public Administration's hearings into the Payments System.

NSW Parliament House, Sydney 15 May 2006

My training is as an economist. I have worked in the Commonwealth Treasury, academia, the previous Prime Minister's office and the financial markets. Most recently, I have been working as an economic consultant with one of my areas of specialisation being aspects of the financial sector including the payments system.

As a consultant, I have worked on the payments system for Visa International and on related matters for the ABA, FICA and APCA. I have also co-authored papers at academic conferences with Professor Ian Harper from the Melbourne Business School, Craig Malam from CRAI and Annette Lancy from Access Economics. I've provided the Committee with copies of the two conference papers.

I 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 System conference at the Melbourne Business School on the relative costs and benefits of different retail payments 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 limited barriers to entry. However, it has gone further than this.

The most contentious element of its regulations has been its imposition of cost-based Interchange Standards. This is a quite interventionist form of regulation and one that should only be contemplated if there is strong evidence of there being a problem with what the market-place left to its own devices would deliver *and* that the intervention will produce a better outcome.

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 efficiency considerations arising from the two-sided nature of payments networks. These efficiency considerations are potentially important to the design of good regulation. 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 pragmatic grounds? The first one is quite artificial, namely the payments system legislation requires that, for there to be direct 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 might be assessed as an optimal level for 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 as a whole.

So, for our paper, we have set the considerations associated with the two-sided network effects to one side – as I've said, they should be considered in any full assessment – 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 transactions purposes exceed those of other payment instruments, and especially those associated with EFTPOS;
- that net benefits to consumers from using credit cards for transactions exceed those from using other instruments; and
- that the net costs to merchants from accepting credit cards exceed those from accepting EFTPOS.

That is, consumers have an incentive to use what is viewed as a costly instrument, namely credit cards, while merchants mightn't like this but don't have the bargaining power not to accept credit cards.

Now, credit cards and EFTPOS are far from being perfect substitutes – they are both elements of separate bundles of financial services and have different costs and benefits. The paper focuses primarily on a narrow situation where they would seem to be relatively close substitutes, namely for face-to-face transactions at retail outlets that accept both instruments. And, in the spirit of the regulations, we focus solely on the function of the cards as payments instruments, not the credit role.

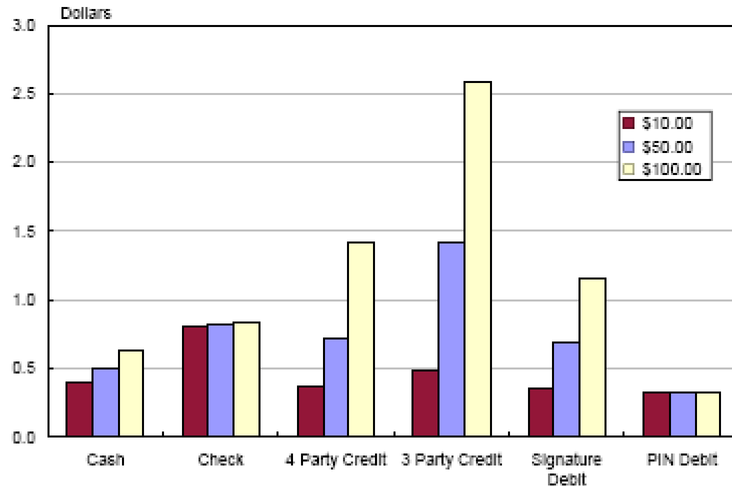
We've also only looked at costs and benefits *at the margin* i.e. what are the net costs and benefits to different parties of a customer using a particular instrument for the incremental transaction with all overhead costs taken as given. The costs and benefits included cover such things as bank charges, the time it takes consumers and merchants to transaction a payment, processing costs, seigniorage, etc. Some of these costs are transfers between two parties, some represent costs or benefits to society overall.

I should stress that there is considerable variation in the costs and benefits for individual consumers and merchants, and that the estimates require a lot of simplifying assumptions. We view the estimates as providing a broad indication of the relevant costs and benefits and trust that the estimates will be refined over time.

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.

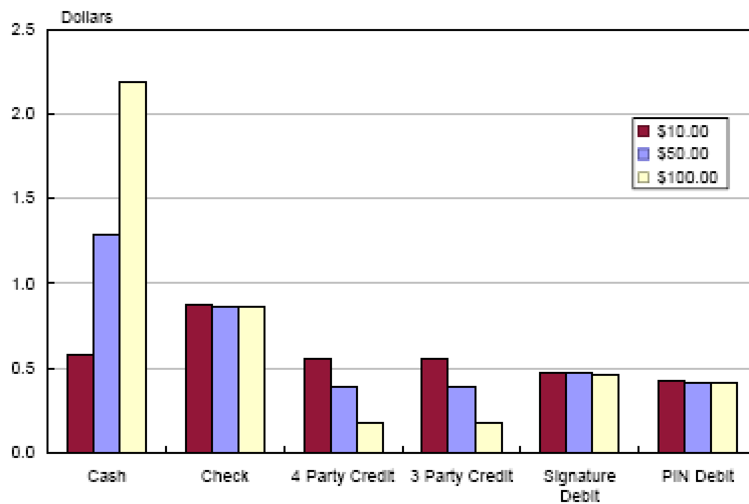
The first chart shows that, for a merchant that has EFTPOS and credit card capability, there is little difference in the net costs they face for small denomination transactions but as the transaction size increases, so too does the cost of using credit cards relative to EFTPOS. The chart shows the net marginal costs to merchants for different instruments for $10, $50 and $100 transactions.

