SUBMISSION TO HOUSE 'ECONOMICS' (EFPA) COMMITTEE

REVIEW OF RESERVE BANK PAYMENTS SYSTEM POLICY

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CARD PAYMENTS POLICY

This submission responds to the Reserve Bank's recently proposed EFTPOS reforms in the context of the EFPA Committee hearings on 15&16 May[*].

Core elements of the RBA's proposals are not sound, not durable and not consistent with the international consensus on 'best practice'. The Committee and the community will be misled if the hearings focus narrowly on EFTPOS and debit-card matters but overlook relevant issues about credit cards. Flaws in the card payment system mainly reflect the insidiously disruptive role of credit card schemes, which the Reserve Bank is still to properly address.

One irony is that the RBA, having foreshadowed a very sensible framework for regulating credit card schemes in December 2001, about-faced in August 2002. When the Bank reneged on its undertaking, inexplicably and without explanation, the stage was set for the endless circle-work that has subsequently characterized the Bank's payments policy 'development'.

The pending irony is that the RBA will almost certainly revert to its December 2001 position in the foreseeable future: the circle will then be complete and the Australian community will hopefully be then enlightened by a formal inquiry into what went wrong for so long.

The stakes in this card game are high.. As between the banks and the community, the ownership of some billions of dollars has already turned on this policy failure in Australia and, quite likely, globally, as the rest of the world could not have ignored sound policy leadership by Australia on this matter in 2002.

I ask this Committee to do what it can to put Australia back on track to reform its retail payments system – one prerequisite is proper regulation of credit card schemes, doing now what the RBA said it would in 2001.

[*] Three submissions of mine about this Reserve Bank review of EFTPOS policy are available at rba.gov.au -- they are dated July & October 2004 and April 2005. There is also a raft of published commentary including in CFO magazine (cfoweb.com.au) and on 'crikey.com.au' which also has previously been circulated to the EFPA Committee.

In drawing this preamble to a close, please imagine the slow polite smiles that would light up the faces of a panel of European payments-policy advisers asked: are the reforms to card payment systems now proposed by the Reserve Bank, likely to promote the use of EFTPOS and correct Australia's excessive reliance on credit cards for purchase transactions?

The bulk of what will be heard over the two days will be about the RBA's decisions on EFTPOS payments system reforms announced last week.

It will suit the big hitters contributing to the hearings to keep to a narrow agenda. None of the major banks or credit card scheme promoters or their associates, or even the RBA itself, will want to see disturbed the deal they did on credit card interchange fees in 2002. The retailers will come with fairly clean hands: conscripted by the banks as their tax-collectors, they have no reason to take a stand contrary to the broader public interest (and even though holding an 'ace' card in this game they cannot be expected to fight for the broader public interest.) The small deposit-takers issuing VisaDebit cards, and their sympathizers, are perhaps feeling aggrieved (without good reason) – they have the fall-back option of issuing credit cards with very restricted credit limits. Those servicing the 'travel and entertainment' market segment will probably stand a little to the side of these proceedings (perhaps their haunting fear is that the Tax Commissioner might eventually make taxable the rewards paid to employees using T&E cards).

For my part, I have been playing front-row in this game for more than two decades and speak about payments policy matters frankly and independently. I am keen to see that the system gets fixed, have been for some time.

THE KEY DECISIONS

A single, sensible decision would substantially fix the major policy issues associated with transaction cards, not least the issues about regulating EFTPOS and VisaDebit schemes that have become ever more complex. Proscribing 'interest free credit' as an eligible cost in setting interchange fees for credit card transactions is the required key decision – it is the one the RBA proposed in 2001 but inexplicably abandoned in 2002.

The UK Office of Fair Trading has now adopted this policy -- deciding that any cost of free credit is 'extraneous' and not relevant to setting cost-based interchange fees. The European Competition Commission and other European central banks have similarly given notice that they will no longer condone the exploitation of their communities that is inherent in banking cartels fixing excessive interchange fees for credit card transactions.

