

# **SUBMISSION TO RESERVE BANK OF AUSTRALIA**

## **REFORM OF CARD PAYMENT SYSTEMS**

This submission addresses the question of whether or not it would be in the public interest for the Reserve Bank to designate the EFTPOS and ATM payment systems in Australia (and determine standards and impose access regimes).

### **1. SUMMARY**

The submission says ‘no’, designation of the EFTPOS system would not be in the public interest.

Designation, current jargon for ‘direct controls’, will be ineffective if underlying market forces remain conducive to market failure and cartel behavior. The Reserve Bank knows this.

About the pricing of ATM services, best-practice would see prices (payable to ATM operators) clearly displayed and levied as an additional debit to the cardholder’s account balance. It is not accepted that ‘designation’ is preferable to regulations issued by an agency responsible for ‘consumer protection’ and embodied in an industry code.

For retail payment systems, the pressing needs are to outlaw agreements among banks on inappropriate trade practices underpinning cartel-like behavior, and to withdraw from banks the overwhelming competitive advantage of tax-evading barter, swapping ‘free services’ for ‘free deposits’.

An interchange fee, an agreed price for wholesale services, is not essential in mature payment networks. They tend to be abused by joint-ventures operating de facto cartels. They are, accordingly, best avoided by setting tight restrictions, in national trade practices legislation, on industry pricing agreements.

Credit card schemes are a case in point, as are the EFTPOS and ATM and BPay schemes, where pricing agreements between banks should be generally proscribed. As the designation of credit card schemes unfolded, a strong argument emerged against leaving discretion to decide trade practice matters with the Reserve Bank: among other things the Bank has substantial militating conflicts of interest.

The following sets out a case against ‘designation’ of EFTPOS (or anything else). An appendix raises some related points for clarification arising from issues raised by the Reserve Bank Governor in testimony given recently to the House of Representatives ‘Economics’ Committee.

## **2. PREAMBLE**

I suspect the general public will be underrepresented in the range of interested parties making submissions. I further suspect that the general public, that is interested, cannot speak clearly because they have not been given relevant background. Even the Parliament, responsible for the legislation, has no independent capacity to advise the Reserve Bank. Accordingly, the interested parties making submissions will probably have much in common with the usual suspects parading self-interest as the public interest.

Previous contributions of mine to the debate about public policy and the retail banking and payment system, are archived at the business magazine, CFO ([cfoweb.com.au](http://cfoweb.com.au)), and the internet media site, [crikey.com.au](http://crikey.com.au). Such public contributions continued an earlier inclination to comment privately.

A recent court decision frustrated the implementation of a deal to set interchange fees for EFTPOS transactions at 'zero' for three years. The key dealers were major banks, minor banks, the ACCC and the Reserve Bank – but not retail merchants. The now unsettled situation for fixing prices for EFTPOS and ATM services interacts with other elements of a wider ranging package-deal involving credit card pricing (already in place) and pending decisions about the VisaDebit and BPay schemes. Some smaller banks are probably financially disadvantaged. The temptation is perhaps for the Reserve Bank to simply overwhelm an unfavorable court decision by now re-imposing the package on its own authority. That temptation should be strongly resisted.

I see no need for wasting time and resources on another study of discretionary costs and revenues in card payment systems (recent, discretionary credit card pricing adjustments are illustrative of banks having such market power that they do what they like in different ways). 'Fixing' credit card schemes first was a tactical error now finessed by the major banks. The priority is about banks abandoning pricing agreements and restoring a competitive environment for transaction services generally.

## **3. SOME PRELIMINARIES**

The promotion of competition and efficiency in the Australian payment system is of public interest and there are different ways that objective might be pursued more or less effectively.

### **3.1 a Reserve Bank responsibility**

It is of the utmost importance that the Reserve Bank now speaks plainly to the people and the Parliament about the payments system, and the probability that the governing legislation is inappropriate. It is not acceptable to claim that the Reserve Bank only applies the law laid down by the Parliament which then becomes responsible for the ineffective operation of markets for retail banking services. The Parliament needs proper advice, urgently.

