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Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005 (First Report)

House of Representatives
Standing Committee on Economics, Finance and Public Administration

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Chairman's foreword

Two areas of economic importance to almost all Australians are monetary policy and the payments system. The Reserve Bank of Australia (RBA) plays a central role in both of these areas—for monetary policy through the Reserve Bank Board, and for the payments system through the Payments System Board (PSB).

The payments system, in particular, has been an area of contention in recent times. The RBA has pursued what some have termed an 'aggressive' reform agenda, with the consequences of those reforms subject to considerable debate.

Conversely, monetary policy has been relatively stable when compared with some of the more turbulent periods in Australia's history. Notwithstanding this, the RBA has lifted the cash rate by 25 basis points twice in the past eighteen months, which, in combination with record petrol prices, has caused some level of community concern.

The committee's February 2006 public hearing with the RBA was the third for the 41st Parliament. Once again, the committee had the opportunity to discuss some of the key monetary policy issues in this important public forum. Overall, the RBA reported that the Australian Economy, which is now in its fifteenth consecutive year of growth, is in a strong position. The RBA attributed Australia's continued growth to 'well above average' growth in the world economy and the emergence of China as an economic superpower.

While describing Australia's economic growth as 'impressive', the RBA did raise some concerns looking forward. In particular, it noted a 'large' current account deficit despite favourable export prices and terms of trade, increasing levels of household debt, and capacity constraints—reoccurring themes from the hearings in 2005.

In terms of interest rates, the RBA noted a number of factors which could put upward pressure on inflation: a high level of capacity utilisation, the tight labour market, and large increases in the cost for some raw materials. In May, interest rates were raised by 25 basis points in response to the realisation of some of these inflationary pressures.

Unlike previous RBA inquiries, this inquiry also included an extensive investigation of the payments system, with a particular focus on the RBA's recent and proposed reforms. The committee found, as has been evident in the media, there is a wide range of views on these reforms. The most contentious of these issues is undoubtedly the reduction of credit card interchange fees. On the one hand, the RBA argues that its reduction of these fees will result in cardholders facing truer price signals when using their cards, while also saving merchants and ultimately consumers millions of dollars each year.

Conversely, the two largest card schemes, Visa and MasterCard, among others, argue that there is no evidence of savings being passed through to consumers. They also argue that their competitors, the three-party schemes American Express and Diners Club, have been unfairly advantaged by the reforms.

The committee is not wholly convinced by either perspective with regard to credit card interchange fees. While there is no empirical evidence that savings have reached consumers, equally, there is no evidence they have not. Further, in competitive markets it seems illogical to suggest that lower costs for merchants do not result in lower prices for consumers. The committee concluded that the benefits of the reform, at this point, outweigh any alleged disadvantages.

Some other reform areas which the committee investigated included the lowering of EFTPOS and scheme debit interchange fees, the removal of the 'honour all cards' rule and the removal of the 'no surcharge' rule. Generally speaking, the committee found the RBA's rationale for these reforms reasonably sound.

One area of concern for the committee is Australia's evident shortfall in payments system technology. While we were once considered to be a world leader in this area, there was consensus during the hearings that we have now fallen behind. To remedy this concern, the committee recommend that those involved in the industry implement, or consider implementing in one case, a number of innovations, namely: PIN authorisations for credit cards, online functionalities for EFTPOS cards and chip technology for all cards.

On behalf of the committee I would like to thank all those who participated in this inquiry. In particular, I would like to thank the Governor of the RBA, Mr Ian McFarlane, and his staff who were, as always, forthright and helpful throughout this inquiry process.

The Hon Bruce Baird MP
Chair

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Deputy Chair	Dr Craig Emerson MP	
Members	Mr Steven Ciobo MP	Mr Stewart McArthur MP
	Mr Joel Fitzgibbon MP	Mr Patrick Secker MP
	Ms Sharon Grierson MP	The Hon Alex Somlyay MP
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Committee Secretariat

Secretary	Mr Stephen Boyd
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Adviser	Mr David Richardson Parliamentary Library
Administrative Officers	Ms Natasha Petrovic
	Mr Cameron Carlile

Terms of reference

The House of Representatives Standing Committee on Economics, Finance and Public Administration is empowered to inquire into, and report on the annual reports of government departments and authorities tabled in the House that stand referred to the Committee for any inquiry the Committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the Committee.

At its meeting on 8 December 2005, the Committee resolved that it would conduct an inquiry into the Reserve Bank of Australia Annual Report 2005. On 13 March 2006, the Committee resolved that it would conduct an inquiry into the Payments System Board Annual Report 2005.

List of abbreviations

ABA	Australian Bankers' Association
ACA	Australian Consumers' Association
ACCC	Australian Competition and Consumer Commission
AMPF	Australian Merchants Payments Forum
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ATM	Automated Teller Machines
CAD	Current Account Deficit
CPI	Consumer Price Index
CUIA	Credit Union Industry Association
EMV	Europay, MasterCard and Visa
GDP	Gross Domestic Product
MIF	Multilateral Interchange Fees
PIN	Personal Identification Number
PSB	Payments System Board
RBA	Reserve Bank of Australia

Recommendation

4 The payments system—reforms and other matters

Recommendation 1

The committee recommends that card schemes, issuers, acquirers and merchants work together to improve Australia's payments system technology. In particular, the committee recommends that this partnership:

- Implements PIN-based authorisations for credit cards;
- Implements 'online' functionality for EFTPOS cards; and
- Considers the widespread adoption of chip technology.

1

Introduction

Background

1.1 The House of Representatives Standing Committee on Economics, Finance and Public Administration (the committee) is responsible for scrutinising the Reserve Bank of Australia (RBA) and for ensuring its transparency and accountability to the Parliament, the community, and the financial sector.

1.2 The RBA Governor's appearances before the committee at biannual public hearings are an important element of the Bank's accountability framework. The details of this framework are set out in the July 2003 Second *Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Peter Costello, MP, and the RBA Governor, Mr Ian Macfarlane. The statement provides for the RBA's accountability framework and formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix D, states:

> The Governor has also indicated that he plans to continue to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration. The Treasurer expresses support for these arrangements, which ensure the continued transparency and accountability of the Reserve Bank's conduct of monetary policy—and therefore the credibility of policy itself.[1]

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1 RBA, *Second Statement of Monetary Policy*, July 2003.

1.3 A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. Accordingly, the committee may inquire into aspects of the annual reports of the RBA and the Bank's Payments System Board.

1.4 The biannual hearings coincide with the release of one of the RBA's quarterly statement on monetary policy. At the February 2006 hearing in Canberra, the committee scrutinised the RBA's *Statement on Monetary Policy* released on 13 February 2006.

Scope and conduct of the review

1.5 In the 41st parliament the third public hearing of the committee with the RBA was held in Canberra on 17 February 2006.

1.6 The proceedings of the Canberra hearing were streamed over the internet through the Parliament's website, allowing interested parties to hear and see the proceedings as they occurred. The Governor's opening statement was taken as a submission and the transcript of the hearing is available through the committee's website.[2]

1.7 Before the hearing, the committee received a private briefing from Mr Alex Erskine of Erskinomics. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing.

1.8 The Canberra hearing was well attended by members of the public and students from secondary schools.

1.9 The public hearings with the RBA continue to bring issues of monetary policy into the public arena, and also have assisted in providing a public face to parliamentary committees and the RBA. The committee welcomes the Governor's frank and open comments at the hearing. In addition, the hearing is an important means whereby financial markets can be better informed on the current thinking of the RBA.

1.10 As with previous committee reports, this report focuses on matters raised at the public hearing. The report does not repeat the detail in the *Statement on Monetary Policy*, the RBA's annual report or proceedings of the public

2 See:< http://www.aph.gov.au/house/committee/efpa/RBA2003_04/index.htm>

hearing. These documents may be viewed through the RBA's website[3] or on the committee's website[4].

Review of the Payments System Board Annual Report 2005

1.11 In addition to scrutinising the RBA on monetary policy, the committee also examined aspects of the payments system through its scrutiny of the Payments System Board Annual Report 2005. The committee conducted public hearings on 15 and 16 May in Sydney and on 17 June 2006 in Canberra as part of its review. Chapters 3 and 4 discuss the payments system and the findings and recommendations arising from the examination.

1.12 Information about the review and the dates of the public hearings were advertised in the *Australian* on 19 April and 3 May 2006.

1.13 The Payments System Board (PSB), established in 1998, is responsible for promoting efficiency, competition and stability in the Australian payments system. The Board has focused on the promotion of price signals which encourage efficient payment choices. One of the key aspects of this is the regulation of interchange fees. A second objective of the PSB is the removal of restrictions in the payments system that effectively limits entry and stifles competition.

1.14 In addressing these issues, the RBA has undertaken a number of studies and sought public comment on reform of the credit card system, the EFTPOS system, the Visa Debit System and the ATM system. The committee, through its public hearings, examined the RBA on progress with its reforms, and sought comment from key stakeholders including card providers, banks, consumer groups, academics and individuals with an interest in the matter.

Next public hearing with the RBA

1.15 The committee will conduct the next public hearing with the RBA on Friday, 18 August 2006 in Sydney. More details about the hearing will be circulated in the weeks leading up to the hearing.

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3 See: <www.rba.gov.au>

4 See:< http://www.aph.gov.au/house/committee/efpa/index.htm>

2

Monetary policy and other issues

Overview of 2005

2.1 The RBA noted that 'growth in world GDP is estimated to have been well above average in 2005, and most observers expect this to continue in 2006.'[1] This has provided a favourable background for the Australian economy. In particular, the RBA noted that 'notwithstanding the inevitable short-term fluctuations in growth, the Australian economy over recent years has been more stable than most, and is now in its fifteenth year of expansion.'[2]

2.2 The unemployment rate has declined from a peak of around 11 per cent in 1993 'to a current level of just over 5 per cent, which is around its lowest since the 1970s.'[3]

2.3 The buoyant conditions in world financial markets are attributed to strong economic growth, low inflation and low interest rates. The RBA noted that central banks in the major economies, with the exception of Japan, have 'begun normalising official interest rates from the unusually low levels they reached in the early part of the decade.'[4]

2.4 Strong global expansion has led to an increase in commodity prices which has resulted in 'sharp rises in the prices of coal, iron ore and a wide range of other minerals.'[5] The RBA noted that this 'has contributed to a

1 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

2 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

3 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

4 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

5 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

substantial lift in Australia's terms of trade, which have increased by around 30 per cent over the past three years, their largest cumulative increase since the 1970s.'[6]

2.5 The rise in the terms of trade has contributed to a highly stimulatory environment for the business sector. The RBA reported that 'business investment is now undergoing a major upswing, having expanded by 18 per cent over the past year and at an average annual rate of 14 per cent over the past three years.'[7] This pattern is in contrast to household expenditure. The RBA stated:

> …households have moderated the growth of their spending in the past year or two. Previously, households had been expanding their borrowing and spending at rates that could not be sustained, but they now appear to have entered a period of financial adjustments. They are still increasing their levels of debt, but are doing so at a slower pace than they were a couple of years ago. Another moderating influence on the growth of household spending has been the mild downturn in the housing construction cycle.[8]

2.6 The RBA noted that while the growth in the economy was favourable there were concerns about its composition. The RBA Governor commented that 'the growth of the economy over the past few years has been more than fully accounted for by growth in domestic spending, while Australia's export performance has been disappointing.'[9] As a result, 'Australia's current account deficit has remained relatively high, at around 6 per cent of GDP in recent quarters.'[10] The RBA concluded that 'with substantial investment in the resources sector and in related infrastructure projects currently underway, it is likely that export volume growth will pick up, though the expected improvement has been slow to eventuate.'[11]

Forecasts for 2006

2.7 The RBA stated that 'global economic conditions are continuing to provide a favourable environment for the Australian economy.'[12] The RBA Governor, Mr Macfarlane, reported that 'with strong investment growth

6 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

7 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

8 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 2.

9 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

10 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 2.

11 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 2.

12 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

and an expected improvement in exports, our forecast for the economy overall is that annual GDP growth will pick up modestly during 2006 to about 3.25 per cent.'[13] Mr Macfarlane noted that 'given the maturity of the expansion it should not be surprising if the average growth of the economy is now less than it was in the earliest stages.'[14] Mr Macfarlane stated:

> As a general principle, it is easier for an economy to grow quickly when there is a large pool of unused resources to be re-employed. In Australia's current position in the cycle, that source of growth is now much more limited. So, in the absence of a significant lift in trend productivity, **we should expect to see GDP growth rates mainly in the twos and threes rather than the threes and fours**, as was typical for most of the expansion.[15]

2.8 In relation to inflation, Mr Macfarlane reported that 'in the latest year, inflation in underlying terms has been close to 2.5 per cent, though the headline CPI figure is higher, principally reflecting the effect of rising fuel prices.'[16]

2.9 It was noted that the inflation forecast was subject to uncertainty. This uncertainty mainly relates to the risk that 'current labour market tightness will result in expected wage increases.'[17] At the same time, however, global disinflationary forces may be stronger than expected which raises the question 'whether these latter forces prove sufficient to contain inflation in an economy operating with little spare capacity.'[18]

2.10 In view of these circumstances, the RBA Board at its most recent meeting judged:

> …the current policy setting to be broadly consistent with the economy's requirements for the time being. Looking ahead, however, it felt that, on balance, **based on the considerations I have outlined here today, it is more likely that the next move in interest rates will be up, rather than down.** [19]

2.11 Mr Macfarlane's advice that the next move in interests rates 'will be up, rather than down' proved to be accurate. On 3 May 2006 the RBA announced that it would increase the cash rate by 25 basis points to 5.75 per cent. The RBA stated:

13 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 2.
14 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 2.
15 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 2.
16 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, pp. 6–7.
17 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.
18 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.
19 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

> International developments are continuing to provide stimulus to growth in Australia. The world economy is growing at an above-average pace for the fourth successive year and, significantly, forecasts have recently been revised upwards. Commodity prices have been increasing strongly for some time, and they have risen further in the year to date. This suggests a strengthening in the outlook for Australia's export earnings, with consequent expansionary effects on incomes and spending.[20]

Inflation targeting and monetary policy

2.12 The *Second Statement on the Conduct of Monetary Policy* between the Treasurer and the Governor of the Reserve Bank sets out the objective of monetary policy and provides an inflation target. The goals of monetary policy as set out in the *Reserve Bank Act 1959* requires the Reserve Bank Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to:

- the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.[21]

2.13 In relation to inflation targeting, the 2003 Statement states:

> In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 percent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the cycle while preserving a clearly identifiable benchmark performance over time. [22]

2.14 Mr Macfarlane noted that Australia's inflation performance over the last decade has been consistent with the bank's medium-term target. He commented that since '1993, when the two to three per cent objective was first articulated, average CPI inflation—excluding the one-off GST effect—has been 2.5 per cent per annum.'[23] Mr Macfarlane pointed out that the bank's inflation objective is expressed as an average and there are periods where it has been above 3 per cent and below 2 per cent.

2.15 Mr Macfarlane cautioned that while inflation has remained contained over the past decade 'it is important, as always, to consider how inflationary

20 RBA, Statement by the Governor, Mr I McFarlane, *Monetary Policy*, media release, 3 May 2006.

21 RBA, *Second Statement on the Conduct of Monetary Policy*, July 2003.

22 RBA, *Second Statement on the Conduct of Monetary Policy*, July 2003.

23 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 15.

pressures might evolve from here.'[24] Some of the factors identified that could lead to upward pressure on inflation are the high level of capacity utilisation, the tight labour market, and large increases in costs for some raw materials. Mr Macfarlane stated:

> Aggregate wages growth has picked up over the past year, and businesses generally are reporting difficulty in attracting labour. These conditions underpin the current forecast of a modest rise in underlying inflation over the year ahead. Based on the current level of oil prices, **this forecast implies that headline CPI would remain close to three per cent over the forecast period**.[25]

2.16 Mr Macfarlane was asked about the impact of tax cuts on inflation and interest rates. He was not overly concerned about this commenting that 'we can afford some changes to taxes or to expenditure' concluding that it was 'simply a matter of what is the right amount.'[26] Mr Macfarlane stated:

> As we go through the year, surprise surprise, taxes are stronger than we thought which is exerting a contractionary influence through the year and then you get to nearly the end of the year and you give it back again. So you have an expansionary impact right at the end of the year. So you really have a within-year seasonal swing in fiscal policy, but from year to year all the years look very similar. From our perspective, it is the fiscal impact, which is the change from year to year, which could potentially cause us difficulties but which has not because the change has been relatively small. Despite the fact that it is talked about frequently in the financial press and amongst economists, it has never figured as an important part of our deliberations on monetary policy.[27]

2.17 During the August 2005 hearing, the committee examined the Reserve Bank's methodology for forecasting inflation. At the February 2006 hearing, the committee focused on the appropriateness of the bank's target of keeping inflation between 2 and 3 per cent. Australia's mid-point target is 2.5 per cent. Table 2.1 shows the mid-point inflation targets of some leading economies.

24 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

25 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

26 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

27 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

Table 2.1 Mid-point inflation targets of some leading economies

Country	Mid point target	Comments
Australia	**2.5%**	**'between 2 to 3 per cent, on average over the cycle'**
Switzerland	1.0%	'Below 2%'
Euro area	1.9%	'Positive inflation below, but close to, 2%'
UK, Canada, Sweden, New Zealand	2.0%	UK: CPI revised down from 2.5% NZ: 1-3%, revised from 0-3% and lower previously
Norway	2.5%	
Japan	No target	No official numerical targets are in place. After Japan's experience with deflation, observers would urge a positive target clear of zero.
US	No target	No official numerical target has been set.

Source: Erskinomics

2.18 Table 2.1 shows that Australia's mid-point inflation target is towards the upper end of the countries selected. The committee has heard from alternative sources that there would be merit in reviewing Australia's existing inflation target.

2.19 If, for example, the target was changed to between 1 and 3 per cent then the mid-point inflation target would reduce from 2.5 to 2 per cent. During the hearing, the Reserve Bank was asked about the merits of reducing Australia's inflation target. Mr Macfarlane noted that the decision to revise the target was a decision for government. This, for example, could form part of any revision of the statement on the conduct of monetary policy. Mr Macfarlane, however, noted that 'my inclination would be that they probably would not be interested in it, because it seems like very finetuning—half a per cent is a very small change.'[28]

Conclusions

2.20 The Reserve Bank has an objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This objective is expressed in the *Second Statement on the Conduct of Monetary Policy*. The committee examined the adequacy of the current 2 to 3 per cent target and also considered other possible targets. The committee notes Mr Macfarlane's view that changing the target range to 1 to 3 per cent 'seems like very finetuning.'

28 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 10.