This critical decision, proscribing 'extraneous costs', would sensibly be reinforced by proscribing also any allowance for 'fraud' in the costs deemed eligible when setting the credit card interchange fee.

Credit-card fraud is a predictable consequence of relying on 'signature' (as distinct from PIN) authorization of card transactions and, with no reasonable excuse for it, any associated cost of 'signature fraud' should not be foisted onto retailers and their customers via interchange fees.

At that point any remaining costs of credit card schemes 'eligible' to be recovered in interchange fees would be of little consequence: my expectation is that the credit card product would then be essentially withdrawn, effectively replaced by an EFTPOS debit card product with the enhanced functionalities (including a line of credit) now the exclusive preserve of credit cards. Implicitly, the related product known as 'scheme debit' (VisaDebit) would be dealt with as a by-product of properly regulating credit card schemes.

Related issues about Amex and Diners cards are superficial, more in the nature of 'diversions': neither scheme would have substance if the tax authorities corrected the anomaly allowing part of tax-deductible 'business expenses' to be converted to 'personal rewards' that are redeemable, as tax-free personal income-in-kind, in the hands of the employees nominally using these cards. In short, issues about Amex and Diners mainly reflect a blatant tax lurk which should be addressed by the ATO – and one would like to hear the RBA say this.

Summing up, it is worth repeating: one manifestly sensible, long-overdue (and once nearly-taken) decision would resolve most of the contentious issues slated for discussion at these hearings.

In this case, the sign should read: 'go back – you were going the right way'.

A REDUNDANT CONTRIVANCE

Credit card schemes, as now promoted, are a redundant contrivance against the public interest: the only wonder is why banking and competition authorities have not reined them back severely -- it now seems that, in Europe at least, we will not be left wondering long.

At the last hearing of the RBA in February, the Governor said "… the issuing of credit cards is still phenomenally profitable." This sentiment was echoed by the European Competition Commissioner, Neelie Kroes: as reported in the Financial Times, she recently said, "....payment card operators were making 'outrageous' profits…". This same sentiment underlies a burgeoning class action against credit card scheme promoters in the US, claiming credit card schemes unfairly impose de-facto taxes on retail spending (words also used by the European Competition Commission).

Whether described as a 'cartel' or a 'closed shop' or more politely as 'a price-setting joint venture' the inference is the same -- under the noses of compliant regulators, participating banks engineered a scheme to exploit the community while hiding behind front organizations, a form of mutually owned cooperative, which fix the rules, and interchange fees, to advantage the participating owner-bank 'members'. There is no longer any excuse for permitting this exploitation.

The latest enhancement of credit card functionality is illustrative of the endemic insolence: a no-need-to-sign, 'tap-n-go' facility to speed credit card payments for small amounts is being introduced to Australia (it is already standard in the US). That 'additional functionality', exclusive to credit cards, comes on top of credit cards alone having an attached line of credit; service performance guarantees and being permitted to be used over the phone or internet to make purchases.

There is, of course, no reason why the same enhanced functionalities could not be extended with appropriate safeguards to EFTPOS debit cards. When making transactions 'over the phone' or 'on the internet' there is no card presented, only numbers being recorded with varying degrees of security. And there is, of course, no reason why an overdraft 'credit limit' could not be added to a deposit account accessed by an EFTPOS debit card.

Attaching 'tap-n-go' functionality to credit card transactions only is simply insolent behaviour by credit card scheme promoters and their owner banks. This development, pirating the much needed low-cost functionality of stored value cards, sees the credit card cartel further handicapping the community with another deadweight cost, clipping a percentage from every transaction on the banks' very own transaction toll road. The bank cartels fix the card game to favour credit card schemes – and the appointed regulator blind-eyes this nonsense and chooses not to respond effectively. 'Tap-n-go' should be stomped.

The point, simply, is that the excessive profitability of credit card schemes is distorting and corrupting the development of Australia's retail payments system. Participating banks are denying their customers appropriate functionality on other transaction accounts, and low-cost stored value cards, because credit card transactions are so excessively profitable for them.

[In the next month or so, the Corporations and Securities Committee of the Parliament is due to report on its deliberations about the 'social responsibility' of businesses: it will be interesting to see if Australia's banks fit the standards that this committee will deem desirable.]