### **3.2 fundamental flaws -- negotiation**

Negotiation, appealing to the social sensibilities of the major banks, is one approach tried and found wanting. Typically, predictably and sensibly banks respond only to market forces with unalloyed self interest.

Negotiation creates new market forces for banks. One, buying time, involves banks talking endlessly about possible voluntary reforms they have no intention of adopting (e.g. the direct entry system). Another involves a form of greenmail – offering a basic banking safety net in exchange for retaining unfair competitive advantages arising in tax avoiding barter, and presumably a 50-50 offer on cutting credit card interchange fees that the Reserve bank could not refuse, is another example.

The ‘social contract’ of basic banking services negotiated with the banks prior to the last election, was fundamentally flawed. The banks and the government got political peace but the community got taken for a ride. This deal confirmed banks’ continuing access to the ‘endowment’ of unaccountable income arising in a tax free barter scheme with bank customers. That soft income is misused for a range of things, mainly underwriting the continuing inefficiency of Australia’s retail payment system. If the Reserve Bank is also of this view, now is a good time to say so rather than playing about with threats of designation and regulation that would compound the problems.

### **3.3 fundamental flaws – designation**

Designation can be summarily assessed as ineffective.

Designation entails substituting direct controls, at the discretion of the Reserve Bank, for market forces – a discretion moderated by negotiation with banks

The Bank would never again propose using ‘direct controls’ to manage bank credit or bank interest rates or exchange rates. While it may have been hoped that a threat of designation would bring banks submissively to the negotiating table, it did not. It is surprising that the Bank thought threats (and time-buying negotiation) inconsistent with market realities would work effectively in the public interest. It never did in the past. It has not in the present. It won’t work in future.

It is remarkable that the Bank is apparently still considering designation as an effective policy option. Like much of the old banking legislation, it was never intended or expected that the Reserve Bank would seek direct control of the retail payments system through ‘designation’.

The process of designating and regulating credit card schemes was illustrative. The process was inordinately protracted and expensive (for the community) before being revealed as substantially ineffective.

In December 2001 the Bank publicly promised a standard for eligible costs included in setting credit card interchange fees, it expressly (and correctly) excluded ‘interest free credit’. In August 2002 it did not explain why it reneged on this commitment and allowed banks to include those largely illusory costs. In credit card schemes, price fixing remains in place unnecessarily and contrary to the public interest – and there is no right of appeal for the public against an exercise of Reserve Bank discretion that many would consider totally inappropriate.

I take issue with the presumption (in the Bank’s media release) that designation would be a precursor to determining standards and imposing access regimes “that would promote efficiency and competition in the Australian payments system”. I do not believe that it would and I doubt the Bank sincerely believes it would either.

A very real concern for the community here is that any discretionary deal to park interchange fees for EFTPOS in neutral for the time being will be a precursor to a later shift to positive interchange fees payable to issuers of EFTPOS card.

As credit card schemes increasingly confront regulatory barriers worldwide, against such a contrivance continuing, it will eventually be mooted that credit card schemes will be absorbed into EFTPOS schemes, but only if the issuers of debit cards (then with a line of credit) are paid interchange fees. A regulatory framework that permitted the Reserve Bank to exercise a ‘discretion’ allowing excessive interchange fees to continue for credit cards, would in future permit it to sanction interchange fees for EFTPOS – with the community having no right of appeal against the exercise of such a discretion (by an authority which can be seen to have a substantial, and conflicting, interest in protecting both the profitability of banks and its own commercial interests in the continued use of conventional currency).

### **3.4 fundamental flaws -- bad tax policy**

Late last year the Reserve Bank illustrated clearly in a submission to the Productivity Commission, how bad tax policy settings distorted the market for housing assets. Better late than never is a maxim that now applies in respect of income tax policy settings that now distort the operation of the market for retail payment services.

The Bank may be more comfortably placed to do this if a formal inquiry was to be foreshadowed and posed the question. Seems not, however, for the time being -- and the Bank may need to take an initiative independently. Conversely, would the government, current or alternative, dissuade the Bank from issuing a frank assessment of the impact on efficiency of the tax avoiding bartering inherent in retail banking operations?