CHART 1: NET COSTS TO MERCHANTS BY TRANSACTION SIZE



The second chart 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, to a lesser extent, 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 growing strongly in the economy.

CHART 3: COSTS AND BENEFITS TO CONSUMERS BY TRANSACTION SIZE

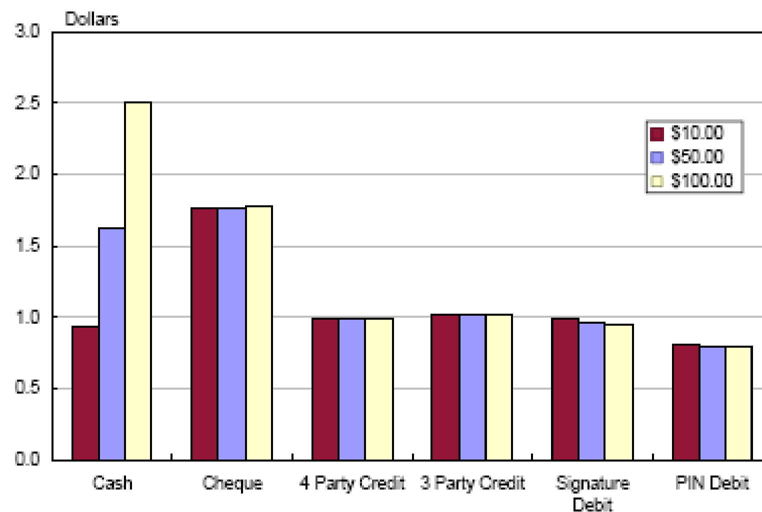


It is the final issue – namely, whether credit cards are a more resource intensive form of making a payment than EFTPOS – is where the RBA's position is weakest. Recall that we are talking about the costs and benefits of the incremental purchase and ignoring any distributional issues.

So, we are talking about additional telecommunication costs, or processing costs, etc – intuitively, any differences would seem to be small. On the material we present here, there is little difference in the marginal costs of using credit cards or EFTPOS, and the differences relate to (i) a small difference in the time it takes at the check out

to conduct a transaction using a pin vs a signature, and (ii) minor differences in processing costs.

CHART4: NET SOCIAL COSTS BY TRANSACTION SIZE



The differences in this chart – especially given the uncertainties involved, and given the fact that they ignore the network benefits of cards – would not seem to warrant intervention in the market place.

This analysis may seem to be rather narrow. It may be argued that other aspects of credit cards are costly. This could take one of two forms:

(1) At least some consumers build up credit card debts that need to be serviced.

(2) There is an additional infrastructure on the back of the infrastructure in place in financial institutions that needs to be supported.

I'd like to finish my opening remarks by commenting on both these issues.

The RBA is *not* regulating in order to influence debt levels, but this, it seems to me, does affect the broader environment in which the issues are being debated. To my mind, we can debate whether household debt levels represent a problem that deserve an explicit policy response but, given the benefits that credit cards have provided as a flexible form of credit for many often low and middle income households, I doubt that constraining the use of credit cards would represent good policy.

Finally, there is separate infrastructure associated with the card networks. As noted above, the instruments are not close substitutes for many purposes. The estimates I've discussed here will tend to favour EFTPOS since they do not capture the wider range of benefits and uses of both cash and the card networks:

- Cash is a convenient form of payment for many purposes beyond the medium-sized purchases reviewed here, notably for low value purchases from virtually all retail businesses, no matter what their size.

- Similarly, the card company networks 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, and purchases made when travelling overseas.

In addition, the roll-out of the credit and signature debit card networks has facilitated wider economic benefits by assisting innovation and competition in the retail sector throughout the economy. For example:

- Large retail chains offered customers their own store cards to strengthen store loyalty. The card networks have helped smaller retailers to compete with the larger chains by effectively providing a substitute for in-store credit cards.

- Credit and signature debit cards have been instrumental in the growth in purchases over the Internet or phone. While other solutions to transact such purchases are possible, the card networks have proved to be the most reliable and effective means of supporting on-line retail activity to date, a fact that is unlikely to change in the next wave of growth in on-line retailing.

The fact that the various payments instruments are not close substitutes across their full range of uses 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 do for EFTPOS through their transactions accounts.

The question then arises as to the circumstances under which direct intervention in pricing mechanisms might be warranted. Our paper confirms 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 social costs for using credit cards tend to be similar to those for EFTPOS and lower that paper-based instruments; and

- that merchants to cap any impact on their marginal decisions should they find one instrument being used excessively from their perspective by surcharging and refusing to accept particular instruments,

the case for basing regulation 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 their businesses is not harmed.