Again summing up, for most of us our credit card and our EFTPOS debit card are both embedded in the one bit of plastic. For one reason only – their unfairly contrived excessive profitability -- some very useful payment options are 'credit card only' and, at the checkout, the incentives are also stacked in favour of using credit cards. This is simply wrong and regulatory authorities choosing not to say so frankly, and react effectively, should be called to account.

FUNDAMENTALLY FLAWED

The situation the RBA has now put before this Committee, and the community, is flawed on two counts. It is an embarrassment for Australia.

The RBA proposal could well find its way back into the legal system, be found wanting on its merits and be set aside for a second time. As well, because the decision on EFTPOS interchange fees 'lacks merit', it will predictably fail to make a material contribution to resolving the problem which the RBA says it is intended to address i.e. the excessive use of credit cards in preference to EFTPOS debit cards. Unless this flawed policy is arrested now, its predictable failure will actually be documented each month by the Reserve Bank in the statistics published on 'payment card activity' -- ask the Bank, ask the banks, ask the credit card scheme promoters if they expect the figures will show a gathering contraction of the number of credit card transactions.

-- another legal challenge?

The essence of the RBA decision on EFTPOS interchange fees has already been the subject of two legal challenges by retailers. When initially made by the ACCC, with encouragement from the RBA, the decision was set aside after being reviewed 'on its merits' by the Australian Competition Tribunal. The RBA then re-made essentially the same decision on its own account and a 'judicial review' process in the Federal Court endorsed it. This outcome, though not surprising, was unedifying. Unlike the Tribunal and the ACCC, the Federal Court was unable to consider the merits of the RBA decision: tied by a precedent known as 'Wednesbury unreasonableness', it was bound to dismiss the retailers' challenge to a decision that, in legal parlance, was not manifestly unreasonable. In short, as we know, the law is an ass – and a reminder may be coming our way soon. I consider it very poor form that the RBA took advantage of a legal technicality and did not correct the basic flaw in the merits of its policy.

The plot thickens this way. Before the end of July it is expected that the Government will adopt the recommendation, in the recent report of the Regulation Taskforce, to allow all decisions of regulatory authorities to be reviewed on their merits by an independent tribunal. If so, and the RBA decision on interchange fees for EFTPOS transactions is again reviewed 'on its merits' it is very likely to be tossed out again because it lacks merit (and, when the Competition Tribunal tossed it out the first time, its decision about the lack of merit left no room for doubt).

This is an 'ace' card in the hands of retailers: they have been given some minor concessions – a small basic interchange fee, no limit on fees for cash-out with EFTPOS transactions and a 'bell ringer' when VisaDebit cards are tendered – but hopefully nowhere near enough to leave the table just yet.

How often does the Reserve Bank need to be told, whenever it can be told, that its approach to regulating the retail payments system, and card payments systems in particular, is fundamentally flawed?

-- unmeritorious, simply ineffective

The RBA proposal on EFTPOS fees lacks merit because it will not work in an effective and timely way to ensure the bulk of credit card transactions are displaced by EFTPOS and other transactions on 'debit card' accounts.

Making more EFTPOS transactions available to customers free of charge will not override the perceptions of many customers that credit card transactions are cheaper: not only are credit card transactions 'always' free of charge but they also appear to come with both 'free credit' and 'reward points'.

Some semblance of a credible accountability for the RBA proposal needs to be established before its policy is put in place. One would like to think that the RBA's 'regulation impact statement' would contain quantitative projections of how its proposed regulation of EFTPOS fees will shift card purchase and payment transactions away from credit cards to EFTPOS and debit card accounts.

What we actually get in the 'policy impact statement' is rubber-worded ducking of this key issue: at page twenty-four, the RBA talks about 'more appropriate price signals' … 'likely to lead to greater use of EFTPOS than would otherwise be the case'. That dissembling nonsense is not indicative of a policy likely to achieve its objectives -- it is a 'policy impact statement' that implicitly says 'probably no impact of any consequence whatsoever'.