Exchange rates and external trade

2.21 At the February 2005 hearing, the Governor indicated that over a 12 to 18 month period, a change in the exchange rate can be the biggest influence on inflation. That is, an appreciating dollar will help keep inflation down, but once the dollar settles at a new level, this impact on inflation dissipates.[29]

2.22 During the February 2006 hearing, Mr Macfarlane noted that the Australian currency had remained relatively stable. He stated:

> The Australian dollar has remained in a relatively steady range over the past couple of years, at levels that are a little bit above average against the US dollar and about 10 per cent above average in trade weighted terms. The currency has been remarkably stable over the last two years. Some people have found this steadiness puzzling against a background of continuing very strong rises in commodity prices and our terms of trade, as such episodes in the past have been associated with strong rises in the currency.[30]

2.23 Mr Macfarlane suggested that the key to understanding this pattern was the interest differential with the United States which has narrowed appreciably over the past 18 months.

2.24 In real trade-weighted terms, the Australian dollar is 12 per cent above its post-float exchange average. The RBA noted that 'at this level, the exchange rate is restraining activity in some trade-exposed sectors, particularly in the manufacturing sector.' The RBA, however, concluded that 'for the economy as a whole, the benefits from the increased terms of trade are likely to have more than offset the adverse effects of the high exchange rate.'[31]

2.25 Mr Macfarlane noted that while the growth of Australia's economy was impressive 'there has been concern expressed about its composition.' In particular, he noted that 'Australia's export performance has been disappointing.'[32] The trade deficit, at around 2 per cent of GDP, and the current account deficit (CAD), at around 6 per cent of GDP, 'both remain large by historical standards.'[33] Mr Macfarlane noted that the level of the CAD has remained high at around 6 per cent of GDP recently despite 'a strong international environment and rising commodity prices.'[34]

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29 Mr I McFarlane, Governor of the RBA, *Transcript*, 18 February 2005, p. 7.

30 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

31 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 45.

32 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

33 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 41.

34 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

2.26 The strength of the global economy and recovery from the global downturn of 2001 has resulted in a marked upswing in Australia's terms of trade, defined as the ratio of our export to import prices. Mr Macfarlane commented that 'currently Australia is benefiting from the largest cumulative increase in our terms of trade since the early 1970s.'[35] In particular, there have been sharp rises in the prices of coal, iron ore and a wide range of other minerals. The Governor stated:

> Over the past three years, Australia's terms of trade have increased by 30 per cent. This is estimated to have added 1½ to two percentage points per annum to the growth in national income, or our real income and capacity to spend over this period, which has been a significant expansionary force on the economy. The effect of this can be seen in a number of areas, including strong growth in business investment, company profits, share prices and imports. Increased export prices also tend to boost government revenues through company taxes and a range of federal and state royalties.[36]

2.27 Earnings from manufactured goods were less favourable. The RBA stated:

> Earnings from manufactured goods exports increased by around 8 per cent over 2005, with volumes estimated to have grown more strongly than overall exports, albeit at a rate well below that seen during the 1990s. Nonetheless, recent business surveys report a pessimistic outlook for manufactured exports, and the Bank's liaison with Australian manufacturers reports that producers are finding it difficult to compete with developing economies in Asia.[37]

2.28 The committee is particularly concerned about this trend and the ongoing challenges faced by Australian manufacturers. In May 2006 the committee commenced an inquiry into the state and future directions of Australia's manufactured export and import competing base.

United States, China and the global economy

2.29 The global economy is expanding strongly. The Governor noted that while this growth has been mainly led by the US and China, 'there have been encouraging signs over the past year that growth is becoming very

35 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

36 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

37 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 42.

broadly based, with conditions improving in Japan as well as in a number of other economies.'[38]

2.30 Importantly, this global growth has been accompanied by generally subdued inflation outcomes. Mr Macfarlane suggested that one factor behind this was 'the increased focus on inflation control by central banks around the world, after the high inflation of the 1970s and 1980s.'[39]

2.31 The US economy posted above trend growth in 2005 with real GDP expanding by 3.5 per cent. The RBA suggested that recent hurricanes and the spike in retail petrol prices 'had little lasting impact on the US economy, and stronger growth is expected to resume in the first half of 2006.'[40]

2.32 The US unemployment rate at 4.7 per cent is at a 4 and 1/2 year low. In September 2005 CPI inflation peaked at 4.7 per cent but as the year ended inflation declined to 3.4 per cent.

2.33 Interest rates stood at 4.5 per cent which is now 'closer to neutral levels, although the Federal Reserve's January policy statement signalled that some further tightening may still be needed.'[41] The Federal Reserve at its meeting on 27–28 March 2006 raised the target federal funds rate 25 basis points to 4.75 per cent. The minutes of the meeting stated:

> Most members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy. However, members also recognized that in current circumstances, checking upside risks to inflation was important to sustaining good economic performance. The need for further policy firming would be determined by the implications of incoming information for future activity and inflation.[42]

2.34 China is now the world's fourth largest economy, and the second largest when measured at purchasing power parity exchange rates. The RBA reported that 'in real terms, the average growth rate since 1992 has been revised up from 9.4 per cent to 9.9 per cent.'[43] At the same time, inflation remains low, with consumer prices rising by 1.6 per cent over the year to December 2005.

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38 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

39 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

40 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 6.

41 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 7.

42 Federal Reserve Board, *Minutes of the Federal Open Market Committee*, 27–28 March 2006 [http://www.federalreserve.gov/FOMC/MINUTES/20060328.htm]

43 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 9.

2.35 The Governor noted that it was China that was contributing strongly to the rapid growth in global demand for resources. As noted previously, this rapid growth has resulted in increases in world prices which Australia is benefiting from.[44]

2.36 Mr Macfarlane commented that the industrialisation of China and the 'huge pool of low-cost labour that this has brought into play has put sustained downward pressure on a wide range of prices of internationally traded goods.'[45] This downward pressure on prices is one of the key forces contributing to disinflationary pressures. Mr Macfarlane stated:

> …this business of producing more than you are consuming brings us back, principally, to China and the fact that, as they bring on stream a massive supply of extremely cheap labour and find more and more ways of producing standard products, internationally traded manufactured goods, cheaper and cheaper, this puts downward pressure on everyone's CPI around the world. That is what we think of as global disinflationary pressure.[46]

2.37 Growth in the Asia-Pacific, while not at the levels of China, was running at 5.2 per cent over 2005. Economic recovery has continued in Korea and Thailand with growth being slower in Indonesia and the Philippines. The RBA noted that 'increasing confidence in the Korean economy contributed to the 50 per cent increase in Korean share prices over 2005 and to the appreciation in the Korean won exchange rate, which in January reached its highest levels in eight years.'[47]

2.38 India, through its strong growth, has contributed to world expansion. The RBA commented that GDP grew by 1.8 per cent in the September quarter, to be 7.9 per cent higher over the year, well above India's 30-year average growth rate of 5.5 per cent.'[48]

2.39 In New Zealand, economic growth is slowing but inflation remains a concern. Consumer prices have risen to 3.2 per cent over the year to December. The RBA noted that wages growth has been strong and house price growth has remained rapid at 13.5 per cent over the year to December. The Reserve Bank of New Zealand increased the official cash rate in both October and December bringing it to 7.25 per cent.[49]

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44 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

45 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

46 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

47 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 10.

48 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 10.

49 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 10.

Oil prices

2.40 During the August 2005 hearing, the committee examined the implications of rising oil prices. At that hearing, the RBA Governor noted that the rise in oil prices was more due to strong world demand rather than supply restrictions as was the case with OPEC1 and OPEC2. Mr Macfarlane pointed out that the rise has not added much to inflation or inflationary expectations. He also noted that oil prices only affect the CPI when they are going up. When oil prices reach a higher level and stay there, then after a quarter or two there will be less effect on the rate of change of the CPI.

2.41 During the February 2006 hearing, the RBA Governor reiterated his views about the impact of oil price increases. Mr Macfarlane stated:

> We know the economy has slowed, but I do not think that [oil price increases] was a major player in it. If you look around the world, every economy has had to face this big increase in oil prices and very few of them have slowed. In fact, most of them have chugged along at the same rate as before or have actually picked up. It seems to me that the contractionary effect of the rise in oil prices has been remarkably small in virtually all countries. I think that is the case here too.[50]

2.42 While this is reassuring, the impact of growing fuel prices remains a concern with the public. During April 2006 petrol prices went past $US70 a barrel. On 19 April 2006 the Treasurer, the Hon Peter Costello, MP, commented that 'we are basically living through another oil shock.'[51] Mr Costello noted that in the first instance increased oil prices will result in increased prices at petrol bowsers which will feed into the CPI. He commented that 'I believe we can contain it as long as businesses that use petrol don't use that as an excuse to move secondary prices, because then you will get a second movement back into the CPI.'[52]

2.43 The concern about oil prices must be couched against key points made by the RBA Governor. First, the current growth in oil prices, as opposed to OPEC1 and OPEC2, is due to strong demand and not supply side restrictions. In addition, while there may be some initial inflationary effects, there are competing disinflationary forces. Mr Macfarlane stated:

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50 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 13.

51 The Hon Peter Costello, MP, transcript of doorstop interview, Odyssey House Richmond, Wednesday, 19 April 2006.

52 The Hon Peter Costello, MP, transcript of doorstop interview, Odyssey House Richmond, Wednesday, 19 April 2006.

> I think that, in the short term, oil prices had a bigger short-term effect, if you want to measure it over the last year or 18 months. In the medium term, it is the other—the worldwide reduction in the prices of internationally traded manufactured goods, and China is the biggest single reason behind that.[53]

2.44 As part of the next hearing with the RBA on 18 August 2006, the committee will seek an update on the impact of oil price increases.

Housing and household debt

2.45 The RBA focused some of its comments on the implications of the growth of household debt. The RBA Governor summarised key aspects of the most recent cyclical peak, noting that in around 2003 household credit growth reached an annual rate of over 20 per cent. He noted that since the bulk of household debt is housing related it is not surprising that this peak was closely associated with a sharp run-up in house prices. Mr Macfarlane stated:

> Nationwide house prices increased strongly for several years up to late 2003, reaching a peak growth rate of around 20 per cent in that year. The increases in credit and house prices were interrelated, with credit availability fuelling price rises, while rising house prices meant people had to borrow larger amounts to achieve home ownership.[54]

2.46 Mr Macfarlane noted that since 2003 the housing market and the demand for credit have cooled. In particular, 'nationwide house prices have been broadly flat over the past two years and prices have fallen in Sydney.'[55] The RBA noted that the price falls in Sydney for the second year, 'together with stable or increasing prices in other capitals, have brought price relativities between Sydney and the other capitals back to the pre-boom levels of the early to mid 1990s.'[56]

2.47 The downturn in housing construction continued in 2005. The RBA reported that dwelling investment has fallen by around 4 per cent from its early 2004 peak, with the decline fairly evenly spread between the two main components, construction of new dwellings and alterations and additions.'[57]

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53 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 23.

54 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

55 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

56 R RBA, *Statement on Monetary Policy*, 13 February 2006, p. 31.

57 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 31.

2.48 The RBA reported that the value of household loan approvals increased by around 6 per cent in the three months to November and by 11.5 per cent over the year to be around its highest level since the end of 2003. The RBA noted that 'recent growth has mostly been driven by an increase in loan approvals to owner-occupiers, although loan approvals to investors have retraced some of their previous falls.'[58]

2.49 The RBA Governor also discussed the growth of household indebtness, which for more than a decade 'has grown at a rate well in excess of the growth in household incomes.'[59] He pointed out that 'this has meant that the aggregate ratio of household debt to household income has trended upwards, as has the proportion of household income required to service the debt, and the gearing ratio (debt to value of household assets).'[60]

2.50 Mr Macfarlane warned that these household debt ratios may rise further. This was because in a low inflation environment, nominal interest rates are also low and 'households are able to service much higher levels of debt than they could in the past.'[61] There were risks for households who were subject to a high debt servicing ratio. Mr Macfarlane stated:

> …if the economy does experience some negative shock, the classic one being significant increases in unemployment or even households that lose a high-paying job and have to take a lower paying job, some of those households would be very vulnerable, given the huge amounts of debt servicing. This is a thing we have drawn attention to repeatedly.[62]

2.51 The RBA Governor pointed out that the fact that Australian households do carry so much debt is something that influences the RBA's decisions on monetary policy. He noted that the level of household debt was 'one of the reasons why this tightening cycle has been more drawn out than previous tightening cycles.' Although in reducing the impact of a rate rise, Mr Macfarlane was not enthusiastic about moving away from a 25 basis points rise to something less such as two 12.5 basis point rises.[63]

2.52 The RBA noted that growth in household consumption slowed during 2005 with real spending increasing by 2.7 per cent over the year to the September quarter. This is a reduction from an annual growth rate of around 6.5 per cent at the start of 2004. The RBA stated:

58 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 31.
59 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.
60 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.
61 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.
62 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 32.
63 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 19.

> Although the saving rate as measured is still negative, the fact that consumption is now growing more slowly than income suggests that households are taking a more cautious approach to their finances. This would be consistent with the further easing in growth in household debt in the September quarter. Nevertheless, the debt-serving ratio increased marginally in the quarter to 10.9 per cent.[64]

2.53 A further issue examined as part of this debate was access to finance and lending practices. Banks and other providers in the competition to provide credit to households have progressively eroded lending standards. Mr Macfarlane commented that 'lenders are now engaging in practices that would have been regarded as out of the question five or 10 years ago'.[65]

Australian share market

2.54 The RBA Governor commented that the Australian share market 'has behaved quite differently from the global market over the past decade.'[66] For example, the Australian share market was less affected by the 'tech bubble' and subsequent collapse. Mr Macfarlane noted that 'along with the Canadian share market, it is the only major market that is currently above earlier peak levels, whereas in Europe and the United States share markets are still about 20 per cent below there early 2000 peaks.'[67]

2.55 Mr Macfarlane in response to a question about the wealth effect of shares commented that 'all the international evidence is that the wealth effect from shares is much smaller than the wealth effect from housing.' He noted that 'I do not think the fact that we are above peak levels makes us vulnerable.'[68]

Supply side (capacity) constraints

2.56 During the August 2005 hearing some of the supply side constraints to growth that were discussed included capacity constraints as a result of 14 years of growth, and deficiencies in infrastructure. Similarly, the RBA's February 2006 statement on monetary policy reported that 'consistent with

64 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 30.
65 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.
66 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.
67 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5
68 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 29.

business surveys, capacity constraints continue to be reported in liaison with firms in most industries.'[69] However constraints appear to have eased in the residential construction industry and 'in parts of manufacturing where trading conditions have been difficult.'[70]

2.57 Labour market shortages including unskilled and skilled labour were discussed. The RBA stated that 'recent data shows that wages are continuing to grow at a rate above the average of recent years, which is consistent with other indications of tight labour market conditions and shortages of suitable labour.'[71] Mr Macfarlane elaborated on the possible consequences of an undersupply of labour:

> The ultimate consequence is that some production just does not get done. This is the sort of thing that does happen, not just here but in other countries, when you get to very high levels of capacity utilisation. In our case, not only are we at high levels of capacity utilisation but also we have a skewed demand in that an inordinate amount of the demand is for expansion of resource capacity. That is why it is not surprising that a Western Australian is bringing this question up. The answer is: some things do not get done, which is disappointing.[72]

2.58 Mr Macfarlane commented that it was labour shortages and aggregate wages growth which has underpinned the current forecast of a modest rise in underlying inflation over the year ahead.[73]

Corporate governance

2.59 The process of appointing people to the RBA board was examined. In particular, the committee examined this in the light of the appointment and subsequent resignation of Mr Robert Gerard. The RBA Governor was asked whether he was consulted about the appointment and whether the events surrounding Mr Gerard's resignation suggested a need for reform of the appointments process. Mr Macfarlane indicated that the Treasurer informed him that he was appointing Mr Gerard. Mr Macfarlane commented that 'I had not heard of Mr Gerard and therefore was not in a position to express an opinion.'[74]

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69 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 33.

70 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 33.

71 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 59.

72 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 20.

73 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

74 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 15.

2.60 The RBA Governor acknowledged that the Gerard appointment had revealed a flaw in the process but this should be compared against previous appointments which had proved successful. Mr Macfarlane stated:

> I think it did expose a problem—there is not much doubt about that—in that someone was appointed who had engaged in some behaviour such that, had it been known, they would not have been appointed. So I think that that does show up a flaw. I am not quite sure how you overcome that particular thing, given the confidentiality of the tax system. As to whether we should adopt a very different way of making board appointments, it is always up to people to come up with suggestions. I am not totally wedded to this one, but I would point out that, in the time I have been in this position, there have been 20 appointments made to the Reserve Bank board or the Payments System Board, including reappointments. Nineteen of them have been excellent and one caused intense controversy.

2.61 Mr Macfarlane, in considering the appointments process, discussed the merits of having parliamentary committee oversight of appointments. Mr Macfarlane stated:

> …would it be improved if a committee such as this could interview prospective board members? That is done in the UK, but my understanding is that that committee does not have a right of veto; it just has the capacity to interview people. As far as I am concerned, that is entirely a decision for the government, the parliament or whoever has strong views on that. I would neither support it nor oppose it; I could live with it.[75]

2.62 Other matters that were discussed as part of the examination of corporate governance included board composition and access to inside information. On the first point, Mr Macfarlane noted that the RBA board was not a group of specialist economists. This was in contrast to other countries where the board members are normally specialist economists who are mostly full-time.[76]

2.63 The issue of board members being in receipt of inside information was also examined. Mr Macfarlane acknowledged that once a recommendation regarding rates is provided at a board meeting, board members are in receipt of 'inside information.' Mr Macfarlane commented that 'to the best of my knowledge, no one has ever acted on it'.[77] The RBA Governor was

75 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 24.

76 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 24.

77 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 24.

asked why board decisions are not announced immediately at the end of a meeting rather than the next day. Mr Macfarlane acknowledged that some non-executive board members do not like the delay. However, he believed it was preferable to make the announcement 'when the money market starts rather than have something change halfway through a money market day.'[78]

Conclusions

2.64 The Gerard appointment to the RBA board brought attention to the process for appointing board members. It should be noted that while the Gerard appointment resulted in controversy the record of appointments has been positive. The RBA Governor noted that of the 20 appointments, including reappointments, that were made during his period as Governor, 19 'have been excellent'.

78 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 23.