[Incidentally, it would be salutary if the value of ‘free credit’ extended to credit card customers were immediately deemed to be taxable income in the hands of the customers – especially if the deeming were based on the high interest rates customers are charged for credit-card credit. Doing this would immediately reorient the market for transaction card services, quickly resolving the current dilemma more effectively than any designation processes.]

### **3.5 fundamental flaws -- bad trade practices**

Better late than never also deserves recognition in the context of exposing a range of banking industry trade practices that are not consistent with the efficient and competitive operation of markets for retail banking and payment services.

The Reserve Bank’s decision to not make a submission to the ‘Dawson’ review of the trade practices legislation was, in my view, unfortunate. Nonetheless the report of the Dawson Committee did address policy issues about price fixing in the context of joint venture agreements. It did so in a way I expect would find sympathy with the Reserve Bank in its intelligent pursuit of competition and efficiency in the retail payments system.

Using the Dawson report as the basis, it would now be instructive if the Reserve Bank were to assess how network scheme agreements between banks may be impeding competition and efficiency in the retail payments system. A next step for the Bank might encourage amendment of the trade practices legislation to limit price fixing in the context of joint venture businesses, including those operated by banks.

## **4. A SENSE OF DIRECTION AND SPEED**

Previously published comment by the Reserve Bank is consistent with an assessment that Australia’s retail payments system falls well short of world best practice and the pace of change too slow.

Policy unchanged, Australia will remain overly reliant on cheque and credit card payment instruments that are essentially ‘not used’ in countries with best-practice systems. Equally important, other countries are making headway with multi-purpose electronic money schemes still unheard of in Australia. One converse is that, in Australia, electronic direct transfers and debit card purchases are grossly underused relative to world best practice – and conventional currency notes and coin overused for point of sale purchases.

### **4.1 Sound public policy**

The broad implications of this assessment are clear enough. The market forces driving the system need to be reoriented both to ensure that cheques and credit cards are progressively taken out of the game, and so the market becomes conducive to pre-paid cash cards displacing conventional cash for point of sale transactions.

One need hardly wonder what a task force of analysts, drawn from countries with best-practice payment systems, would say about the system Australia now has.

#### **4.2 designation -- a deceptive simplicity**

Superficially, the proposed designation of debit card schemes would have a helpful impact. Though total costs of making debit card transactions would be little changed, lower explicit prices charged to customers would put EFTPOS on a more visibly competitive footing with cash and credit card transactions, that typically attract ‘no charge at all’.

The problem however is that costs of EFTPOS transactions, which should stay between customers and their banks, would then be ‘buried’ in higher retail prices charged by retailers. This prospect precludes transparency of costs and a reasonable ‘user pays’ correspondence of costs and (explicit) prices charged to users.

There is no good reason why banks’ costs should be recovered by retailers from their customers in terms of an administrative fiat sponsored by the Reserve Bank.

One can see why the ‘burying’ option appeals to the banking industry, to authorities like the Reserve Bank and to politicians – it is an extension of the offensive ‘out of sight, out of mind’ mentality underlying the present bartering of ‘free services for free deposit balances’ and the associated ‘off budget’ financing of the basic banking safety net.

The Reserve Bank knows full well that such deceptive simplicity is cheap politics and bad public policy. Designation would institutionalize deadweight costs in an inefficient retail payments system: waste which, on the Bank’s own estimation is running at some 1% or more of GDP. It would institutionalize a sense of Australia’s major banking groups having unassailable domestic market power to operate inefficiently and book excessive costs to the general public account.

The Reserve Bank would normally be among the first to argue that the provision of social security benefits – such as free basic banking services - should be fully funded from budget revenues and not by regulatory taxes imposed on service providers -- such as banks. Requiring retailers to load prices to finance bank costs for over-providing under-priced banking services is not good public policy – it is a cop out unbecoming.

#### **4.3 designation -- a courageous alternative**

The essence of a courageous alternative approach for the Reserve Bank is sketched above – ask government forthrightly to correct the way the tax system interacts inappropriately with retail banking operations and amend the trade

practices law to ensure that price fixing agreements contrary to the public interest are proscribed, including such agreements between banks.

To that end it would help mightily if the Bank were to speak frankly to the people – and to the Parliament - about the flaws in public policy now handicapping the efficiency of the retail banking industry.