Does the RBA have any expectation of its proposals making a material impact on the problem it says it wants to fix -- and how does the Bank quantify this expectation for the next couple of years? What reduction in the number of credit card purchase transactions could the community expect?

As the balance stands, there are still about 1.25 billion credit card transactions each year, much the same as the number of EFTPOS purchases. A raft of RBA reforms to supposedly reduce the use of credit cards – less attractive rewards for users; surcharging by a few retailers and the prospect of more 'free' EFTPOS transactions – does not have the feel of a program likely to make a substantial difference. At best this 'ever so gentle nudge and a wink' is slowly likely to be somehow in the right direction – it is not the policy to address the problem. [About the RBA's alleged 'reforms' fostering 'new entry' into retail banking, the less said the better. There may be a few 'low cost' lenders newly issuing credit cards, in association with an established bank operation, but they are selling loans, not really expecting the repeated day-to-day transactions of card holders who never borrow but, unknowingly, feed the river of gold flowing along the banks' transaction toll road.]

Credit card schemes are still 'phenomenally profitable' as the RBA Governor says -- their promoters are still milking deceptive marketing scams to cover what is, anyway, mainly an illusory cost of proffered illusory benefits.

The ‘Nelsonian’ regulatory eye apparently does not see that the marketing strategy for credit card promoters also relies on them monopolizing ‘additional functionalities’ which, at the discretion of the banks, unfairly attach only to credit card products. The regulator stands idle while ever more access roads are commandeered as ‘toll roads’: ‘highway robbery’ used to be hyperbole.

The bottom line is that what the RBA has done, and proposes to do, does not credibly align with the effective policy reforms the community wants implemented. If the issues were ever properly put before the community the RBA approach would be derided. The unanswered question is why the RBA abandoned, four years ago, a policy that would have already largely displaced credit cards, as it now and then says it wants and wanted to do: if the UK and Europe more generally can do it, so can Australia.

THE SYSTEM IS A SYSTEM

The RBA decisions, mainly about a range of issues associated with the EFTPOS system, cannot sensibly be discussed and assessed in isolation.

As the foregoing illustrates, the relevant context includes the ‘competing’ credit card schemes, which practically overwhelm the whole card payments game -- any suggestion that the RBA has ‘completed’ its policy development for ‘separate’ credit card schemes must be dismissed out of hand. Credit card interchange fees still dominate the immediately relevant agenda.

Even that expanded context is only part of the fully relevant context, including for these hearings.

As I have previously suggested to the Committee, a fundamental reason for the retail payments system not developing properly lies in the way banks are permitted to barter ‘free transactions’ for ‘interest free deposit balances’ in transaction accounts. If the credit unions and other aspiring deposit takers want to know why neither they nor anyone else can effectively enter the retail banking business -- the explanation lies there, the major banks have an unassailable advantage.

In case the Committee, among others, is wondering what is going on here: take it as given that, each year, billions of dollars of interest, at some 5% p.a., is not being paid by the major banks on the ‘hundreds’ of billions of dollars on deposit in customer accounts on which ‘no’ interest is paid – and by implication billions of dollars of tax is not being paid on the unpaid interest income. Practically this converts to an annual subsidy of some $billions (perhaps 4 or more) given to the major banks by the Government (off budget, if not underhand, and totally unaccountable).

Part only of this lavish endowment so taken by banks is used to cover the cost of providing under-priced transactions – cheque payments, EFTPOS payments and ATM withdrawals as well as ‘basic bank accounts’ conducted free of charge.

Providing ‘under priced’ transactions in this way further corrupts the efficiency of the retail payments system because consumers have no idea what any transactions ‘cost’ or how or how much they pay for them in ways so ‘hidden’ and ‘buried’ in retailers prices they could never fathom the deception. The RBA proposals on EFTPOS would bury even more of the banks costs in retailer prices, costs which should be recovered directly and explicitly from customers so they can choose sensibly among alternative payment possibilities.