3

The payments system—overview

3.1 The payments system refers to arrangements which allow consumers and businesses to pay for goods and services. The key payment instruments include cash, cheques and electronic funds transfers (e.g. credit and debit cards). Non-cash payments involve arrangements that ensure that funds move to and from accounts at financial institutions. Consumers and businesses will select a payment system based on convenience, security and incentive.[1]

3.2 Within this framework, the Reserve Bank of Australia (RBA) has important regulatory responsibilities for the payments system and plays a key role in its operations. The RBA:

- has regulatory responsibility for the payments system, with the objectives of controlling risk, and promoting efficiency and competition;
- provides facilities for final settlement of payments system obligations; and
- participates in the system as banker to the Australian Government and a limited range of other customers.[2]

3.3 In its regulatory role, the RBA is particularly keen to ensure the promotion of clear price signals between the different payment methods so as to ensure efficient payment choices for consumers. The RBA has sought to achieve this largely, but not solely, through the regulation of interchange

1 RBA, *Australian Payments System*, RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

2 RBA, *Australian Payments System*, RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

fees. In addition, the RBA has sought to limit various restrictions in the payment system that could effectively limit entry and restrict competition.[3]

Cash

3.4 Cash is probably the most important instrument for small-retail transactions and for transfers of value between individuals. Anecdotal evidence and experience suggest that cash transactions account for the dominant share of the number of transactions, but a very small share of their value.[4]

3.5 The ready availability of cash through automated teller machines (ATMs) has sustained its use. In the year to March 2006, withdrawals from ATMs averaged around $11.3 billion a month, which equates to around $550 per person.[5]

Non-cash payments

3.6 Non-cash payments account for most of the value of payments in the Australian economy. On average, non-cash payments worth more than $155 billion are made each business day, equivalent to about 20 per cent of GDP.[6]

3.7 Most payment systems involve two or more financial institutions and/or other payments providers, requiring payments to be 'cleared' between them. For instance, details of a cheque drawn on one financial institution and deposited at another must be returned to the first financial institution so that it can debit its customer's account and verify that the customer has sufficient funds.[7]

3.8 Arrangements for clearing most payment instruments in Australia are co-ordinated by the Australian Payments Clearing Association, although

3 RBA, *Payments System Board Annual Report 2005,* RBA, Sydney, 2005, p. 1.

4 RBA, *Australian Payments System*, RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

5 RBA, *Bulletin*, RBA, Sydney, May 2006..

6 RBA, *Australian Payments System,* RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

7 RBA, *Australian Payments System,* RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

Visa, MasterCard and BPAY have their own independent payments clearing systems.[8]

3.9 Once payments are cleared between institutions, they accrue obligations which must be settled. In Australia, final settlement of obligations between payments providers is by entries to their Exchange Settlement Accounts at the Reserve Bank.[9]

3.10 While all non-cash payments involve the same fundamental elements (clearing, settlement etc.), the non-cash payments system is made up of a number of separate payments systems:

- the debit and credit card payment systems predominantly used for retail payments by consumers;
- the direct credit and debit payment systems used by both consumers and businesses;
- the cheque payment system that, today, is mainly used by businesses; and,
- the RTGS system primarily used by banks for settlement of money market and foreign exchange transactions.[10]

3.11 Of most interest to Australian consumers are the card-based and electronic transactions which they perform on a day-to-day basis. The different types of these transactions are outlined below, as well as some of the systems which facilitate them.

3.12 However, before beginning this discussion, there are some important terms to define, which are used frequently in the card-based payments system:

- **Cardholder:** The individual who has been provided with a payment card by the issuing institution.
- **Issuer:** The financial institution that issues the card to the cardholder. It provides credit in the case of credit cards, or access to the cardholder's funds in the case of debit cards.
- **Merchant:** The entity that is accepting a card as payment for goods or services.
- **Acquirer:** The financial institution that provides payment to merchants who have accepted a card as payment. Responsible for requesting authorisation of a transaction from the issuing institution.

8 RBA, *Australian Payments System*, RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

9 RBA, *Australian Payments System*, RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

10 RBA, *Reasons for the decision to designate the EFTPOS payment system*, RBA, Sydney, October 2004, viewed 15 March 2006, <http://www.rba.gov.au/PaymentsSystem/Reforms/Eftpos/reasons_designate_eftpos.htm>.

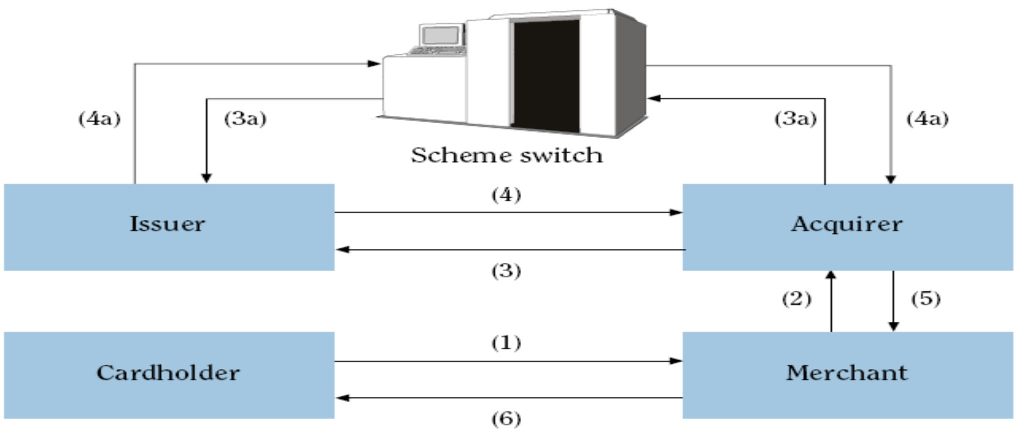
Credit and charge cards

3.13 Credit and charge cards are non-cash payment instruments with which a consumer can pay for goods and services using credit from the financial institution that issued the card.

3.14 Payments can occur in person at the point of sale, as well as via the phone or the internet. Payment occurs with a flow of information, which is outlined below and shown in figure 3.1:

1. The credit card is swiped through an electronic terminal on the merchant's counter;
2. The transaction and cardholder details are routed to the merchant's financial institution (the acquirer);
3. If the acquirer is also the issuer the transaction can be authorised internally and the authorisation returned to the merchant. However, if the issuer is another institution, the acquirer routes the transaction to that issuer either bilaterally (3) or via a 'switch' facility provided by the credit card scheme (3a);
4. The issuer either authorises or declines the transaction and a message is sent back to the acquirer bilaterally (4) or through a switch (4a);
5. The acquirer tells the merchant if the payment is authorised; and
6. If the transaction is authorised, the customer signs the voucher. The merchant checks the signature against the card and, if all is in order, the transaction is complete.[11]

Figure 3.1 Information flows for a credit card transaction



Source *RBA & ACCC, Debit and credit card schemes in Australia: A study of interchange fees and access, p. 18.*

3.15 The above diagram represents the information flows for a 'four-party' or 'open' scheme (also see figure 3.2 below). They are called four-party schemes because, as the name suggests, there are four parties involved in

11 RBA and Australian Competition and Consumer Commission (ACCC), *Debit and credit card schemes in Australia: A study of interchange fees and access*, Sydney, October 2000, pp. 17-18.

transactions—the issuer, acquirer, cardholder and merchant. Four-party schemes are also referred to as 'open' because the issuer and acquirer can be any financial institution—thus the schemes are 'open' to participants.

3.16 In four-party schemes, credit cards are issued by financial institutions. The issuer provides the cardholder with a line of credit up to a specified limit. The scheme—most commonly Visa or MasterCard—provides a range of services including transaction processing and international networking.[12]

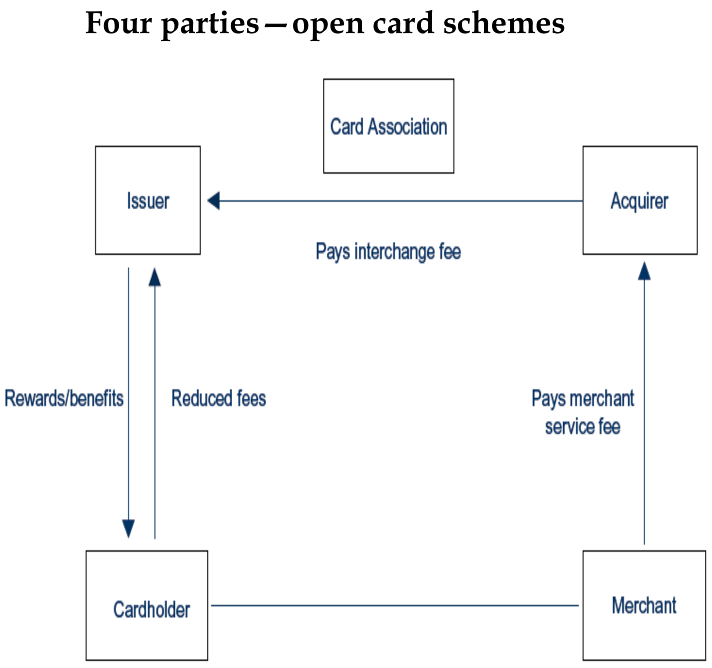
3.17 An interchange fee (discussed in detail below) may be paid between an issuer and an acquirer. For credit card (and scheme debit) transactions, it is paid *by* the acquirer *to* the issuer. Where an issuer of a credit card is also by chance the acquirer, the transaction is internal and therefore no interchange fee is paid. To recoup the costs of providing services to merchants, including the interchange fee, acquirers charge merchants a 'merchant service fee'.

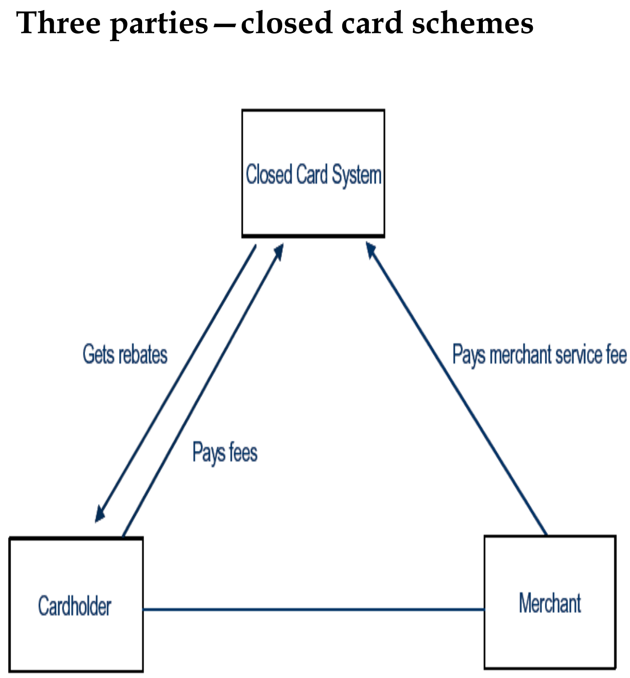
3.18 In three-party schemes—Diners Club and American Express—issuing and acquiring are both typically performed by the scheme. Therefore three-party schemes are also referred to as 'closed', because the issuer and acquirer are generally the same institution—thus they have tended to be 'closed' to outside participants. As there are generally no outside participants involved, there is no interchange fee involved.[13] However, American Express cards are now issued by two Australian banks. While in this arrangement there are four parties involved in transactions, American Express remain the sole acquirer of their transactions and therefore the scheme is still partly closed. A per-transaction fee is paid between American Express and the issuing banks.

12 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 14.

13 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 14.

Figure 3.2 Four-party vs. three-party schemes





Source I Harper, R Simes & C Malam, *The Development of Electronic Retail Payments Systems*, paper presented to the International Telecommunications Society Africa-Asia-Australasia Regional Conference, 2005.

3.19 In addition to the distinction between three-party and four-party schemes, credit cards can also be differentiated according to the nature of the credit line. In Australia, most credit cards provide a revolving line of credit. The money that cardholders borrow from an issuing institution does not have to be paid back in a set time, apart from a minimum monthly payment. However, the issuer charges interest on any amounts owing, usually after a set interest-free period. The issuer, in some cases, also charges an annual fee.[14]

3.20 In contrast some cards—often referred to as charge cards—provide a line of interest-free credit that must be paid in full at the end of the statement period. Charge card providers also charge their cardholders an annual fee.[15]

3.21 A major advantage of both credit and charge cards is that you can make purchases and pay bills online or via the telephone. Increasingly, businesses' websites have credit card payment functionalities, which allow consumers to pay bills from their home or office. Payments by credit card are also made through third parties, as is discussed below.

14 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 14.

15 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 14.

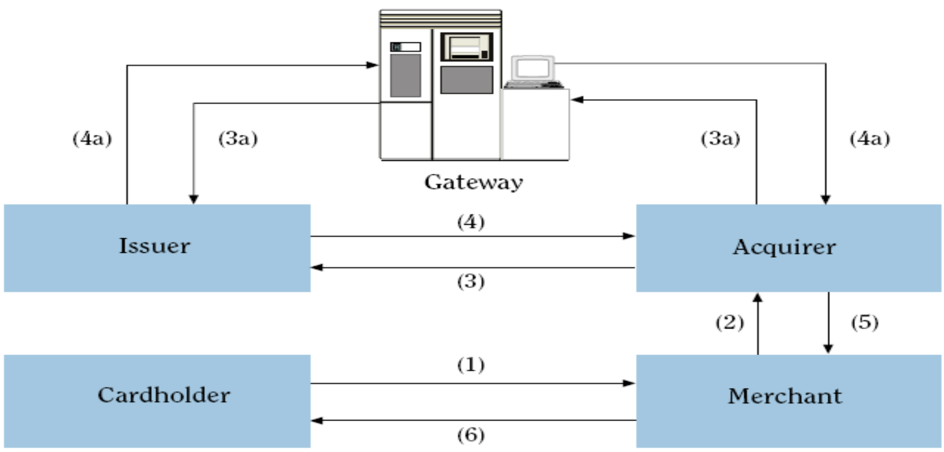
Debit cards

3.22 Debit cards provide users with electronic access at the point-of-sale to a transaction account at their financial institution. Unlike credit and charge cards, debit cards provide users with access to their own money, not to credit provided by a financial institution.

3.23 There are two types of debit card in Australia—EFTPOS and scheme debit. The EFTPOS system is operated by Australian banks. It is only available in Australia and transactions are authorised using a personal identification number (PIN). The flow of information is outlined and illustrated below:

1. The cardholder presents the card to the merchant and enters a PIN;
2. The relevant data are transmitted to the merchant's financial institution (the acquirer);
3. If it is one of the acquirer's own cards, the account is checked internally and authorisation returned to the merchant. If the card is issued by another financial institution, the information is switched to the card issuer either directly via a bilateral link (3) or, if the issuer does not have this link, via a third institution acting as a gateway (3a);
4. The issuer then checks the account and returns an authorisation (or a decline) to the acquirer either directly (4) or via the gateway (4a);
5. The acquirer passes the message to the merchant; and,
6. The transaction is complete.[16]

Figure 3.3 Information flows for an EFTPOS transaction



Source *RBA & ACCC, Debit and credit card schemes in Australia: A study of interchange fees and access, p. 21.*

16 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 20.

3.24 PINs are initially assigned by the issuer of the cards; however, they can later be changed to a number chosen by the cardholder. Examples of these cards are the 'Handycard' for Westpac customers, or the 'Keycard' for customers of the Commonwealth Bank. There are, of course, numerous other examples.

3.25 In an EFTPOS transaction an interchange fee is paid *from* the issuer *to* the acquirer—the reverse of the credit card system. The EFTPOS interchange fee is also a flat fee rather than a percentage of the transaction value. Similarly, the merchant service fee is often, although not always, a flat fee per transaction. In addition, because acquirers receive rather than pay an interchange fee, some of the larger merchants who are involved in maintaining their own EFTPOS networks are actually paid a rebate on each transaction they process, rather than paying a merchant service fee.

3.26 'Scheme debit' cards, which are offered by both Visa and MasterCard[17], operate through the credit card schemes' systems. Aside from operating through different networks, there are two other key differences between scheme debit and EFTPOS transactions. Scheme debit transactions:

- Involve signature-based authorisation rather than a PIN; and
- Have an interchange fee that is paid in the opposite direction to that in an EFTPOS transaction—*from* the acquirer *to* the issuer.

3.27 Scheme debit cardholders are generally not charged to transact, in part because their issuer *receives* an interchange fee. EFTPOS cardholders usually pay account keeping fees—typically around $5 per month—and are able to make a number of EFTPOS transactions at no additional charge. At some institutions there is no limit to the number of 'free' EFTPOS transactions, while at others there may be limits, after which customers are charged an additional per-transaction fee.

3.28 While scheme debit products normally require signature authorisation, some merchants, as with credit cards, allow them to be used without this authorisation—generally over-the-phone or internet. In Australia EFTPOS transactions must always be authorised using a PIN and therefore cannot be used for online or over-the-telephone purchases.

Automated Teller Machines (ATMs)

3.29 ATMs allow people to access funds from their transaction accounts and their credit card accounts, in the form of cash. The RBA asserts that ATMs:

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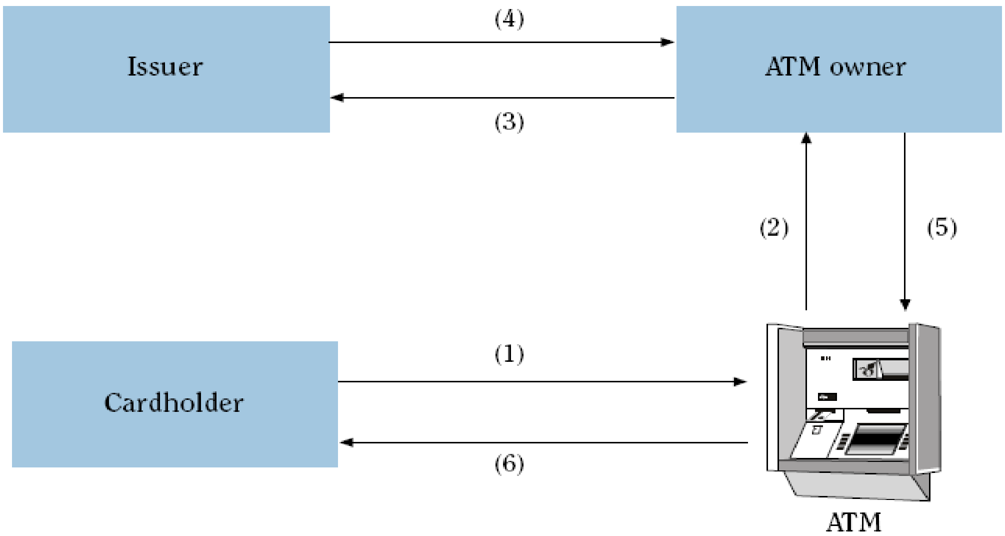
17 MasterCard Debit has only very recently been introduced in Australia, issued for the first time by BankWest in November 2005.

> Were [initially] installed to provide customers with greater convenience and to encourage transactions away from costly branch operations to this less costly electronic service.[18]

3.30 ATM transactions typically occur with the following flow of information between participants:

1. The cardholder puts their card into an ATM, enters their PIN and the details of the withdrawal;
2. The relevant information is then transmitted to the ATM owner;
3. If the ATM owner and card issuer are the same institution, the transaction remains internal to that network. If the card has been issued by another institution, the ATM owner will 'switch' the information to that issuer (3).
4. The issuer then checks if its customer has available funds, and if so, it will return an authorisation message via the ATM owner.
5. That message is then sent to the ATM; and,
6. Cash is dispensed.[19]

Figure 3.4 Information flows for an ATM transaction



Source RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 14.

