SUBMISSION 15

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House of Representatives Standing Committee on Economics, Finance and Public Administration – Review of the Reserve Bank & Payments System Board Annual Reports.

Hearing: Sydney: Monday 15 May 2006, NSW Parliament House, Committee Room 814/815 9.00am - 5.00pm. ABA's hearing is at 11.30am.

ABA's Opening Statement

We would like to thank the Committee for inviting the Australian Bankers' Association (ABA) to give evidence before your hearing into the payments systems reforms.

In its submission to the Government's Regulation Taskforce (Attachment 1), the ABA recommended reforms to the regulatory architecture of the payments system in order to foster more accountability and better regulatory decision making. This, in ABA's view, is a prerequisite to promote innovation and investment.

The most important of these recommendations is the introduction of an independent merits review of Reserve Bank payments systems decisions. Currently, Reserve Bank decisions can be reviewed on procedural or administrative grounds, but there is no avenue to have an independent party review decisions on their merits.

The industry is advocating that scheduled 2007 review of payments systems reforms is undertaken by an organisation independent of the reform process so far, such as the Productivity Commission.

Background

In 1998, the Commonwealth Parliament passed the Payment Systems (Regulation) Act (1998) giving the Reserve Bank, through the newly established Payments System Board (PSB), powers to 'designate' payments systems and then set 'access' regimes and 'standards' for those designated systems.

While stronger than in any other country, the powers were understood at the time to be 'reserve' powers only.

Since 1998, these PSRA powers have been used to effect changes in the operation of payments systems. The powers have been used both directly, as in EFTPOS, credit cards and Visa Debit, but also indirectly, in the case of cheque clearing, ATMs, BPAY and statistical collections (and indeed indirectly with EFTPOS access).

In October 2000, a major ACCC/RBA Joint Study was published into interchange fees and access arrangements in credit card, EFTPOS and ATM systems. Its main finding was that interchange fees were promoting credit card use over EFTPOS use even though credit cards were more costly to provide.[1]

This and other findings began the RBA's regulatory reform process. The following examples demonstrate why ABA is arguing in favour of merits review for payments regulation.

AMEX and Diners Club

In August 2002, the Reserve Bank published its first credit card[2] regulations. The central regulation was the imposition of a cost-based methodology for setting the credit card interchange fee in four-party schemes, but there was no equivalent regulation for the competing three-party schemes, AMEX and Diners Club.

The RBA disagreed with concerns that their proposed regulations would favour the three-party schemes in its 2002 regulatory statement (p34):

> *"The Reserve Bank does not accept that its reforms of the designated credit card schemes constitute a regulatory bias that favours the 3-party card schemes, American Express and Diners Club. .... The Reserve Bank has not been persuaded that competition in the payment card market, strengthened by its reform measures, will encourage the growth of the smaller, higher cost card schemes over the larger, lower cost schemes in Australia."*

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

Cost-based interchange fee

The methodology used by the RBA to regulate interchange is a 'cost-based' methodology whereby the interchange fee is set no higher than the sum of 'eligible' costs.

In economic theory on two-sided markets, of which credit cards are one example, there is currently no consensus that a cost-based interchange fee will maximise social welfare. The range of 'eligible' costs allowable by the RBA is arbitrary, and

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[1] This finding is now being challenged by Harper, Simes and Lancy, 'Costs and Benefits of Alternative Payments Instruments in Australia' by Ric Simes & Annette Lancy, Access Economics, and Ian Harper, Melbourne Business School, Presentation to Payments System Conference, Melbourne Business School, 14 March, 2006.

[2] Note - The concerns over the arbitrary regulatory treatment of interchange fees in the credit card market also apply to interchange treatment for the Visa Debit product.

excludes costs that would normally be considered legitimate such as the cost of capital.

The RBA has stated that it has no guidance on the optimal setting of interchange fees, but there is no proposal to discontinue this approach.

Without a strong academic underpinning, the cost-based methodology used by the Reserve Bank will remain vulnerable to arbitrary change. For the banks, this means continued uncertainty.

The effect on reforms on prices of goods and services

A policy objective of the Reserve Bank's credit card interchange regulation was to lower prices of goods and services by reducing the merchants' costs of accepting credit card transactions.[3]

For this to happen, it required (a) banks to pass on interchange savings to retailers through lower merchant servicing fees (MSFs), and then (b) retailers to pass lower MSFs to customers in lower prices.

Merchants are receiving around $580m in annual savings from reduced MSFs but there is no evidence this amount is reaching consumers. (Note - the flip side of lower merchant service fees has been increases in annual fees and reductions in loyalty program benefits for credit card holders, eroding the value of these products to the consumer.)

While it is reasonable to assume competitive elements in retailing will, in time, pass on the savings, the reverse is true for industries where market power exists: supermarkets, department stores, taxis, air transport, telecommunications and utilities.

When the interchange fee fell, the competitive conditions the banks faced meant that the lower MSFs were quickly passed on, but no evidence has been produced showing a similar decrease in prices charged by retailers.