This whole deal is a corruption of every principle of proper public policy – it is a deal that buys banks, the Reserve Bank and the Treasurer the protection of ‘agreeable confusion’ about a contrived contentiousness in public policy – the idea that the people are entitled to ‘free transactions’ is politically convenient and very profitable for the banks. For the community it is absolute nonsense.

When this Committee pauses to wonder why the facts on new entry never match the regulatory rhetoric supposedly ‘longing for competition in retail banking’ – the explanation lies here (nonetheless the rhetorical regulatory nonsense goes on and on).

HOW DID THIS HAPPEN?

It is remarkable that the Reserve Bank continues to be the appointed regulator, responsible for the efficiency of the retail payments system in Australia.

The RBA’s current responsibilities for the payments system have, in essence, been in place since May 1984. What was known as the Australian Payments System Council, and widely considered ineffective under the Chairmanship of the RBA, became, with more formal powers, the Reserve Bank Payments System Board in 1998. The PSB is also widely considered ineffective, notwithstanding the confusing aura of purposeful activity. Eight years on, problems well known to be fundamental long before the PSB was established are seemingly no closer to being corrected and, if anything, the burgeoning mess looks ever more complex.

No one in regulatory authority could possibly now tell the community the truth about the workings of the retail payments system without also asking that the RBA be relieved of this responsibility. Practically the real politic is that the RBA has to ‘go’ first, before the truth is told by a new regulator seeking the trust of the community.

Some six years ago the Cruickshank Committee investigating similar problems with the retail payments system in the UK highlighted the informal ‘understanding’ between the Bank of England and the main UK banks, that the rules would cosset the banks’ solvency, allowing various soft income arrangements in the retail payments system to featherbed their profitability, provided the banks did what they were occasionally asked to in the political or national interest. The Bank of England was then taken out of the game in the UK.

The situation in Australia was ever identical, just never so forthrightly acknowledged. These days the deal is still about the banks smoothing over politically sensitive issues – like agreeing to provide 'free' basic banking services (and not threatening to withdraw them). It is still also about underwriting the risk of bank failure with featherbedded access to such lavish licks of soft income that banks can trade their way out of whatever problems they encounter. Remember the early 1990s.

Whatever may be the appearances about the separation of responsibility for 'prudential regulation' the reality is that the RBA is still at the heart of the arrangements in place for protecting the community's underlying faith in its dealings with the financial system, especially banks. If the Government ever needs to bail out some failin 'bank' it will be the RBA that writes the cheque.

When a public policy agency, like the RBA, is given directly conflicting responsibilities it is prone to choose to do one thing well and not only fail to achieve a sensible balance between its conflicting objectives, but possibly pervert the other objective to assist with its priority. Asking the RBA to be responsible for both the never-fail 'stability' of the banking system and its 'efficiency' is such a conflict – actively pursuing efficiency in the banking system would expose parts of the banking system to the risk of failure.

In short, if the Government wants the RBA to protect the stability of the banking system it cannot sensibly also ask the RBA to ensure the banking system concurrently operates efficiently. The authority to regulate the payments system is tuned to cosset the stability of the banks: the situation with credit cards and the tax free bartering of 'free transactions' for 'free deposits' are obvious illustrations.

That is the lesson.

The lesson is not only credible in its obvious capacity for prediction, it describes the observable, demonstrably practical situation after 20 years of expecting the RBA to reform the retail payments system as the community would want it to. As noted the community can no longer afford such high cost protection from the Reserve Bank – the community needs an efficient retail payments system (as well as prudently managed banks).

WHAT NEXT?

If anyone is any longer in doubt about the impracticality of asking the RBA to ensure the efficiency of Australia's retail banking and payment system, please reconsider this background note in conjunction with my earlier related submissions and published commentary.

One 'what next' inference is that this responsibility – for retail payments policy --would most sensibly be allocated to a different regulatory agency.

This decision cannot, however, be taken on the run. It is the way of the world in these situations for the critical structural decisions to be more or less taken before a more formal and wide ranging inquiry is convened to take and process the evidence that openly explains the need to make the necessary changes. In the circumstances it would seem appropriate for the Committee to set such a process in train.

Peter Mair
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