3.31 When ATMs were first introduced, customers of a particular institution were only able to use their institution's ATMs to withdraw cash. However, agreements now exist between ATM networks, therefore allowing people to use ATMs all over Australia, regardless of who owns the machine.

18 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 12.

19 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 13.

3.32 Interchange fees in the ATM network are paid by the issuer to the ATM owner. If the ATM owner is also the issuer then ATM transactions are often free for cardholders. If the issuer is not the ATM owner then the issuer usually charges the cardholder a foreign fee, which in most cases is higher than the interchange fee.

Third-party bill payments

3.33 A significant contributor to the non-cash payments system are payments that involve the consumer interacting with a third party to initiate the transaction, rather than with the merchant.

3.34 Within this category, payments occur in a number of different ways, depending on which service is used.

Australia Post

3.35 The first and most common third-party payment involves Australia Post. Consumers can make payments in person, by telephone or via the internet. While internet payments are increasingly important, a recent Reserve Bank survey of 40 Australian billers showed that over-the-counter payments at the post office remain the most popular.[20]

3.36 Australia Post accepts payment in cash and by cheque, as well as by debit and credit card.[21] The payment is deposited to Australia Post's bank account, which is then forwarded to the biller, minus a transaction charge, the size of which depends on the payment method.

3.37 The information flows in Australia Post's bill payments service reflect those of the debit and the credit systems outlined previously, with the addition of a final step—the transfer of funds from Australia Post's financial institution to the biller's institution. Australia Post's bill payment service is not regarded as a separate payment system because it simply operates within existing structures.

PayPal

3.38 Another type of third party payment occurs through PayPal. PayPal is a service—predominately used by EBay members and which only operates online—that allows people to create an account by registering their email address and the details of their credit card(s) and/or bank account(s). They

20 RBA, *Payments System Board Annual Report 2005,* RBA, Sydney, 2005, p. 25.

21 Australia Post's internet payment service, www.postbillpay.com.au, only accepts credit cards and payments directly from transaction accounts.

are then able to log into their PayPal account and transfer money to other PayPal members—most often for items purchased on EBay.

3.39 PayPal members paying money to a biller first pay that money to PayPal, who subsequently forward the money to the seller's PayPal account. Billers can then opt to transfer funds to their financial institution from their PayPal account. PayPal does not charge consumers, only the biller, and, once again, the charge reflects the payment method.

3.40 PayPal, like Australia Post's bill payment service, does not constitute a separate payment system, because payments simply occur within the structures of other payment systems.

BPAY

3.41 BPAY is a type of third party payment, although it differs quite significantly from the likes of Australia Post and PayPal. The main difference, as described on BPAY's website, is that: 'BPAY … has no direct relationship with billers or end customers'.[22]

3.42 Another difference is that BPAY does not operate within the existing debit and credit card systems as the other bill payments services do—it has its own unique structure, information flows and fees. Therefore, BPAY is regarded as a separate payment system.

3.43 Since its introduction in 1997, BPAY, which is owned by a group including the major banks, has grown rapidly. The Reserve Bank stated:

> In 2004, BPAY processed around 106 million transactions valued at around 65 billion dollars … and the total value of BPAY payments exceeds the total value of EFTPOS transactions.[23]

3.44 In some ways BPAY can be likened to credit card schemes Visa and MasterCard:

- It has its own payment clearing system;[24]
- It performs a processing function between the two financial institutions;
- It sets interchange fees centrally; and
- Interchange fees are paid *from* the customer's bank *to* the merchant's bank.[25]

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22 BPAY Pty. Ltd., *BPAY Today*, BPAY, Sydney, viewed 9 March 2006, <http://www.bpay.com.au/about/bpaytoday.asp>.

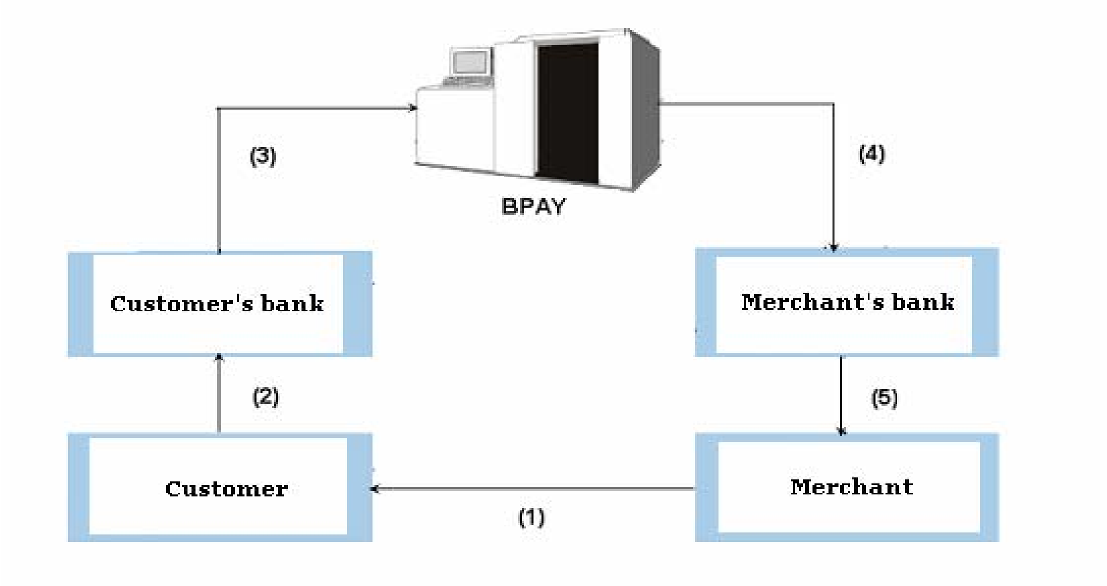
23 RBA, *Payments System Board Annual Report 2005,* RBA, Sydney, 2005, p. 27.

24 RBA, *Australian Payments System*, RBA, Sydney, viewed 22 February 2006, <http://www.rba.gov.au/PaymentsSystem/australian_payments_system.html>.

3.45 BPAY's unique information flows are described and displayed below:

1. The merchant sends the consumer a bill for services or goods provided.
2. The consumer decides that they will pay using BPAY. They use their bank's phone or internet banking to make the payment. The consumer tells the bank the merchant's BPAY number, the customer reference number and the amount they wish to pay. If the transaction is successful (i.e. all details are correct and there is sufficient money or available credit in the account) the consumer will receive a receipt if online, or a receipt number if using the phone.
3. The customer's institution provides the payment details to the merchant's institution via BPAY.
4. BPAY processes the details and if correct forwards the details and the funds to the merchant's institution.
5. The merchant's institution then informs the biller of the transaction.

Figure 3.5 Information flows for a BPAY transaction



Source *Adapted from: RBA & ACCC, Debit and credit card schemes in Australia: A study of interchange fees and access, p. 18.*

What are interchange fees?

3.46 According to the Reserve Bank, interchange fees are:

> Fees that are paid between the cardholder's bank and the merchant's bank every time a payment [or ATM withdrawal] is

25 RBA, *Payments System Board Annual Report 2005,* p. 28.

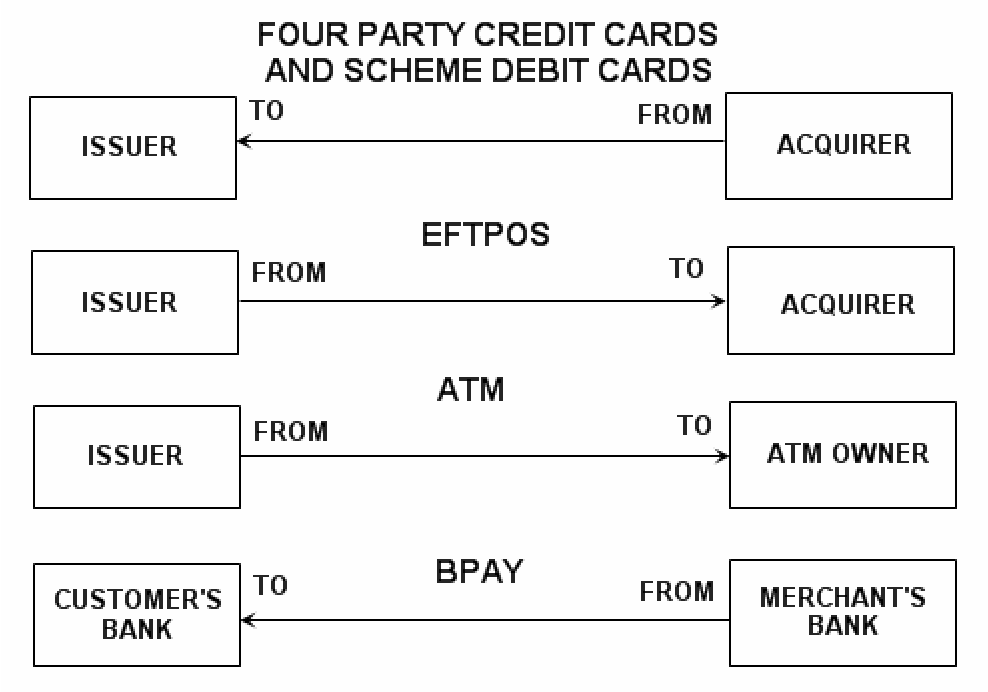
made with a Bankcard, MasterCard or Visa credit card, or made with an EFTPOS or Visa Debit card or through BPAY.[26]

3.47 For credit cards (Visa and MasterCard debit included) and BPAY, interchange fees are set centrally in agreement between the financial institutions and the schemes. For EFTPOS and ATMs, interchange fees are negotiated bilaterally between the participating institutions.

3.48 As discussed above, there are generally no interchange fees in American Express and Diners Club transactions, because the schemes are both the acquirer and the issuer. However, where a bank issues an American Express branded credit card, fees are paid from American Express—the sole acquirer—to the issuing institution. This fee is negotiated bilaterally.

3.49 The flow of interchange fees was discussed above in the outline of each separate payment system, and is also demonstrated below in figure 3.6.

Figure 3.6 Flow of interchange fees in different payment systems



3.50 The level of interchange fees in the various payment systems will be discussed in Chapter 4 on the reform of the payments system.

What is the purpose of an interchange fee?

3.51 Electronic payment systems operate through a series of networks. As discussed above, the parties involved in these networks are largely the same for each payment system—financial intuitions, consumers and

26 RBA, *Payments System Board Annual Report 2005,* p. 2.

merchants. For a payment network to grow, all of these parties need to participate in the network, but they will only do so when they are going to receive a benefit—either real or perceived.[27]

3.52 For merchants and cardholders a payment instrument is a means to an end; namely the exchange of goods or services for a price that satisfies both parties. Merchants and cardholders choose payment instruments based on a number of criteria, such as cost and convenience. For the financial institutions who participate in payment systems, their goal is to provide a service to their customers but, in doing so, also to make a profit.

3.53 If the cost of participation in the network exceeds the real or perceived benefits to an individual or organisation, they will not participate in the network.[28] Interchange fees exist for the purpose of redistributing some of the cost of providing non-cash payments—thus providing whoever is receiving the interchange fee with an incentive for network participation.

3.54 In the credit card network, for example, merchants are willing to bear a cost, provided it does not exceed the benefit they receive from accepting credit cards. Acquirers participate if the fee they receive from the merchant covers their costs and generates an appropriate profit margin. Issuers will participate if the revenues they receive from interchange fees and charges from the cardholder exceed the cost of providing the service. Cardholders will obtain and use a credit card if they perceive that the value of benefits that they receive—access to merchants, no need for cash and, in some cases, reward programs—exceed any fees they pay.[29]

27 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 23.

28 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, pp. 23-26.

29 RBA & ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, pp. 25- 26.

4

The payments system—reforms and other matters

4.1 In recent times the Reserve Bank of Australia (RBA), in its regulatory role, has been particularly keen to ensure that the payments system is both efficient and competitive. According to Dr Philip Lowe, Assistant Governor (Financial System), the RBA has assessed a number of conditions in pursuing the goals of efficiency and competition:

- relative prices reflect the relative resource costs;
- merchants are free to choose the price they charge for accepting payment instruments and are free to choose which instruments they accept;
- prices are transparent;
- restrictions on access are limited to those strictly necessary for the safe operation of the system; and
- there is competition within and between individual payment systems.[1]

4.2 Since 2000, the RBA has determined that the Australian payments system does not meet all of these conditions. Therefore, they have embarked on a series of reforms, which aim to rectify the areas of concern. The reforms have generally focussed on two key areas:

- The promotion of price signals to users of payments services that encourage efficient payment choices … [which] has largely, although not exclusively, involved the regulation of interchange fees; and

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1 Dr P Lowe, *Reform of the Payments System*, Speech to Visa International Members Forum, 2 March 2005.

- The removal of various restrictions in the payments system that effectively limit entry and stifle competition.[2]

4.3 Throughout the early stages of the 41st Parliament, the committee, through its mandate to oversee the activities of the RBA, has taken an interest in the RBA's reforms. Consequently, the committee decided to broaden its biannual review of the RBA to specifically investigate these matters. The committee heard from a number of interested parties—an individual, two academics, and a number of organisations and associations—both at public hearings and via written submissions. Unsurprisingly, the committee's evidence uncovered a wide range of views on the reforms.

4.4 The ensuing discussion will outline some of the key issues surrounding the RBA's reforms, as well highlighting a number of the opposing views the committee heard in its evidence. The committee will also make a number of observations.

2007 review of RBA reforms

4.5 The RBA has indicated that it intends to review its payments system reforms in 2007:

> When the credit card interchange fee reforms were introduced we indicated we would do a review of how things had gone four or five years afterwards. That is what we are planning to do.[3]

4.6 Some groups, however, question the appropriateness of the RBA reviewing its own reforms. They instead suggest that the 2007 review should be conducted by an independent body. For example, the Australian Bankers Association stated:

> The [banking] 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.[4]

4.7 Similarly, ANZ Bank argued 'that the planned 2007 RBA review of the reforms be done by an independent body or reviewer.'[5]

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2 RBA, *Payments System Board Annual Report 2005,* p. 1.

3 Dr P Lowe, RBA, *Transcript,* 17 February 2006, p. 38.

4 Mr D Bell, ABA, *Transcript,* 15 May 2006, p. 39.

5 Ms J Nash, ANZ Bank, *Transcript,* 16 May 2006, p. 35.

4.8 Mr Peter Mair agreed that an independent review of the payments system is necessary and that the Productivity Commission would be an appropriate group to conduct such a review.[6]

Committee conclusions

4.9 The committee is pleased that the RBA has foreshadowed the 2007 review of its payments system reforms. It is prudent that such significant reforms be reviewed to ascertain whether the objectives have been met.

4.10 The committee believes it is appropriate for the RBA to conduct a review of its own reforms. The RBA is well placed to conduct a review given the expertise it has built up throughout the reform process. The committee does not believe, at this stage, there is a need for an independent review.

Reducing four-party scheme interchange fees

4.11 The RBA stated that its interest in the credit card system stems from:

> The observation that from a cardholder's perspective, credit card transactions are typically priced much more attractively than EFTPOS transactions.[7]

4.12 From the RBA's perspective:

> This appeared to be somewhat paradoxical, given that the EFTPOS system has substantially lower costs of operation than the credit card system.[8]

4.13 The RBA also noted that:

> Cardholders who use credit cards purely as a payment instrument contribute least to the cost of credit card schemes and, in some cases, are effectively paid to use credit cards.[9]

4.14 The concern was that competition between payments providers did not ensure that the lower cost of providing EFTPOS transactions was reflected in a lower price to cardholders for EFTPOS. The lower cost system—

6 Mr P Mair, *Transcript*, 16 May 2006, p. 3.

7 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

8 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

9 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access*, p. 59.

EFTPOS—actually costs consumers more. The RBA found that 'a major reason for the lower-cost system being offered … at a higher price is the existence of interchange fees.'[10] The RBA therefore sought to regulate and cut interchange fees.

4.15 The reforms, which came into effect from the end of October 2003, involved 'the adoption of an objective, transparent and cost-based benchmark which will be used as a basis for determining interchange fees in credit card schemes.'[11] The cost-based benchmark, which was determined by the RBA separately for each of the four-party schemes—Visa, MasterCard and Bankcard—was based on 'the costs of transaction processing, authorisation, fraud and fraud prevention and funding the interest free period.'[12] The benchmark does not include the costs of rewards schemes.

4.16 The reforms, according to the RBA, have:

- Cut the average interchange fee by around 40 basis points. Now when $100 is spent on a credit card the issuer gets, on average, around 55 cents, rather than around $1. The interchange fee has remained as a percentage of the transaction value.
- Also passed through to merchant service fees. The average fee is now a little under 1 per cent, compared with nearly 1½ per cent in early 2003 and around 1¾ per cent in the late 1990s. [13]
- Saved merchants and their customers around $580 million. [14]

Arguments against the RBA position

Savings have not been passed on to consumers

4.17 There are a number of groups who oppose the RBA's intervention. One aspect of this opposition is the argument that the savings from the reduction in interchange fees have been passed through to merchants, but not through to consumers. Visa, for example, asserted that 'there has been

10 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

11 RBA, *Reform of credit card schemes in Australia*, media release, 27 August 2002.

12 RBA, *Interchange fees for the Bankcard, MasterCard and Visa credit card schemes*, media release, 31 October 2003.

13 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

14 RBA, *Payments System Board Annual Report 2005,* p. 15.

no discernible benefit passed on to consumers from merchants, who are now paying significantly lower merchant service fees.'[15]

4.18 Similarly, the ABA claimed 'there is no evidence that [merchants] have passed those savings on.'[16] MasterCard also argue in similar terms to both Visa and the ABA. In support of their position, MasterCard cited a quantitative study which showed that 'of the 300 merchants … surveyed, the majority were unaware of reduced merchant service fee pricing.'[17]

4.19 When questioned about the purported savings to merchants, the Australian Merchants Payments Forum (AMPF) stated that the savings have 'flowed through' to consumers.[18]

4.20 The Australian Consumers' Association (ACA), in part, agreed with the AMPF, stating 'we have seen consumers benefit through lower prices in some areas.'[19]

4.21 While the RBA acknowledge there is no quantitative proof merchants have passed savings on, they maintained 'there is reason to have confidence that ultimately the lower costs [to merchants] flow through to lower prices … the link between costs and prices is a long one.'[20] Ultimately, the RBA believes merchants have passed savings on.

The removal of restrictive rules would have been sufficient

4.22 Some groups argued that the removal of the no-steering provisions, the honour-all cards rule and the no-surcharge rule would have been a sufficient solution to the RBA's concerns—in other words, they argue interchange fee reform was unnecessary. The ABA, for example, stated:

> 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.[21]

4.23 In response to these claims, the RBA made three points:

> The first is that interchange fees are not subject to normal competition, the second is that the EFTPOS system is a lower cost

15 Mr B Mansfield, Visa, *Transcript,* 15 May 2006, p. 84.
16 Mr D Bell, ABA, *Transcript,* 15 May 2006, p. 46.
17 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 100.
18 Mr D Howell, Coles Myer, *Transcript,* 15 May 2006, p. 64.
19 Mr P Kell, ACA, *Transcript,* 15 May 2006, p. 77.
20 Dr P Lowe, RBA, *Transcript,* 15 May 2006, p. 9.
21 Mr D Bell, ABA, *Transcript,* 15 May 2006, p. 48.