#### **4.4 designation -- any cash-out with that?**

The Reserve Bank itself is privately a key player in, and beneficiary of, the prevailing inefficiency and attendant waste in the retail payments system.

The Reserve Bank issues Australia's currency notes. Some of the \$30 billion notes on issue to the general public are used (along with coins) to make cash transactions at the point of sale. The business of issuing banknotes is a very profitable one – currently returning some \$1.5 billion p.a. to the Reserve Bank.

Australia should have a strategy in place to progressively substitute electronic cash for conventional currency. Key elements of such a strategy include,

- Ensuring that banks charge prices, commensurate with costs, for debit and credit card transactions, would focus the attention of banks and others on the scope to develop a prepaid e-money card for making point of sale purchases at very low-cost.
- Addressing issues raised by the conflict between high social costs for conventional cash transactions and the unwritten rule that cash transactions must be free of charge. Largely a matter for the Reserve Bank itself which needs a plan to ensure the community is aware of the relatively high costs of using conventional cash and how a better alternative might be made popular.

There are no easy options for meeting this 'cash out' request – but cash does have to be substantially taken out of the Australian payments system if it is to be efficient and in line with world best practice.

Given the monumental waste and inefficiency that the Reserve bank is prepared to condone in the retail payments system it would surely be of minor consequence to spend some public funds on encouraging the development of an e-money prepaid card.

#### **4.5 designation – red alert**

The essence of the Reserve Bank's 'designation' strategy for non-cash payments entails subsidies to be paid to banks that will be financed by an off-budget tax imposed on the community (by the Reserve Bank) and collected by retailers.

The emerging plan will see the community paying higher retail prices for everything so that low-cost EFTPOS transactions are available ‘free’ and thus ‘priced’ competitively with high-cost credit card and cash transactions that are also ‘free’: it will concurrently remove any incentive at all for a prepaid electronic cash card to be developed in Australia.

It is not a good plan.

It is a plan that suits the private commercial interests of both banks and the Reserve Bank but is contrary to the public interest.

Under this plan, banks would have little incentive to either minimize their costs or stop providing, and overcharging for, inefficient services. For its part, the Reserve Bank, which gets a \$1.5 billion annual profit each year from the currency note issue, would comfortably rule out any electronic money scheme emerging as a competitor to conventional cash.

#### **4.6 designation – substantial conflict of interests**

The total conflict of interest facing the Reserve Bank is a very substantial one -- so substantial that the Reserve Bank should probably not be making any decisions about designation, including of EFTPOS.

The Reserve Bank has a predictable and long standing inclination to protect banks’ access to soft income streams. Protecting bank profits fosters the stability of the financial system, for which the Reserve Bank is responsible, but in this case it is unfortunately inimical to the efficient conduct of retail payment operations by banks.

The Reserve Bank is, concurrently, predictably protective of its own access to soft revenues associated with the currency note issue. Newly pricing more EFTPOS transactions at ‘zero’ will, of course, displace some mid-size cash transactions. However, it will do nothing to advance the cause of prepaid e-money cards that are prospectively more efficient than cash for point of sale transactions of all values. If EFTPOS transactions are to be ‘free of charge’, there will be little incentive left at all for the development of e-money alternatives to conventional currency transactions which depend on being seen to be much cheaper as well as more convenient. This will suit the Reserve Bank but not the Australian community.

Australia will be considerably disadvantaged if the EFTPOS system is designated as proposed.

Getting cash out of the system, literally – or at least providing an electronic alternative to round pieces of metal and colored pieces of paper – may well mean moving the responsibility for the currency issue from the Reserve Bank to new agency, a Currency Commission. If so, the Currency Commission could be given a charter to promote the development of an electronic currency scheme.

The case for taking the Reserve Bank out of the game is quite strong – the case for ducking the issue and letting the Reserve Bank designate the EFTPOS system is very weak. The Reserve Bank plan would lock Australia into a very inefficient payments system which the community would never comprehend because all payment system costs would be buried out of sight in either retail prices or a tax lurk based on interest free deposit balances.

[While I will not labor the point here, the similar case for developing a form of cheap electronic money for use on the internet is similarly overwhelming. Prospective substantial benefits of the new dot.com economy are denied by not having a low cost medium of exchange for so called, micro transactions.]