The importance of this issue is amplified given the RBA's reforms also gave merchants the freedom to surcharge customers for using credit cards. The possibility therefore is that merchants with market power are not only paying less MSFs, but in addition securing more income by surcharging by more than the MSF. This may partly explain why merchants lobbied so strongly for the credit card reforms.

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[3] "The consequence of the current structure of price incentives is that consumers using credit cards are not necessarily those who ultimately bear the costs. The community bears a significant proportion of credit card costs: because merchants have no alternative but to pass merchant service fees into the general level of prices, the costs are borne by all consumers, whether they use a credit card or not." - The Reserve Bank's Reform of Credit Card Schemes in Australia - IV Final Reforms and Regulation Impact Statement issued on 27 August 2002.

Competitive advantage to Australia Post from BPAY disclosure

BPAY is a joint venture between the banks, building societies and credit unions providing customers with a convenient bill payment service. To make the system work, an interchange fee is used (known as the capture reimbursement fee) between participating banks.

The Reserve Bank wrote to the BPAY scheme requesting publication of its interchange fee. Interchange fees provide valuable information to competitors, so the scheme was willing to publish it only if its main competitor, Australia Post, was required to do a similar disclosure. The Reserve Bank saw this as unacceptable and threatened BPAY with regulatory intervention.

BPAY has now published its interchange fee, so Australia Post now has information about BPAY's cost base, but has retained confidentiality regarding its own costs.

EFTPOS access – subsidising new entrants

The banks, through the Australian Payments Clearing Association (APCA), developed rules making EFTPOS participation easier for those seeking access.

Once the technical provisions of the new EFTPOS Access Code were settled, the Reserve Bank threatened 'designation' unless the access price was set in such a way that only one existing participant would recover the cost of facilitating a new entrant; all the other participants now effectively subsidise new entrants. This, in ABA's view, is not good policy.

More broadly, a consequence of this regulatory approach is to make businesses reluctant to engage in self-regulatory initiatives in the future.

EFTPOS interchange –'cash out' exemption

In its final policy announcement regarding EFTPOS interchange regulations, the Reserve Bank announced it had modified a previous position[4] and decided to exempt from interchange regulation EFTPOS transactions where the customer withdraws cash in addition to paying for the goods and services.

There was no consultation with the banks on this exemption, even though, ABA understands, it requires further investment to bank systems to make separate interchange fees for 'cash outs' feasible.

There remains some doubt as to whether the EFTPOS Access Regime is feasible with a non-standard interchange fee.

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[4] We understand this was due mainly to lobbying by large retailers. It is mainly the large retail chains that provide this facility, this carve out will benefit them relative to smaller merchants that do not typically offer this service.

The 'cash out' transaction exemption also raises the question over whether the assumption of payment transaction substitution between credit and debit cards is as strong as often stated.

Governance of payments system

ATM and EFTPOS payments networks are based on bilateral links between participating banks. This means that banks exchange transaction messages directly with each other, and not via a central hub-type switch, such as used in the Visa and MasterCard systems.

Last year, the Reserve Bank questioned whether the current bilaterally-linked systems are technologically redundant and provided arguments favouring a move to replace the bilateral link system with a centralised switch system.

This has come at a time when the Federal Government is requiring expensive systems upgrading to deal with anti-money laundering, counter-terrorist financing and fraud generally. Large investments in security upgrading are also underway. They include ATM/EFTPOS encryption (Triple-DES).

With the Reserve Bank floating the merits of changing EFTPOS and ATM networks, the case for upgrading the current systems is complicated by regulatory uncertainty. Business investment thrives on certainty. If the Reserve Bank intends one day to force adoption of a central switch, there is little incentive to invest now in the current system.

Cost of cash

One of the justifications for payments systems reforms was that privately set interchange fees encouraged usage of more expensive payment instruments. Credit cards were identified as of particular concern.

A shortcoming of this analysis was the absence of a formal study into the cost of cash usage. Notionally, one would expect cash to be more expensive than other electronic-based systems. Cash involves costs of handling, transport, insurance, and security. Without this understanding, the risk of a poor overall reform outcome is higher.

Conclusion

We believe the examples above demonstrate that there are questions over the certainty, predictability and accountability of payments regulation. That is why ABA is advocating the right of merits review for all payments systems regulations.

The question is - where do we go from here?

Looking back, we trace much of the difficulty in payments regulation to the RBA/ACCC Joint Study of October 2000. This document claimed the public interest could be improved by regulating interchange fees and making participation in systems easier.

Broadly, the industry has supported initiatives to open access and remove unnecessary restrictions. The main problem has arisen from attempts to set interchange fees.

These fees should be competitively set by the system owners with future growth and investment as the objective. As with all economic reform, it should only be undertaken where a clear net benefit can be demonstrated.

As a final point, the industry is advocating that the scheduled 2007 review of payments systems reforms is undertaken by an organisation independent of the reform process so far, such as the Productivity Commission.

Thank you for the opportunity to present this morning.