> system—yet the configuration of interchange fees discourages the use of EFTPOS—and the third is that surcharging was unlikely to become sufficiently commonplace to send the appropriate price signals to card holders.[22]

The costs included in the cost-based methodology are flawed

4.24 The ABA argued that the costs included in the cost-based methodology that the RBA has used to calculate interchange fees are flawed:

> 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 … 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.[23]

4.25 While MasterCard agreed that a cost-based approach was the best way to determine interchange fees, they differed with the RBA on what should be 'the component parts of the cost based formula.'[24]

4.26 ANZ Bank were equally critical of the eligible components which make up the cost-based formula:

> Costs of running the system, including statement production and distribution, operating risk capital, risk assessment, payment processing, card plastic, except for lost or stolen cards, core operating system costs and a return on the cost of capital invested in providing the system and regulatory and compliance costs [are] no longer eligible to be recovered from merchants [through interchange fees].[25]

4.27 Against the claims of the four-party card schemes and the banks, the RBA argued that their cost-based approach is 'objective' and 'transparent'.[26]

The effect of the reforms has been 'neutral'

4.28 Prior to the reforms, Professor Joshua Gans argued that the RBA's interchange fee reform would have a 'neutral' effect:

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22 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 41.

23 Mr D Bell, ABA, *Transcript,* 15 May 2006, p. 40.

24 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 106.

25 Ms J Nash, ANZ Bank, *Transcript,* 16 May 2006, p. 34.

26 RBA, *Reform of credit card schemes in Australia,* media release, 27 August 2002.

> What neutrality means is that even were the interchange fee to change dramatically, other prices in the system would adjust (particularly if surcharging was permitted) so that consumers and merchants faced exactly the same decision regarding whether to make use of credit cards or not. For example, a lower interchange fee would tend to lead to increased card fees for consumers (and lower loyalty rewards). However, it would also lead to a lower merchant service fee. So merchants would be more encouraging of consumers to use cards to offset the direct impact of higher fees on those consumers. In the extreme, these changes would balance out and we would see little change in historic patterns of card use.[27]

4.29 In terms of the actual effect of the interchange fee reforms, Professor Gans argued that his hypothesis has largely proven true. He told the committee 'on a causal look at the data, [the] effect does not appear there.'[28] Similarly, Dr Ric Simes argued 'I think we have seen a redistribution within consumers but little net effect on consumers overall.'[29]

4.30 Evidence given by the RBA contradicts the proposition that the reforms have had a neutral effect. They told the committee that the reforms have had a substantial effect—reducing costs for merchants and consumers, and improving price signals for cardholders.

Three-party schemes have been given a competitive advantage

4.31 Both Visa and MasterCard argue that these reforms have given the three-party schemes—American Express and Diners Club—a significant competitive advantage. This issue is discussed in detail below under *Non-designation of three-party schemes*.

Interchange fees should be set at zero

4.32 Both Peter Mair and the AMPF argued that interchange fees should be set at zero, instead of being reduced. This issue is discussed in detail below under *Zero interchange fees.*

Reduced interchange fees result in reduced incentive to invest

4.33 Several groups argued that the reduction in credit card interchange fees has (and will in the future) resulted in less incentive to invest in new

27 Prof J Gans, *Submission no. 2,* p. 2.

28 Prof J Gans, *Submission no. 2,* p. 2.

29 Dr R Simes, *Transcript,* 15 May 2006, p. 33

technology. This issue is discussed in detail below under *Payments system techonology.*

Committee conclusions

4.34 The committee acknowledges there are differing perspectives on the issue of credit card interchange fees. On the one hand, the RBA argues interchange fees must be regulated because they are not subject to competitive forces and they have a pervasive effect on the price cardholders pay. The RBA asserts its reforms have delivered merchants, and consequently consumers, a $580 million saving. They also contend cardholders now face more appropriate price signals when using credit cards.

4.35 On the other hand, those who oppose the reforms—predominantly banks and four-party card schemes—generally argue the RBA's intervention was never actually required. They also disagree with the way in which the RBA has calculated the interchange fee benchmark. Essentially, those who oppose the reforms argue that the RBA has unnecessarily interfered in the credit card market, and there is no proof consumers are any better off.

4.36 The committee is not wholly convinced by either perspective. While there is no proof merchants have passed savings through to consumers, equally, there is no proof they have not passed savings on.

4.37 The committee does, however, have some general observations on credit card interchange fee reform. In terms of the promotion of more appropriate price signals, the committee generally supports the RBA's philosophy. The committee accepts that interchange fees are not set in a highly competitive market and that they have a pervasive influence on the price cardholders pay for payments products. Further, the committee agrees that consumers should not be excessively subsidising credit cardholders' free transactions and reward schemes. This is particularly true given that 45 per cent of consumers do not have credit cards.

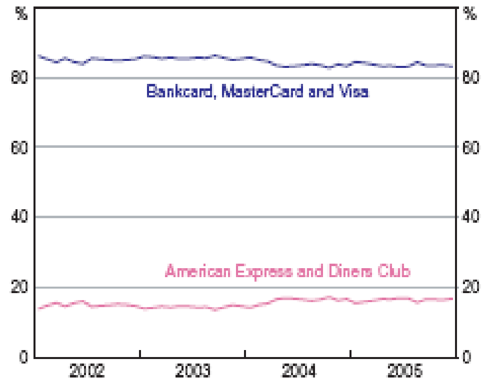
Non-designation of three-party schemes

4.38 As mentioned above, three-party card transactions do not involve interchange fees. Therefore, the three-party schemes have not been subject to the RBA's reform of interchange fees, nor have they been formally subject to any of the RBA's recent reforms. There are concerns that because three-party schemes are not subject to fee regulation, they have a competitive advantage. The RBA stated:

> The fact that this decline in [three-party schemes' merchant] fees has been less than that in the credit card schemes has led to periodic calls for the Bank to regulate American Express and Diners Club in the same way as it regulated the other schemes.[30]

4.39 Furthermore, there has been an evident increase in the three-party schemes' market share following the reforms of four-party schemes' interchange fees. Three-party schemes have increased their share from 14.6 per cent to 16.5 per cent.[31] (see figure 4.1 below)

Figure 4.1 Market shares of card schemes by value of purchases



Source *P Lowe, The evolution and regulation of the payments system, Speech to the Payments System Conference 2006, 14 March 2006.*

4.40 The RBA argues that three- and four-party schemes' different business structures mean that it was 'simply not possible to regulate American Express and Diners Club in the same way, as there were no interchange fees in these schemes.'[32]

4.41 However, American Express credit cards are now issued by two Australian banks, and therefore some American Express transactions now involve interchange fees. The RBA considered whether these fees should be regulated, but decided that there 'was not a strong case to do so.'[33] The RBA's reasoning behind this decision was:

> A reduction in these [interchange fees] through regulation would be unlikely to cause a decline in American Express' merchant fees. This is the contrary of the situation with the credit card schemes

30 RBA, *Payments System Board Annual Report 2005*, p. 15.
31 RBA, *Payments System Board Annual Report 2005*, p. 16.
32 RBA, *Payments System Board Annual Report 2005*, p. 15.
33 RBA, *Payments System Board Annual Report 2005*, p. 16.

> where regulation of interchange fees saw merchant fees decline immediately. This difference reflects the fact that … American Express is the sole acquirer of transactions on its cards. This means that unlike in the credit card schemes, the causation runs from merchant service fees to interchange fees, not the other way around.[34]

4.42 The schemes have, however, agreed to a number of voluntary changes after discussions with the RBA:

> In 2002, they agreed to remove the no surcharge clauses from their merchant contracts and in 2005 to remove anti-steering provisions from their contracts. The schemes have also agreed to publish their average merchant fees and their combined market share.[35]

4.43 The RBA argues that these voluntary reforms have been significant:

> As a result of these changes, merchants now have a greater range of options, and better information, when negotiating with American Express and Diners Club.[36]

Arguments against the RBA position

4.44 Both MasterCard and Visa argued to the committee that the two three-party schemes—American Express and Diners Club—have been advantaged by the regulation of interchange fees. A major concern of the four-party schemes is that three-party schemes' merchant service fees have fallen by much less than their own. MasterCard highlighted this point, stating:

> The average merchant fee payable for a MasterCard or Visa transaction was 0.98% for the December 2005 quarter, down from 1.45% in September 2003 and 1.8% in 1999. In comparison the average merchant fee payable to the unregulated American Express was 2.33% for the same period, down from 2.7% in 1999. The gap between American Express merchant fees and those chargeable for MasterCard, Visa and Bankcard transactions has grown from 0.90% in 1999 to 1.35% in December 2005 or, expressed in a different way, American Express fees are now 138% higher than those applicable to regulated schemes.[37]

34 RBA, *Payments System Board Annual Report 2005,* p. 17.

35 RBA, *Payments System Board Annual Report 2005,* p. 28.

36 RBA, *Payments System Board Annual Report 2005,* p. 28.

37 MasterCard, *Submission no. 5,* p. 3.

4.45 Visa and MasterCard argued that as a result of this difference in merchant fees it is much easier for three-party schemes to offer their cardholders generous rewards, and therefore increase their market shares. Consequently, they argued that American Express and Diners Club have been significantly advantaged.

4.46 Visa and MasterCard argued that the three-party schemes' increase in market share, which some describe as modest, is in fact significant. MasterCard contended:

> The combined share of unregulated schemes grew immediately from 13.7% to 16.9%. This represents a shift of more than $4.5 billion in spend from the regulated to the unregulated schemes—costing merchants an additional $63 million in merchant fees per annum.[38]

4.47 Likewise, Visa asserted:

> 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.[39]

4.48 Conversely, the RBA asserted that three-party schemes' increase in market share has been small, stating:

> Our assessment to date—and people present the numbers differently—is that the movements in market share are relatively small. So, despite the more generous reward schemes being offered by some of the cards, there has not been a wholesale migration from the four-party schemes to the three-party schemes.[40]

4.49 Professor Joshua Gans also argued that the increase in three-party schemes' market share has been 'slight'. In addition, Professor Gans argued that 'it is not clear [increased market shares for three-party schemes] would not have been happening that way anyway.'[41]

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38 MasterCard, *Submission no. 5,* p. 4.

39 Mr B Mansfield, Visa, *Transcript,* 15 May 2006, p. 84.

40 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 54.

41 Professor J Gans, *Transcript,* 15 May 2006, p. 27.

4.50 The RBA has previously conceded that the reform of four-party schemes' interchange fees has not necessarily resulted in competitive neutrality:

> While in an ideal world regulation would be competitively neutral, designing such regulations is problematic when the various card schemes have different structures and are subject to different competitive dynamics.[42]

4.51 However, the RBA also noted that 'if [competitive neutrality] is going to be the pre-eminent principle then we do not have any regulation of interchange fees.'[43] Instead of looking at competitive neutrality as the principle underpinning reform of the payments system, the RBA commented that 'the parliament has said we have to take the public interest into account, and that is really what we have done.'[44]

4.52 When asked at what point they would consider that competitive distortions had outweighed the public benefit, the RBA stated:

> There is no magic point here. The observation that I would make would be that if the market shares of the three-party schemes were to increase significantly and at the same time … there was no reduction in the average merchant service fee of those schemes, then that would raise the issue of whether the competitive positions of the different schemes were starting to undermine the benefits of the reforms. But you would need to see both of those things, because there is nothing wrong with American Express increasing its market share. That may well be the outcome of a competitive marketplace. It would concern us more if we thought that that outcome was the result of the regulatory reforms, and one sign that that could be occurring is if the average merchant service fee that they charge did not fall any further.[45]

4.53 Overall, the RBA's approach to the different structures of three- and four-party cards schemes has been:

> To focus its efforts on those areas where it has judged that competition is not working appropriately. For the credit card schemes this has primarily involved the regulation of interchange fees, while for American Express and Diners Club it has primarily involved ensuring that merchants are not unnecessarily restricted in their negotiations with the schemes. This approach has

42 RBA, *Payments System Board Annual Report 2005,* p. 17.

43 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 54.

44 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 54.

45 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 52.

> delivered significant benefits for consumers, and these benefits are likely to grow through time as merchants use the full range of tools now available to them.[46]

Committee conclusions

4.54 The committee acknowledges that, once again, there are divergent views on this issue. The RBA claims that any advantage to the three-party schemes has been small, which it argues is proven by the relatively modest increase in their market share. Moreover, the RBA claims its reforms are justified on the grounds of a significant public benefit. Conversely, Visa and MasterCard are of the view that Diners Club and American Express have been advantaged by the RBA's reforms. They see the increase in three-party schemes' market share as significant, rather than modest.

4.55 Once again, the committee is not wholly convinced by either side of this argument. The claims of the three- and four-party schemes are, as one would expect, self serving.

4.56 The object of the RBA's reform was to fix the problems it saw within each scheme. The fact is three-party schemes do not have multilaterally set interchange fees, and therefore it is not possible for the two schemes to be regulated in the same way. The RBA was only able to address the problems it saw within each scheme. For three-party schemes the problems were the no steering rule, the no surcharge rule and the publication of merchant fees. For four-party schemes the problem was predominately the collectively set interchange fee.

4.57 The committee acknowledges that three-party schemes have been advantaged when compared to the pre-reform situation. However, it must be remembered that the pre-reform situation was one in which four-party schemes had built a dominant market share operating with centrally set, unregulated interchange fees. The RBA has subsequently found that the operation of a centrally set, unregulated interchange fee is inappropriate—a finding with which this committee generally agrees (see above under reducing four-party scheme interchange fees)—and as such has moved to regulate it.

4.58 One of the effects of this regulation has been to provide some kind of 'advantage' to three-party schemes. However, it is only an advantage when compared to the pre-reform situation—a situation which has subsequently been found to be inappropriate. The other effect of these

46 RBA, *Payments System Board Annual Report 2005*, p. 17.

reforms has been to provide structure and transparency in the setting of interchange fees—fees which are centrally set between organisations that are in direct competition. In the committee's view the latter effect outweighs any alleged advantage.

4.59 In the post-reform situation, if a four-party scheme wishes to offer its customers significant rewards in an effort to compete with three-party schemes, then it can charge its customers high annual fees, just as three-party schemes do. It is true, however, that four-party schemes now have less revenue available from merchants to provide reward schemes. This is because their charges to merchants, which are transferred through interchange fees, are now considerably lower. This actually advantages four-party schemes in some respects. For example, because their product is cheaper for merchants, a lot more merchants accept it. Therefore, in terms of accessibility, their cards are considerably more attractive to consumers. Essentially, the committee believes that the main advantages and disadvantages of each scheme lie within their fundamentally different business structures, not in the RBA's reforms.

Reducing debit card interchange fees

4.60 As noted above, the EFTPOS system has lower operating costs than the credit and scheme debit card systems but costs cardholders more to use. The RBA has attempted to address this imbalance through regulation of credit cards, and have now also introduced changes to the debit card system—both for EFTPOS *and* for scheme debit.

4.61 Prior to the reforms, when a person made a scheme debit card transaction their bank (the issuer) *received* an interchange fee from the acquirer of, on average, 40 cents. Conversely, when a person made an EFTPOS transaction their bank *paid* an interchange fee to the acquirer of, on average, 20 cents.[47]

4.62 These arrangements resulted in a 60 cent interchange fee differential between the two systems. The RBA's concern was:

> The structure of [debit card] interchange fees creates a strong incentive for financial institutions to promote the Visa Debit system over the EFTPOS system, despite the EFTPOS system having lower operating costs.

4.63 The RBA argued:

47 RBA, *Payments system reform,* media release, 24 February 2005.

> If the [debit card] arrangements were to remain unchanged, it is highly likely that the Visa Debit system would grow at the expense of the EFTPOS system, simply because of the structure of interchange fees.[48]

4.64 Consequently, the RBA has initiated changes to interchange fees for both EFTPOS and scheme debit cards. In determining these fees the RBA noted that it used similar methodology to that used in determining credit card benchmarks—nominating eligible costs. Once a benchmark has been determined, average interchange fees are required to be at or below that level.[49]

4.65 The eligible costs for the EFTPOS benchmark, which comes into force on 1 November 2006, are the acquirers' switching and processing costs. While the interchange fee will still flow in the opposite direction to credit and scheme debit cards—from issuer *to* acquirer—the average fee is expected to reduce from an average of 20 cents, to around 4 or 5 cents.[50]

4.66 The eligible costs for the scheme debit card benchmark are the issuer's authorisation and processing costs. This benchmark differs from the credit card benchmark (scheme debit cards having previously been set at the same level as a scheme's credit cards), by removing the costs of fraud and fraud prevention, and funding of the interest free period. Under these new standards, scheme debit card interchange fees are expected to be reduced from an average of 40 cents per transaction, to a flat fee expected to average around 15 cents per transaction.[51]

4.67 These reforms will apply to all EFTPOS transactions, except those involving the provision of cash by merchants to cardholders. With respect to this exclusion, the RBA asserted that:

> At this stage, the Bank is not convinced that the public interest would be served by regulating these fees, particularly when interchange fees for cash withdrawals through ATMs are not subject to regulation. As a result, issuers and acquirers will be able to negotiate a separate interchange fee for EFTPOS transactions involving the provision of cash.[52]

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48 RBA, *Payments system reforms,* media release, 27 April 2006.

49 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

50 RBA, *Payments system reforms,* media release, 27 April 2006.

51 RBA, *Payments system reforms,* media release, 27 April 2006.

52 RBA, *Payments system reforms,* media release, 27 April 2006.

4.68 The scheme debit card standards have not been gazetted as the RBA is allowing Visa and MasterCard an opportunity to voluntarily comply. The standards will be gazetted if, at 1 July 2006, Visa and MasterCard have not provided an undertaking to the RBA that they will voluntarily comply with the changes.[53]

4.69 Overall, the RBA argues that the reform of debit card interchange fees:

> Will promote competition between the schemes based on the benefits that they offer to cardholders and merchants, rather than on fees that are not subject to normal competitive pressures.[54]

Arguments against the RBA position

Lower interchange fees for scheme debit will push people to credit cards

4.70 The Credit Union Industry Association (CUIA) argued that the imminent reduction in scheme debit interchange fees will push people away from debit cards and toward credit cards:

> A cardholder buying a $1000 washing machine 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 earn the card issuer 15 cents.
>
> …
>
> CUIA believes the price signals starkly shown in the above example will push Visa Debit issuers to steer cardholders towards credit cards.[55]
>
> …
>
> 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.[56]

4.71 The ACA shared the concerns of CUIA, stating 'we think [scheme debit changes] have the potential, if things go the wrong way, of driving consumers back to more expensive credit card based transactions.'[57]

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53 RBA, *Payments system reforms,* media release, 27 April 2006.

54 RBA, *Payments system reforms,* media release, 27 April 2006.

55 CUIA, *Submission no. 7,* p. 2.

56 Ms L Petschler, CUIA, *Transcript,* 15 May 2006, p. 55.

57 Mr P Kell, ACA, *Transcript,* 15 May 2006, p. 77.

4.72 In response to these claims, the RBA stated:

> One consequence of that narrowing is that, at the margin, building societies and credit unions find it less attractive to issue Visa Debit. At the margin, a few more customers may use credit cards rather than Visa debit as a result of these reforms. But I think the entirety of the package is a set of reforms that will encourage the use of debit relative to credit and it will make sure that the EFTPOS and the Visa Debit systems compete on their merits rather than through interchange fees, which are longstanding and not subject to competitive pressures.[58]

The costs included in the cost-based methodology are flawed

4.73 CUIA agreed that a four-party scheme's credit and debit transactions should have different interchange fees:

> 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.[59]

4.74 However, CUIA had concerns as to the level at which the RBA has set scheme debit interchange fees:

> 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.[60]

4.75 MasterCard shared similar concerns, stating:

> 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

58 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 48.

59 Ms L Petschler, CUIA, *Transcript,* 15 May 2006, p. 56.

60 Ms L Lawler, CUIA, *Transcript,* 15 May 2006, p. 58.

> counterproductive, particularly in the debit interchange formula that the bank is proposing.[61]

4.76 The RBA, in the debit card reforms' Regulation Impact Statement, defended the level at which scheme debit interchange fees will be set, stating:

> The Bank's approach to interchange fees is not one in which interchange fees are set to recover costs on one side of the system. Rather, the Bank is concerned with the overall effect on the efficiency of the payments system of the configuration of interchange fees across the various individual systems.[62]

Interchange fees should be set at zero

4.77 Both Peter Mair and the AMPF argued that interchange fees should be set at zero, instead of being reduced. This issue is discussed in detail below under *Zero interchange fees.*

Reduced interchange fees result in reduced incentive to invest

4.78 Several groups argued that the reduction in debit card interchange fees will in the future result in less incentive to invest in new technology. This issue is discussed in detail below under *Payments system techonology.*

Committee conclusions

4.79 The committee has found that there is little resistance to the lowered interchange fee for EFTPOS transactions. While merchants initially challenged the reform in the Federal Court, they came to the committee with a new perspective—zero interchange fees—which will be discussed below.

4.80 There is more resistance to the reduction in interchange fees for scheme debit transactions. The major objections came from the Credit Unions, who issue most of the scheme debit cards in Australia, as well as Visa and MasterCard. They essentially argued that reducing interchange fees would push scheme debit cards out of the market and push people toward credit cards. Conversely, the RBA argues that its reforms are necessary to promote more appropriate price signals between the two debit products.

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61 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 102.

62 RBA, *Reform of the EFTPOS and Visa Debit systems in Australia: Final Reforms and Regulation Impact Statement,* April 2006, p. 28.

4.81 The committee once again recognises that interchange fees have a strong influence on the fees cardholders are charged. Therefore, the committee considers that it appropriate for the RBA to regulate when interchange fees are causing distorted price signals. Indeed, the Credit Unions have agreed that scheme debit interchange fees should be lower than credit card interchange fees—they simply differ with the RBA on where it should be set.

4.82 At this point, the committee suggests there is no evidence as to the appropriateness of the level at which interchange fees have been set for the two debit products. Further, there is no evidence as to whether scheme debit customers will be drawn to use credit cards. Given that at the time of writing these reforms were not yet implemented, the committee feels that it would be premature to make any assessments. This issue should be closely scrutinised as part of any future review.

Are interchange fees unlawful?

4.83 Throughout the committee hearings and submissions there was debate over the legality of the four-party card schemes' multilateral interchange fees.

4.84 The submission of American Express contended:

> The multilateral interchange fees (MIF), which are a feature of the MasterCard and Visa card schemes in all countries, have been found by competition regulators in other countries to be unlawful anti-competitive agreements. [63]

4.85 In rebuttal of this claim, Visa stated:

> Regulators in the UK and Australia have expressed concern about the way interchange operates and the level of the interchange fee. They have subsequently either required or negotiated changes to the process of setting interchange fees. However, none of these regulators have found interchange fees to be illegal under any aspect of competition law.[64]

4.86 In similar terms, MasterCard maintained 'interchange fees have not been found to be illegal in any country in the world'.[65]

63 American Express, *Submission no. 6,* p. 14.

64 Visa, *Submission no. 23,* p. 5.

65 Mr A Naffah, MasterCard, *Transcript,* 15 May 2006, p. 103.

4.87 The Australian Competition and Consumer Commission (ACCC) confirmed to the committee that the setting of four-party schemes' interchange fees was thought to be in breach of the *Trade Practices Act*:

> The way the fees were set was the issue.[66]
>
> …
>
> There was a multilateral agreement between banks whereby they would set an interchange fee which had the effect or likely effect of controlling or maintaining the merchant service fee levels. [67]

4.88 However, the ACCC also stated:

> We did not have necessarily a problem with the interchange fee system as such and that there were potential public benefits that could result from a proper system being devised.[68]

4.89 Given this statement, the ACCC 'encouraged the banks to approach [them] for authorisation of an interchange fee system.'[69] However, in 2001 the ACCC concluded that an authorisation was not likely to occur:

> It was the Commission's view that effective and timely reform of the interchange fee system was not occurring. We therefore recommended that the Reserve Bank actually designate and use its powers to reform the system.[70]

4.90 The ACCC formed a view that 'the designation process of the Reserve Bank is a more direct and potentially more effective way of achieving [interchange fee reform].'[71]

4.91 Once the RBA designated under the *Payments System (Regulation) Act 1998,* the *Trade Practices Act 1974* ceased to apply to four-party schemes:

> Following the designation of those services by the Reserve Bank, the arrangements behind the interchange regime in relation to both credit and debit card systems fall outside the scope of the competitive provisions of the TPA and, accordingly, fall outside the scope of our enforcement and compliance activities.[72]

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66 Mr J Dimasi, ACCC, *Transcript,* 15 June 2006, p. 7.

67 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

68 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

69 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

70 Mr T Grimwade, ACCC, *Transcript,* 15 June 2006, p. 7.

71 Mr J Dimasi, ACCC, *Transcript,* 15 June 2006, p. 7.

72 Mr J Dimasi, ACCC, *Transcript,* 15 June 2006, p. 7. Under section 18A of the *Payments System (Regulation) Act 1998,* any actions involved in complying with Standards set under the Act are exempt from the provisions of the *Trade Practices Act 1974.*

Committee conclusions

4.92 The committee notes that four-party schemes' interchange fees, prior to designation, may have been in breach of the *Trade Practices Act.* However, now that the schemes have been designated under the *Payments System (Regulation) Act*, and interchange fee standards have been set, four-party schemes' interchange fees are regarded as lawful by both the RBA and the ACCC.

Zero interchange fees

4.93 At the committee's hearings both the AMPF and Mr Peter Mair proposed that Australia move to zero interchange fees for all payments systems.

Arguments for zero interchange fees

4.94 The AMPF stated that 'having zero interchange fees would remove any distortion in the payments system and may well avoid a swing to credit cards.'[73]

4.95 Mr Peter Mair argued that interchange fees are only necessary in infant systems:

> There may be a case for having an interchange fee in the early stages of setting up a payments network but, for a mature payments network like credit cards, BPay or EFTPOS, there is no longer any need for that.[74]

4.96 Some of the other proposed benefits of zero interchange fees are:

- Cardholders would be presented with true price signals for each product.
- Zero interchange fees would mean that cardholders are bearing costs, not consumers generally.

4.97 The RBA, while not necessarily supporting the concept, commented:

> It is an interesting idea and worth further exploration. Of course, we already have zero interchange fees in a number of our payment systems in Australia. In the cheque system there is no interchange fee, in the direct debiting system there is no interchange fee and in

73 Mr R Zimmerman, AMPF, *Transcript*, 15 May 2006, p. 63.

74 Mr P Mair, *Transcript,* 16 May 2006, p. 10.

> the direct crediting system there is no interchange fee. Zero interchange fees exist in some very successful debit card systems around the world.[75]

4.98 Interestingly, a recent report of the European Commission found that 'interchange fees are not intrinsic to the operation of card payment systems, as several national systems operate without an interchange fee mechanism.'[76]

Arguments against zero interchange fees

4.99 A number of groups were either opposed, or raised arguments against, zero interchange fees. The RBA, for example, stated:

> There are solid theoretical arguments as to why non-zero interchange fees might promote the efficiency of the system. There is a large and growing volume of academic literature exploring the rationale for non-zero interchange fees. Many of the points in that literature have merit.[77]

4.100 ANZ Bank commented on the implications of zero interchange fees for cardholders, stating:

> Zero interchange would mean credit card holders would likely face increased annual fees, increased interest rates, reduced or no interest-free period (which delivers benefits to card holders and merchants) and curtailed or no loyalty programs.[78]

4.101 CUIA criticised the proposal as an attempt from merchants to escape contributing to the cost of issuing credit cards, asserting:

> By seeking zero interchange fees, merchants are asking cardholders to pay for services provided by card issuers that benefit merchants. CUIA believes merchants should pay for services that benefit merchants.[79]

4.102 MasterCard considered that zero interchange would not respect past and future investment in networks, arguing:

> I do not believe it respects the investment that has gone into building the network both domestically and globally by

75 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 43.

76 European Commission, *Interim report I: Payments cards,* 12 April 2006, p. 32.

77 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 43.

78 ANK Bank, *Submission no. 17,* p. 2.

79 CUIA, *Submission no. 18,* p. 2.

> MasterCard and our customers. So I think it is highly inappropriate.[80]

4.103 Visa commented on the likely effect of zero interchange on innovation and technology:

> If card schemes such as Visa International were compelled to set the interchange fee at zero, they would be prevented from addressing the investment incentive problem on the issuer side. Cardholders would need to pay the full cost of card innovation even though it is clear that many of these innovations in cards provide substantial benefits to merchants, particularly innovations in the area of security and anti-fraud measures.[81]

4.104 Visa also commented on the likely effect on its business:

> If the current Visa International interchange fee were reduced to 0 while the implicit MIF embodied in the merchant service fee that American Express charges its merchants was unregulated, the potential pool of funds for investing in the cultivation of cardholder membership would be cut by millions of dollars each year. For these issuers the prospect of issuing American Express cards would become relatively more attractive than issuing VISA cards, leading them to promote issuing of American Express payment cards at the expense of Visa International. [82]

4.105 Another argument against zero interchange is that it would result in less incentive to invest in new technology. This issue is discussed below under *Payments system technology.*

Committee conclusions

4.106 The committee is of the view that while the concept of zero interchange fees is an interesting one, it would require intense examination before being considered in the context of the Australian payments system. Reducing interchange fees to zero would have the greatest impact on four-party scheme credit cards—debit cards interchange fees will be near to zero when the reforms come into effect. If credit card interchange fees were moved to zero, the committee believes that there would be two direct consequences:

80 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 110.

81 Visa, *Submission no. 23,* p. 8.

82 Visa, *Submission no. 23,* p. 8.

- Issuers would need to recoup all of their costs from cardholders. Therefore, the prices paid by cardholders would increase; and
- Merchants' costs would be reduced because the merchant service fees, which are largely determined by interchange fees, would fall.

4.107 Those who are in favour of zero interchange fees support both of these outcomes. They argue that cardholders should bear the costs of issuing a credit card, not merchants.

4.108 It is true that any credit card interchange costs that are imposed on merchants result in higher prices for goods and services, and are therefore paid by all consumers, irrespective of whether they use credit cards. However, it is also true that all payment instruments incur a cost for merchants. There are costs for merchants in accepting cash, which, as with merchants' (who do not surcharge) interchange costs, are blended into the price of goods and services. The committee is not concerned that *some* of the costs of issuing credit cards are, in effect, paid by all consumers, just as the costs of merchants accepting cash, and any other payment product, are paid by all consumers. Under the old credit card interchange fee arrangements, merchants and consumers were effectively paying *all* of the costs. Under the current arrangements these costs are more evenly shared.

4.109 The committee notes that if surcharging were to be adopted by all businesses it would have the same effect as zero interchange fees—cardholders would be bearing all of the issuers' costs. While the committee supports the right of merchants to surcharge—a right they now have with all payment instruments—the committee doubts that surcharging will ever be common practice, as is explained below.

Removing the 'no surcharge' rule

4.110 According to the RBA the no surcharge rule:

> Prevents merchants from passing merchant service fees onto customers who choose to use credit cards. Merchants therefore face an 'all or nothing' choice—accept credit cards and absorb the merchant service fees into their overall cost structure, or refuse to accept credit cards at all.[83]

4.111 The RBA argues that:

83 RBA, *Standard on merchant pricing*, media release, December 2002.

> [Merchants'] ability to resist credit cards has been increasingly eroded as consumers respond to current price incentives by increasing the take-up of credit cards and demanding to make more and more use of them. Merchants have only limited negotiating power to put pressure on merchant service fees and indirectly, interchange fees.[84]

4.112 Therefore, the RBA, as of 1 January 2003, has required that four-party credit card schemes remove the no surcharge rule. Since this change, the RBA notes that:

- There has been charging in a wide range of industries, although the vast majority of merchants still do not charge.
- There have been some high-profile examples of large merchants surcharging, but surcharging has also become quite common amongst small firms operating in very competitive low-margin businesses—computer shops, removalists and carpet layers for example.
- In some cases the ability to levy a charge has actually led merchants to introduce credit cards as a payment option. Previously these cards were simply too expensive, so they were not offered.[85]

4.113 While not falling under the RBA's regulation, the three-party schemes—American Express and Diners Club—voluntarily agreed to comply with the removal of the no surcharge rule.[86] The removal of the no surcharge rule also already applies in practice to the Visa and MasterCard debit cards, although discussions are ongoing with these schemes as to whether its formal removal will be made voluntarily, or through the determination of standards by the RBA.

4.114 Overall, the RBA is highly supportive of merchants' right to surcharge. In fact, the RBA is so supportive of surcharging that the Governor of the RBA, Mr Ian McFarlane, stated 'we think [merchants] are acting in the national interest when they [surcharge].'[87]

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84 RBA, *Standard on merchant pricing*, media release, December 2002.

85 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

86 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* RBA, Sydney, August 2002, p. 33.

87 Mr I McFarlane, RBA, *Transcript,* 17 February 2006, p. 37.

Arguments against the RBA position

4.115 The committee did not hear a great deal of evidence which completely opposed the removal of the no surcharge rule. Visa, however, opposed the removal of the rule in part stating 'it is inappropriate to permit surcharging where interchange fees are strictly regulated.'[88]

4.116 Other groups were supportive of the rule's removal. Diners Club, for example, stated:

> We regard surcharging as an issue between the retailer and the customer, not between the retailer and us. If the retailer believes that it is positive for their relationship with their customer to negate and refuse their payment choice, then that is what the retailer should do.[89]

4.117 Similarly, CUIA stated:

> 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.[90]

4.118 However, there was evidence about concerns that the right to surcharge was being abused. For example, Visa asserted:

> 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.[91]

4.119 A number of groups therefore commented that the surcharge should be capped at the merchants' costs. MasterCard, for example, stated:

> 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.[92]

4.120 On the possibility of capping surcharges, the RBA stated:

> The credit card standard says that the acquirer may come to an agreement that the surcharge is to be no greater than the merchant service fee. The standard specifically allows that possibility. The

88 Mr B Mansfield, Visa, *Transcript,* 15 May 2006, p. 85.
89 Mr M McDonald, Diners Club, *Transcript,* 16 May 2006, pp. 15–16.
90 Ms L Lawler, CUIA, *Transcript,* 15 May 2006, p. 58.
91 Mr B Mansfield, Visa, *Transcript*, 15 May 2006, p. 85.
92 Mr L Clapham, MasterCard, *Transcript,* 15 May 2006, p. 101.

> Reserve Bank, though, does not have the legislative power to say to the merchants of this country, 'You may not charge more than X for accepting a payment instrument.' That is beyond the scope of the power that the parliament has given the Reserve Bank. That is not something that the Payments System Board could do. It would have to be an initiative of government to pass relevant legislation.[93]

Committee conclusions

4.121 The committee believes that merchants should, in principle, have a right to surcharge, particularly when they are faced with significantly different prices for different payments products. The no surcharge restrictions only applied to credit and charge card transactions—merchants were always allowed to surcharge for all other payment products, including cash, debit cards, cheques and BPAY. These reforms bring all payments products into line.

4.122 However, the committee notes that surcharging has not yet become commonplace, particularly in highly competitive industries. Unsurprisingly, the committee heard that surcharging has only become common in industries where organisations have market dominance. While the committee is supportive of the rights of merchants to surcharge, the committee doubts whether surcharging will ever become widespread. Many merchants actually prefer being paid by card and therefore would not want to discourage its use by surcharging.

4.123 The committee was concerned by evidence which suggested that some merchants are profiteering from the ability to surcharge. While the committee notes proposals for surcharges to be capped at a merchant's costs, it does not believe a cap would be entirely effective. Surcharging—and in particular excessive surcharging—occurs in markets not subject to high levels of competition. If merchants in these markets want to charge excessively, they could simply do so through the prices of goods and services. If surcharges were to be capped, it is possible that other prices would rise to compensate for the lost revenue.

Removing the 'honour all cards rule'

4.124 The honour all cards rule imposed by Visa has meant 'merchants that accept Visa credit cards are also required, by Visa, to accept Visa Debit

93 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 47.

cards.'[94] The RBA argued that this rule meant that 'normal competitive pressures [could not] bear upon the price or acceptance of Visa Debit cards.'[95]

4.125 Therefore, the RBA developed the Honour All Cards standard, which:

> Requires that this tying of acceptance of Visa credit and debit cards be removed by Visa. It also requires that Visa Debit cards be identified both visually and electronically to allow merchants to decline acceptance if they so choose.

4.126 These standards only refer to Visa's debit product; however, MasterCard—who are new to the scheme debit business in Australia—has given an undertaking that they will comply. As with the changes to scheme debit interchange fees, Visa and MasterCard are being given an opportunity to voluntarily comply with the standard.[96]

Arguments against the RBA position

4.127 Several groups argued strongly against the removal of this rule. CUIA, for example, stated:

> 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.[97]

4.128 Visa shared similar concerns, asserting:

> 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

94 RBA, *Payments system reforms,* media release, 27 April 2006.
95 RBA, *Payments system reforms,* media release, 27 April 2006.
96 RBA, *Payments system reforms,* media release, 27 April 2006.
97 Ms L Petschler, CUIA, *Transcript,* 15 May 2006, p. 54.

> for such cards to be part of their kids' daily lives. It's 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.

4.129 The AMPF, however, agreed with the RBA's perspective, stating:

> 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.[98]

Committee conclusions

4.130 The committee notes that there is differing opinion on this reform. The RBA argues that scheme debit cards and credit cards are fundamentally different products and therefore their acceptance should not be tied. Those who oppose the reform generally argue that it was unnecessary given the changes to scheme debit card interchange fees and the introduction of surcharging. They also argue that the reform will unnecessarily affect small institutions—credit unions and building societies—and scheme debit cardholders.

4.131 The committee does not believe that removing this rule will see widespread non-acceptance of scheme debit cards by merchants. Once the debit card interchange fee reforms are introduced, there will only be a small difference between the prices merchants pay for scheme debit and EFTPOS transactions. Therefore, the committee believes in competitive markets it would be unlikely that merchants would not accept scheme debit cards. The RBA should consider the impact of removing the honour all cards rule as part of its 2007 review.

Payments system technology

4.132 There was general consensus that Australia was once at the forefront of payments technology, but that it has subsequently fallen behind. Primarily, there was discussion about chip technology for all cards, and PIN technology for credit cards. There was also debate as to why EFTPOS cards do not offer the internet or over-the-phone functionality that credit cards do.

98 Ms D Karai, Woolworths, *Transcript,* 15 May 2006, p. 65.

Where has Australia fallen behind?

PIN-based credit cards

4.133 As outlined in chapter 3, credit card authorisation is signature-based, not PIN-based. It was noted during evidence that many countries around the world have moved to PIN-based authorisation. It was also noted that PIN-based systems are much more resistant to fraud.

4.134 Concerns were raised that Australians' signature-based cards may, at some point, become unusable in certain countries.

4.135 The AMPF told the committee that the capability to move to PIN-based credit cards has existed in Australia 'for 20 years'.[99]

Online EFTPOS

4.136 In Australia it is not possible to use EFTPOS cards over the internet or phone to make 'card not present' transactions. The RBA commented on this issue, stating:

> 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.
>
> …
>
> 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.[100]

4.137 The ACA commented on the desirability of having an online EFTPOS functionality.[101]

Chip technology

4.138 There was also some discussion of chip technology or 'EMV' (acronym for Europay, MasterCard and Visa) as it is also known. According to a report in *the Australian*, 'EMV compliant cards offer greater security against skimming, or copying the contents of a card's magnetic strip.' Further, the

99 Mr R Tweedle, Woolworths, *Transcript*, 15 May 2006, p. 76.

100 Dr P Lowe, RBA, *Transcript*, 15 May 2006, p. 18.

101 Mr P Kell, ACA, *Transcript*, 15 May 2006, p. 78.

article reports that 'Visa says this technology makes it almost impossible for a criminal to steal information to create counterfeit cards.'[102]

4.139 According to Visa's website, chip technology is already in widespread use:

> In Asia Pacific there are currently over 32 million Visa chip cards, which can be used in 750,000 chip terminals in 14 countries—Australia, Cambodia, HK, India, Japan, Korea, Malaysia, Maldives, NZ, Pakistan, Taiwan, Thailand, Vietnam, Singapore. Smart cards can be used at merchant locations worldwide and on the Internet.[103]

Why has Australia fallen behind?

The move to new technology is a cost-benefit proposition

4.140 During evidence the committee heard on numerous occasions that the move to new technology is a cost-benefit proposition—to justify any upgrade in technology the cost of fraud must be more than the cost of upgrading. Diners Club, for example, stated:

> Australia, as part of the wider global organisation, has obviously looked at chip and PIN based systems. The drivers of that are economic and a little bit political. The economics are the point at which your share of the cost to change the terminal fleet is roughly equal to the fraud that you are incurring or avoiding. That is the point at which you start to get interested in bearing, as I say, your share of replacing the terminal fleet.[104]

4.141 Similarly, the RBA stated:

> When we talked to the banks about why the upgrade to chip and PIN had not occurred in Australia, the answer has been that there is not a business case to do so. The argument has been that Australia already has very low levels of credit card fraud—we heard that again this morning—and there are few cost savings to be gained, at least at the moment, from the introduction of PIN on credit cards. As a result, in terms of fraud reduction, the investment simply did not pass the cost-benefit tests.[105]

102 K Mills, 'Smartcard surge tipped', *The Australian*, 16 May 2006.

103 Visa, *Chip Technology*, viewed 18 June 2006, <http://www.visa-asia.com/ap/au/cardholders/security/chip_technology.shtml?#What_are_smart_cards>.

104 Mr M McDonald, *Transcript*, 16 May 2006, p. 21.

105 Dr P Lowe, RBA, *Transcript*, 16 May 2006, p. 42.

Less interchange revenue means less incentive to invest

4.142 A number of groups told the committee that because there is less money in the system from the reduction in interchange fees, there is less incentive to invest in new technology. Visa, for example, argued:

> That the regulation is also contrary to good policy principles because it dampens incentives to invest by not allowing flexibility or the ability to obtain an adequate return on investment.[106]

4.143 Dr Ric Simes agreed that there is a connection between interchange revenue and investment, asserting:

> 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.[107]

4.144 Conversely, the RBA dismissed the connection between lower interchange fees and the incentive to invest, stating:

> The example that is most commonly cited is the lack of PIN and chip functionality on credit cards. In our view this has nothing to do with interchange fees. I note here that this chip and PIN functionality does not exist in the United States, where interchange fees are over three times higher than they are in Australia. In some other countries chip and PIN exist on debit cards where there are no interchange fees at all. I think the relationship between interchange fees and the decision to invest in chip and PIN is very weak. Ultimately, innovation is financed through revenue earned from fees charged to card holders and merchants. The RBA has not regulated these fees at all.[108]

4.145 The RBA also asserted:

> The RBA over a long period have stated that around 80 per cent of the costs of upgrading to chip and PIN fall on the acquiring side of the market and not on the card-issuing side. This is because most of the main costs in moving to chip and PIN involve the updating of merchants' terminals rather than the reissue of cards. Given the costs fall mainly on the acquiring side, I find it puzzling that people have argued that reducing interchange fees paid by the

106 Visa, *Submission no. 4*, p. 3.

107 Dr R Simes, *Transcript,* 15 May 2006, p. 34.

108 Dr P Lowe, RBA, *Transcript,* 16 May 2006, p. 42.

> acquirer to the issuer has in fact reduced the incentive for acquirers to upgrade their systems.[109]

4.146 ANZ Bank agreed that there is not necessarily a connection between investment and interchange fees, stating:

> In terms of why Australia has not rolled out chip technology when a number of countries around the world have, I would not say that that is directly related to interchange fees.[110]

Committee conclusions

4.147 The committee is concerned by the seemingly consensus view that Australia has fallen well behind in terms of payments system technology. In evidence, the committee heard that the reduction in issuers' interchange revenue was one of the reasons this has occurred. The committee does not accept this proposition. In the US, technology is even further behind but interchange revenues are three times as high. Conversely, technology is more advanced in some debit systems where interchange fees are zero.

4.148 The committee is particularly concerned that Australian credit cards still rely on signature-based, rather than PIN-based, authorisation. While credit card fraud is comparatively low in Australia, this does not mean steps should not be taken to prevent it. The committee considers that a move to PIN-based authorisation would be highly desirable in terms of fraud prevention. In addition, PIN-based authorisation would ensure that Australians' credit cards remain functional in overseas markets where PIN-based authorisation has been adopted.

4.149 The committee is also concerned that EFTPOS cards do not offer the same functionalities as credit cards or scheme debit cards—online and over-the-phone purchasing. The RBA noted in evidence that in other countries EFTPOS cards do offer these functionalities. Given that a significant proportion of Australians do not have a credit or scheme debit card, it seems they are excluded from the convenience of extra functionalities without good reason.

4.150 The committee notes the future importance of chip technology. The committee is of the view that its widespread introduction in the Australian payments system would be beneficial in terms of reducing fraud.

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109 Dr P Lowe, RBA, *Transcript*, 16 May 2006, pp. 42–43.

110 Dr J Fagg, ANZ Bank, *Transcript*, 16 May 2006, p. 39.

Recommendation 1

4.151 **The committee recommends that card schemes, issuers, acquirers and merchants work together to improve Australia's payments system technology. In particular, the committee recommends that this partnership:**

- **Implements PIN-based authorisations for credit cards;**
- **Implements 'online' functionality for EFTPOS cards; and**
- **Considers the widespread adoption of chip technology.**

Other reforms

4.152 There are a number of areas of reform or areas where there is proposed reform, which are less controversial and which were less prevalent in the committee's evidence. These topics are outlined below.

Improving interchange fee transparency

4.153 The RBA has argued that 'prior to [our] investigation, the level of interchange fees and merchant service fees were sometimes seen as close to state secrets.'[111] As part of their reforms, the RBA required more transparency and disclosure of interchange fees, merchant service fees and market shares.[112]

4.154 These changes, according to the RBA, 'have helped improve understanding of the credit card market and given merchants better information when negotiating with their banks.'[113]

Introducing a standard benchmark for four-party scheme interchange fees

4.155 Following the introduction of the initial interchange fee reforms there was around 2 basis points difference between the two major credit card

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111 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

112 RBA, *Payments System Board Annual Report 2005,* p. 9.

113 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

schemes' average interchange fee benchmarks. According to the RBA, this disparity partly resulted from:

> Differences in authorisation and processing costs across issuers as well as differences in the average cost of the interest-free period due to issuers having different portfolios of cardholders.[114]

4.156 The RBA determined that having a higher interchange fee provided one scheme with a competitive advantage over others. As the RBA noted:

> This difference, while small, may be encouraging credit card issuers to issue cards under the scheme with the higher interchange fee simply to receive more interchange revenue for each dollar spent by cardholders.[115]

4.157 Consequently, the RBA, instead of having a benchmark for each scheme based on their individual costs, has introduced a common benchmark to apply to all four-party card schemes. Under these changes, which are to apply from 1 November 2006, 'the weighted-average interchange fee in each of these … schemes must be no greater than a common benchmark.' The RBA will recalculate the benchmark every three years.[116]

Removing restrictions on access to four-party schemes

4.158 The RBA believed that credit card schemes were imposing unnecessary restrictions, which limited new entrants into the schemes. The RBA stated:

> Each scheme in Australia imposes minimum entry standards that are intended to ensure the safety of the scheme, but have the effect of unduly limiting competition.[117]

4.159 In particular, the RBA was concerned that:

- Only authorised deposit-taking institutions supervised by the Australian Prudential Regulation Authority (APRA) were eligible for participation.
- Two of the schemes prohibited their members from acting only as acquirers and two schemes have penalties for members whose business is weighted heavily towards acquiring rather than issuing.[118]

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114 Dr P Lowe, *Reform of the payments system*, Speech to Visa International Members Forum, 2 March 2005.

115 RBA, *Payments system reform,* media release, 20 July 2005.

116 RBA, *Payments System Board – November 2005,* media release, 25 November 2005.

117 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* p. 6.

118 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* p. 7.

4.160 The RBA argued that these penalties and restrictions:

> Discourage the participation of specialist credit card acquirers which could promote competition in the acquiring market and strengthen the representation of acquiring interests in the process of setting interchange fees.[119]

4.161 The RBA therefore introduced a new access regime that:

> Requires that specialist credit card institutions supervised by the Australian Prudential Regulation Authority (APRA) be eligible to apply for membership in the designated credit card schemes on the same basis as other authorised deposit-taking institutions. It also requires the removal of certain restrictions and penalties on the credit card acquiring activity of members. [120]

4.162 The access regime applies to Visa's and MasterCard's credit cards (and also applied to Bankcard, until the recent revocation of its designation—see below). Visa's debit products are subject to a separate formal access regime although it 'is largely the same as that imposed on the … credit card system.'[121]

Removing restrictions on access to the EFTPOS network

4.163 In 2000 the joint study of the RBA and ACCC determined:

> Access to the debit card network through a series of bilateral agreements can put both new issuers and acquirers at a competitive disadvantage, because they may need to use more expensive gateway arrangements.[122]

4.164 The RBA has also noted Australia's unique EFTPOS access arrangements:

> Typically, in other countries, there is a single point of entry to the system for new participants, who must meet a single set of technical criteria and business requirements. Where there are entry fees, these fees are usually known in advance and, where there are interchange fees, they generally apply uniformly to all participants. In contrast, in Australia, the system is built around a series of

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119 RBA, *Reform of credit card schemes in Australia: final reforms and regulation impact statement,* p. 7.

120 RBA, *Reform of credit card schemes in Australia – access regime*, media release, 23 February 2004.

121 RBA, *Payments System Board decisions*, media release, 22 August 2005.

122 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 71.

> bilateral connections and there is much less standardisation of the terms of access.[123]

4.165 The RBA raised three specific concerns about access to the Australian EFTPOS network:

- A new participant wanting to establish direct connections must separately approach each of the existing eight participants with direct connections to negotiate the technical and business arrangements for exchanging EFTPOS transactions;
- Existing direct connectors have little incentive to facilitate the entry of a new participant, particularly when the entrant is likely to be a direct competitor in at least some business lines; and
- An existing participant might be unwilling to agree to an interchange fee that is similar to the fee paid to, or received from, existing participants. [124]

4.166 As a result of these concerns, the RBA and Australian Payments Clearing Association (APCA) have undertaken a co-regulatory approach to reforming EFTPOS access, through the APCA's 'access code' and the RBA's 'access regime'. According to the RBA, the APCA code will:

> For the first time, provide new and existing participants the right to establish direct connections with participants in the EFTPOS system, and require that existing participants establish such connections within a specified time frame.[125]

4.167 Further, the RBA states that its own access regime will:

> Place a cap on the price that can be charged by existing participants to establish these connections, and it also contains provisions that ensure that negotiations over interchange fees cannot be used to frustrate entry.[126]

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123 RBA, *Reforms of debit card systems in Australia: A consultation document,* RBA, Sydney, December 2005, p. 3

124 RBA, *Reforms of debit card systems in Australia: A consultation document,* RBA, Sydney, December 2005, p. 3

125 RBA, *Reform of debit card systems in Australia,* media release, 20 December 2005.

126 RBA, *Reform of debit card systems in Australia,* media release, 20 December 2005.

Revoking Bankcard's designation

4.168 The RBA has:

> Decided to revoke the designation of the Bankcard scheme, given that the scheme has announced that no new Bankcard cards will be issued and that the scheme will be wound up in first half of 2007.[127]

4.169 The RBA argues that this change will prevent Bankcard from having to incur the expense of collecting the cost data that will facilitate the changes to the benchmarking of interchange fees at the end of this year.[128]

4.170 The RBA also noted:

> While the Bankcard scheme will no longer be subject to regulation under the *Payment Systems (Regulation) Act 1998*, the Bank expects that the scheme's current interchange fees will be maintained until the scheme is closed.[129]

Possible reform of ATM transactions

4.171 Currently, interchange fees are paid by a cardholder's bank (issuer) to the ATM owner, which are negotiated bilaterally between participants. These interchange fees are not subject to RBA regulation as debit and credit card transactions are. Interchange fees in the ATM network are, on average, around $1.00.[130]

4.172 Issuers pass the cost of interchange fees onto customers by way of a so-called 'foreign fee'. This fee is, on average, around $1.50. [131] Where a cardholder uses an ATM owned by their bank, there is no interchange fee and transactions are often free.

4.173 In 2000 the joint study of the RBA and ACCC asserted that 'interchange fees for ATM services are around double the average cost of providing these services.'[132]

127 RBA, *Payments system reforms,* media release, 27 April 2006.

128 RBA, *Payments system reforms,* media release, 27 April 2006.

129 RBA, *Payments system reforms,* media release, 27 April 2006.

130 RBA, *Payments System Board Annual Report 2005,* p. 29.

131 RBA, *Payments System Board Annual Report 2005,* p. 29. Recently, a number of institutions have increased their foreign ATM fee to $2.00.

132 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 42.

4.174 The RBA has stated that it has not yet become involved in regulating ATM transactions because:

> Many participants in the ATM industry [want] to pursue voluntary reform, with a view to increasing competition in the charges cardholders pay when using so-called 'foreign' ATMs.[133]

4.175 One of the most commonly proposed options for reform is to remove interchange fees and have ATM owners directly charge cardholders at the time of transaction.

4.176 The potential advantages of direct charging are:

- Cardholders would know at the time of transaction the fee they are being charged, rather then subsequently being charged a 'foreign fee' by their banks;
- ATM owners would be forced to compete for business with their transaction fees, which should reduce prices for cardholders; and
- ATM owners would be encouraged to put machines in remote locations where they could charge higher fees. Currently, interchange fees are the same regardless of the location of an ATM.[134]

4.177 There are also a number of potential concerns:

- It may be difficult for small financial institutions with a limited ATM network of their own to offer their cardholders a widespread network that is free to use; and
- Direct charging meet with consumer opposition, as has been evident in the UK and the US.[135]

4.178 While the direct charging model has come under consideration by the banks and the RBA, there is little prospect of it being implemented in the near future. The RBA has stated:

> Despite considerable effort, the various parties have been unable to agree on an alternative set of arrangements to those currently in place and, as a result, the industry reform process has stalled.
>
> …

133 RBA, *Reform of card payments in Australia,* media release, 9 September 2004.

134 RBA and ACCC, *Debit and credit card schemes in Australia: A study of interchange fees and access,* p. 41.

135 RBA, *Payments System Board Annual Report 2005,* pp. 30-31.

> It [has become] clear that support in the banking industry for a broad-based move to direct charging by ATM owners ha[s] declined.[136]

4.179 At this point, the RBA has not indicated any intention to intervene in the ATM system to introduce direct charging through regulation. Concerns remain over whether direct charging would be in the public interest.

4.180 Instead, the RBA has focussed on other issues surrounding ATM transactions. The RBA has recently written to the Australian Bankers' Association asking them to consider two issues:

> - The first relates to access to the system. In the [RBA's} view, current arrangements for access to the ATM system are unnecessarily restrictive. As part of the development of more appropriate arrangements, the [RBA] has also indicated to the Australian Bankers' Association that it sees merit in ensuring that bilateral negotiations over interchange fees cannot be used in a way that adversely affects access or competition. One way of doing this would be the establishment of a common interchange fee in the ATM system, as exists in many other countries.
> - The second relates to the ability of ATM owners to levy a direct charge if they wish to do so. While the [RBA] is not proposing to make such charges mandatory, it is of the view that ATM owners should be able to levy such charges if they see a case for doing so. At present, there are some technical impediments to ATM owners levying such charges, and there is a concern amongst some ATM owners that should they do so, their access to the system may be curtailed. In the [RBA's] view, there is a strong case for the removal of any technical or business restrictions that limit the ability of ATM owners to impose a direct charge.[137]

Possible reform of BPAY

4.181 As discussed previously, BPAY, like Visa and MasterCard, sets interchange fees centrally and has interchange fees that flow *from* the biller's institution *to* the payer's institution. Discussing BPAY's interchange fees, the Reserve Bank stated that:

136 RBA, *Payments System Board – November 2005*, media release, 25 November 2005.

137 RBA, *Payments System Board – November 2005*, media release, 25 November 2005.

> BPAY is the only system in Australia that currently has an interchange fee that has not been subject to actual or proposed regulation.[138]

4.182 The RBA has noted that BPAY's interchange fee consists of two parts—a flat fee that applies to all transactions and an *ad valorem* fee that only applies where payment is made from a credit card account.

4.183 The flat fee differs depending on whether the payment is from a deposit account or a credit card account. The fee for a transaction from a debit account has fallen from $0.75 in 2002 to $0.44 in 2005 (excluding GST). For a transaction from a credit card account the fee has fallen from $0.67 in 2002 to $0.38 in 2005.[139]

4.184 The additional *ad valorem* fee for credit card transactions 'has fallen from 0.8 per cent in 2002 to 0.27 per cent in 2005.'[140]

4.185 With regard to possible regulation of these fees, the RBA has stated:

> A decline in interchange fees, through regulation, would be likely to lead to a reduction in the price charged to billers for accepting payments through BPAY, but that it would also be likely to lead to an increase in the price charged to consumers for using the BPAY system.
>
> …
>
> One likely effect of such a change in pricing would have been a shift away from BPAY towards other methods of bill payment, including credit card payments directly to billers, cheques and over-the-counter cash payments. Given the current relative prices and resource costs of these alternative payment methods, the Bank's view is that such a shift could not have been said to be in the public interest.[141]

4.186 The RBA therefore decided against regulating BPAY's interchange fees. They did, however, request that BPAY publish their interchange fees. The RBA stated:

> If BPAY was unable to agree, then the Bank would consider designating BPAY as a first step to possibly setting a 'transparency'

138 RBA, *Payments System Board Annual Report 2005*, p. 27.

139 RBA, *Payments System Board Annual Report 2005*, p. 28.

140 RBA, *Payments System Board Annual Report 2005*, p. 28.

141 RBA, *Payments System Board Annual Report 2005*, pp. 28–29.

standard that would require publication of interchange fees. In response BPAY agreed to publish its interchange fees.[142]

4.187 With regard to possible future regulation, the RBA stated:

> In announcing its decision not to regulate BPAY, the Bank noted that it will again review BPAY's interchange fee arrangements in 2007 as part of its review of all systems with interchange fees.[143]

The Hon Bruce Baird MP
Chair
22 June 2006

142 RBA, *Payments System Board Annual Report 2005*, p. 29.

143 RBA, *Payments System Board Annual Report 2005*, p. 29.

A

Appendix A—submissions

Reserve Bank inquiry

No.	Provided by
1	Reserve Bank of Australia

Payments system inquiry

No.	Provided by
2	Professor Joshua Gans
3	Australian Merchants Payments Forum
4	Visa International
5	MasterCard International
6	American Express
7	Credit Union Industry Association
8	Mr Peter Mair
9	Australian Consumers' Association
10	National Retail Association
11	Reserve Bank of Australia
12	Dr Ric Simes
13	ANZ Bank
14	MasterCard International (supplementary)

15	Australian Bankers' Association
16	Australian Consumers' Association (supplementary)
17	ANZ Bank (supplementary)
18	Credit Union Industry Association (supplementary)
19	Mr Peter Mair (supplementary)
20	CONFIDENTIAL
21	CONFIDENTIAL
22	CONFIDENTIAL
23	Visa International (supplementary)

B

Appendix B—exhibits

No.	Description
1	R Simes, A Lancy & I Harper, *Costs and benefits of alternative payments instruments in Australia,* April 2006. (Presented by Dr R Simes)
2	R Simes, I Harper & C Malam, *The development of electronic retail payments systems.* (Presented by Dr R Simes)
3	Network Economics Consulting Groups, *Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes: Is the market responding as the RBA predicted?* May 2005. (Presented by Visa International)
4	Dr S Vidler, *The consumer payments system and RBA reform program: A Review of the Australian Consumers' Association,* 23 February 2006. (Presented by the Australian Consumers' Association)
5	Extract from: East & Partners, *Australian merchant acquiring and card markets: Special purpose market report prepared for Visa Australia,* April 2006. (Presented by Visa International)
6	Australian Bankers' Association, *Submission to the taskforce on reducing the regulatory burden on business,* 16 December 2005. (Presented by the Australian Bankers' Association)
7	M North, *Email: Figures from Fujitsu report,* 10 May 2006. (Presented by Mr D Behar)

C

Appendix C—hearings and witnesses

Friday, 17 February 2006—Canberra

Reserve Bank of Australia

Mr Ian Macfarlane, Governor
Mr Glenn Stevens, Deputy Governor
Mr Ric Battellino, Assistant Governor (Financial Markets)
Dr Malcolm Edey, Assistant Governor (Economics)
Dr Philip Lowe, Assistant Governor (Financial System)

Monday, 15 May 2006—Sydney

Reserve Bank of Australia

Dr Philip Lowe, Assistant Governor (Financial System)
Dr John Veale, Head, Payments Policy Department
Ms Michele Bullock, Chief Manager, Payments Policy Department

Professor Joshua Gans

Dr Ric Simes

Australian Bankers' Association

Mr David Bell, Chief Executive Officer
Mr Nicholas Hossack, Director, Prudential, Payments & Competition Policy

Credit Union Industry Association

Ms Louise Petschler, Head, Public Affairs
Mr Luke Lawler, Senior Adviser, Policy & Public Affairs

Australian Merchant Payments Forum

Mr Russell Zimmerman, Chairman
Mr Warren Hosking, Australia Post
Mr David Howell, General Manager, Financial Services, Coles Myer
Mrs Dhun Karai, Group Head, Financial Services, Woolworths
Mr Barry Palmer, Payment System Manager, Caltex Australia
Mr Rod Tweedle, Senior Manager, Payments, Woolworths

Australian Consumers' Association

Mr Peter Kell, Chief Executive Officer
Dr Nick Coates, Senior Policy Officer

Visa International

Mr Bruce Mansfield, Executive Vice-President, Australia & New Zealand
Mr Bruce Meagher, Head, Public Affairs, Asia Pacific
Mr Greg Storey, Head, Products & Strategy, Australia & New Zealand

MasterCard International

Mr Leigh Clapham, Senior Vice-President & General Manager, Australasia
Mr Albert Naffah, Business Leader, Business Planning & Corporate Affairs

Tuesday, 16 May 2006—Sydney

Mr Peter Mair

Diners Club Australia

Mr Moray McDonald, Managing Director

American Express Australia

Mr Pierric Beckert, Managing Director, Australia
Mr Colm Lorigan, Group Counsel
Mr Luisa Megale, Head of Public Affairs & Communication

Australia New Zealand Banking Group

Dr Jennifer Fagg, Managing Director, Consumer Finance
Ms Jane Nash, Head of Government & Regulatory Affairs
Ms Carlene Wilson, Senior Manager, Government & Regulatory Affairs

Reserve Bank of Australia

Dr Philip Lowe, Assistant Governor (Financial System)
Dr John Veale, Head, Payments Policy Department
Ms Michele Bullock, Chief Manager, Payments Policy Department

Thursday, 15 June 2006—Canberra

Australian Competition and Consumer Commission

Mr Joe Dimasi, Acting Chief Executive Officer
Mr Scott Gregson, General Manager, Adjudication Branch
Mr Tim Grimwade, General Manager, Mergers & Asset Sales

D

Appendix D—second statement on the conduct of monetary policy

The Treasurer and the Governor of the Reserve Bank

July 2003

This statement records the common understanding of the Governor, as Chairman of the Reserve Bank Board and the Government on key aspects of Australia's monetary policy framework. It builds on the 1996 Agreement between the Treasurer and the Governor on the respective roles and responsibilities in the operation of monetary policy in Australia.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the re-appointment of the Governor of the Reserve Bank, it is appropriate and timely for the Governor and the Government to reaffirm and update their mutual understanding of the operation of monetary policy in Australia.

This statement should continue to foster a better understanding, both in Australia and overseas, of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

Relationship between the Reserve Bank and the Government

The Reserve Bank Act 1959 (the Act) gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes. The Act nominates the Governor as Chairman of the Board.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute.

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's independence in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Bank's responsibility for monetary policy the Act provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time.

Objectives of monetary policy

The goals of monetary policy are set out in the Act which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to:

- the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Board to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the cycle while preserving a clearly identifiable benchmark performance over time.

Since the first Statement on the Conduct of Monetary Policy in 1996 inflation has averaged 2.4 per cent. The Governor takes this opportunity to express his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

Transparency and accountability

Monetary policy needs to be conducted in an open and forward looking way. A forward looking focus is essential as policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank continues to report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

In carrying out the 1996 Agreement, the Reserve Bank has taken steps to make the conduct of monetary policy more transparent. Changes in monetary policy and related reasons are now clearly announced and explained. In addition, the Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses, its quarterly statements on monetary policy and monthly statistical bulletins, have been crucial in promoting increased understanding of the conduct of monetary policy. The Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

The Treasurer expresses support for these arrangements, which ensure the continued transparency and accountability of the Reserve Bank's conduct of monetary policy – and therefore the credibility of policy itself.

The Government and Bank continue to recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

E

Appendix E—glossary of terms

Australian Competition and Consumer Commission (ACCC). A Commonwealth statutory authority responsible for ensuring compliance with the *Trade Practices Act 1974* and the provisions of the Conduct Code and for administering the *Prices Surveillance Act 1983*. The Commission's consumer protection work complements that of State and Territory consumer affairs agencies.

Australian Payments Clearing Association Limited (APCA). A public company owned by banks, building societies and credit unions which has specific accountability for key parts of the Australian payments system, particularly payments clearing operations

Australian Prudential Regulation Authority (APRA). APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry

Australian Securities and Investments Commission (ASIC). One of three Australian Government bodies (the others being the Australian Prudential Regulation Authority and the Reserve Bank of Australia) that regulates financial services. ASIC is the national regulator of Australia's companies. ASIC has responsibility for market protection and consumer integrity issues across the financial system.

accrual accounting. Revenues and expenses are recorded as they are earned or incurred, regardless of whether cash has been received or disbursed. For example, sales on credit would be recognised as revenue, even though the debt may not be settled for some time.

acquirer. An institution that provides a merchant with facilities to accept card payments, accounts to the merchant for the proceeds and clears and settles the resulting obligations with card issuers.

average weekly earnings*.* Average gross (before tax) earnings of employees.

average weekly ordinary time earnings (AWOTE)*.* Weekly earnings attributed to award, standard or agreed hours of work.

average weekly total earnings*.* Weekly ordinary time earnings plus weekly overtime earnings.

balance on current account*.* The difference between receipts and payments as the result of transactions in goods, services, income and current transfers between Australia and the rest of the world. A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

bankruptcies. Bankruptcies and Administration Orders under Parts IV and XI of the Bankruptcy Act.

basis point. A basis point is 1/100th of 1 percent or 0.01 per cent. The term is used in money and securities markets to define differences in interest or yield.

BPAY. BPAY is a payments clearing organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay billing organisations which participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

business investment. Private gross fixed capital formation for machinery and equipment; non-dwelling construction; livestock; and intangible fixed assets.

card issuer. An institution that provides its customers with debit or credit cards.

cash rate (interbank overnight). Broadly defined, the term cash rate is used to denote the interest rate which financial institutions pay to borrow or charge to lend funds in the money market on an overnight basis. The Reserve Bank of Australia uses a narrower definition of the cash rate as an operational target for the implementation of monetary policy. The Reserve Bank of Australia's measure of the cash rate is the interest rate which banks pay or charge to borrow funds from or lend funds to other banks on an overnight unsecured basis. This measure is also known as the interbank overnight rate. The Reserve Bank of Australia calculates and publishes this cash rate each day on the basis of data collected directly from banks. This measure of the cash rate has been published by the Reserve Bank of Australia since June 1998.

cash rate target. As in most developed countries, the stance of monetary policy in Australia is expressed in terms of a target for an overnight interest rate. The rate used by the Reserve Bank of Australia is the cash rate (also known as the interbank overnight rate). When the Reserve Bank Board decides that a change in monetary policy should occur, it specifies a new target for the cash rate. A decision to ease policy is reflected in a new lower target for the cash rate, while a decision to tighten policy is reflected in a higher target.

charge card. A charge card is a card whose holder has been granted a non-revolving credit line enabling the holder to make purchases and possibly make cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.

consumer price index. A measure of change in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.

credit card. A credit card is a card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit. The credit granted can be settled in full by the end of a specified period or in part, with the balance taken as extended credit. Interest may be charged on the transaction amounts from the date of each transaction or only on the extended credit where the credit granted has not been settled in full.

debit card. A debit card is a card that enables the holder to access funds in a deposit account at an authorised deposit-taking institution.

derivative. A financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index). Examples of derivatives include futures, forwards, swaps and options

employed persons. Persons aged 15 and over who, during a period of one week, worked for one hour or more for pay or worked for one hour or more without pay in a family business or on a family farm.

G-10. Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and USA; plus Bank for International Settlements (BIS), European Commission, International Monetary Fund (IMF), and the Organisation for Economic

Co-operation and Development (OECD). It was formed in conjunction with the establishment of the General Arrangements to Borrow, under which members agreed to make resources available to the IMF.

G-20. Group of Twenty Forum: Members are finance ministers or central bankers from - Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK and US; plus representatives of the IMF, European Union and World Bank. The G-20 aims to broaden the dialogue on key economic and financial policy issues among systemically significant economies, and promote co-operation to achieve stable and sustainable world economic growth.

G-22. Group of Twenty-two. The G-22's aim was to advance issues related to the global financial architecture. It operated through three Working Parties - on Transparency and Accountability, International Financial Crises, and Strengthening Financial Systems. The group made its recommendations in 1998, and its work has since been taken up in other forums.

G-7. Group of Seven countries: Canada, France, Germany, Italy, Japan, UK and USA. The G-7 Summit deals with issues covering macroeconomic management, international trade, international financial architecture, relations with developing countries, and other global issues.

G-8. Group of Eight countries: G-7 countries and Russia.

gross domestic product. The total market value of goods and services produced after deducting the cost of goods and services used up in the process of production but before deducting for depreciation.

gross domestic product—chain volume measure. Also known as *real GDP*, this is a measure used to indicate change in the actual quantity of goods and services produced. Economic growth is defined as a situation in which real GDP is rising.

gross domestic product at factor cost. Gross domestic product less the excess of indirect taxes over subsidies.

gross foreign debt. All non-equity financial claims by non-residents on residents of Australia. The major component of gross foreign debt is the amount of borrowings from non-residents by residents of Australia.

household debt ratio. The amount of household debt at the end of a quarter expressed as a proportion of annual household gross disposable income.

household gross disposable income. The amount of income that households have available for spending after deducting any taxes paid, interest payments and transfers overseas.

household net disposable income. Household gross disposable income less depreciation of household capital assets.

household saving ratio. The ratio of household income saved to household net disposable income.

housing loan interest rate. The variable rate quoted by banks for loans to owner-occupiers.

implicit price deflator for non-farm gross domestic product. A measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices.

index of commodity prices. A Reserve Bank of Australia-compiled index (based 2001/02=100) which provides a measure of price movements in rural and non-rural (including base metals) commodities in Australian Dollars (AUD), Special Drawing Rights (SDR) and United States Dollars (USD).

inflation. A measure of the change (increase) in the general level of prices.

inflation target. A tool to guide monetary policy expressed as a preferred range or figure for the rate of increase in prices over a period. In Australia, the inflation target is between 2 and 3 per cent per annum on average over the course of the business cycle.

interchange fee. A fee paid between card issuers and acquirers when cardholders make transactions

interest rate. The term used to describe the cost of borrowing money or the return to the owner of the funds which are invested or lent out. It is usually expressed as a percent per annum of the amount of money borrowed, lent or invested.

labour force*.* The employed plus the unemployed.

labour force participation rate. The number of persons in the labour force expressed as a percentage of the civilian population aged 15 years and over.

labour productivity. Gross domestic product (chain volume measure) per hour worked in the market sector.

long-term unemployed*.* Persons unemployed for a period of 52 weeks or more.

macroeconomy. The economy looked at as a whole or in terms of major components measured by aggregates such as gross domestic product, the balance of payments and related links, in the context of the national economy. This contrasts with microeconomics which focuses upon specific firms or industries.

market sector. Five industries are excluded from the market sector because their outputs are not marketed. These industries are: property and business services; government administration and defence; education; health and community services; and personal and other services.

monetary policy. The setting of an appropriate level of the cash rate target by the Reserve Bank of Australia to maintain the rate of inflation in Australia between 2 and 3 per cent per annum on average over the business cycle.

natural increase. Excess of live births over deaths.

net foreign debt*.* Gross foreign debt less non-equity assets such as foreign reserves held by the Reserve Bank and lending by residents of Australia to non-residents.

net overseas migration. Net permanent and long-term overseas migration plus an adjustment for the net effect of 'category jumping'.

non-farm gross domestic product*.* Gross domestic product less that part which derives from agricultural production and services to agriculture.

overseas visitors. Visitors from overseas who intend to stay in Australia for less than 12 months.

prime interest rate. The average rate charged by the banks to large businesses for term and overdraft facilities.

profits share*.* Gross operating surplus (the excess of gross output over costs incurred in producing that output) of all financial and non-financial corporate trading enterprises as a percentage of gross domestic product at factor cost.

real average weekly earnings. Average weekly earnings adjusted for inflation as measured by the Consumer Price Index.

real prime interest rate. The prime interest rate discounted for inflation as measured by the Consumer Price Index.

seasonally adjusted estimates*.* Estimates in which the element of variability due to seasonal influences has been removed. Seasonal influences are those which recur regularly once or more a year.

terms of trade*.* The relationship between the prices of exports and the prices of imports. The usual method of calculating the terms of trade is to divide the implicit price deflator for exports by the implicit price deflator for imports.

trade weighted index*.* A measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners.

turnover. Includes retail sales; wholesale sales; takings from repairs, meals and hiring of goods; commissions from agency activity; and net takings from gaming machines. From July 2000, turnover includes the Goods and Services Tax.

unemployed persons*.* Persons aged 15 and over who, during a period of one week, were not employed but had actively looked for work in the previous four weeks and were available to start work.

unemployment rate. The number of unemployed persons expressed as a percentage of the labour force.

wage price index. A measure of change in the price of labour (i.e. wages, salaries and overtime) unaffected by changes in the quality or quantity of work performed.

wages share*.* Wages, salaries and supplements (the total value of income from labour) as a percentage of gross domestic product at factor cost.

youth unemployment. Number of 15–19 year olds looking for full-time work.

youth unemployment rate. Number of 15–19 year olds looking for full-time work expressed as a percentage of the full-time labour force in the same age group.

Source: Parliamentary Library and Reserve Bank of Australia