Peter Mair  
9 July 2004

## APPENDIX

### ISSUES ARISING: GOVERNOR AT EFPA COMMITTEE HEARING

Testimony given by the Governor on 4 June 2004 to the House of Representatives ‘Economics’ Committee touched on a range of matters relevant to the question of the Reserve Bank directly regulating, designating, the EFTPOS payment system.

A proper understanding of relevant background could be enhanced if the Reserve Bank put on the public record the submission it made by to the Australian Competition Tribunal about the EFTPOS payment system. This submission, referred to by the Governor at the hearing, is not yet on the public record: some additional comment may be appropriate once it becomes available.

The format of what follows notes evidence given by the Governor and poses questions which might be addressed by the Bank when announcing its intentions about designating or, preferably not designating, the EFTPOS system. [Page references are to the draft Hansard posted on the parliamentary web site.]

#### **Particular matters**

##### **(i) safety nets**

The reference to “a little safety net (free basic banking services)” begs the question of how this social security is best funded -- from budget revenues or an off-budget imposition on banks (page 26).

**(ii) margins and fees**

The comment “.bank fees have not risen any faster than banks’ assets”, suggests a sense of connection between ‘fees’ and ‘assets’ and ‘number of transactions’ that warrants fuller explanation (page 26)

**(iii) a sense of responsibility**

The tone of the remark, “We got into it because we got an Act that said we were responsible for the efficiency, competition and safety of the...retail payment system”, begs a question about the sense of responsibility the Bank accepts for the task (page 27). [It also seemingly ignores the sense of responsibility the Bank may have felt, since May 1984, when it was first given a comparable responsibility under the auspices of the Australian Payments System Council.]

**(iv) consumers in favor**

The consistently favorable flavor of the Bank’s self assessment of its reform efforts includes references – pages 27 and 28 – to support that the bank received from ‘consumers’ among others, for both the credit card changes and (planned) changes to the EFTPOS system. It would be interesting to know who represented ‘consumers’ in expressing this support and whether their communications with the Bank are on the public record.

**(v) in the opposite direction....and banks indifferent to it**

Australia was somewhat unique in having an interchange fee for EFTPOS transactions paid to ‘acquirers’ – mainly major banks -- rather than to ‘card issuers -- financial institutions generally (page 28). The background to this probably warrants some further explanation -- as do the subsequent related remarks, about setting EFTPOS interchange fees at zero, that ‘there is nothing in it ... it was a zero sum game for the (major) banks... and they wanted to get it down to zero’(also page 28). One might wonder why the banks did not put a convincing case to the Tribunal either?

**(vi) we put in a submission**

The Governor’s comment (at page 29) that the Bank had ‘put in a submission’ to the Australian Competition Tribunal, as a friend of the court, begs two questions: first, why was the submission not put on the public record (as a gesture of friendship to the community); and, second, why did the Tribunal then feel the need to say in a judgment generally critical of the Bank that “As for the RBA .... If the RBA had really wanted to provide (useful) information to this Tribunal ....”. There is a mystery here that needs to be cleared up – releasing the Bank’s submission to the Tribunal may help.

**(vii) submit it to the public again**

There is the suggestion (at page 29) that the Bank acted with the support of the (general) public and that it would now “consult again with the public” to “see if those views had changed”. What is now on the record: who said what about the views of the (general) public? There is little point asking people who do not understand the issues for considered responses. Will the Bank now assist the establishment of a well informed public, which may then speak more credibly?

**(vii) ....the international experience**

The Governor said (at page 29) “We think some things are very persuasive – for example, the international experience (of zero interchange fees for EFTPOS transactions)” – and went on to be dismissive of the Tribunal for ‘not being persuaded by that (international experience)’.

At the risk of being churlish, I often feel the Bank’s regard for international experience is very selective to say the least – and it rarely selects, as a basis for comparison, those countries considered to be ‘best practice’ in terms of the efficiency of their retail payment systems (countries operating ‘without’ cheques or credit cards but with emergent electronic currency cards).

**(viii) RBA and ACC in complete agreement**

The disclosure (at page 30) that the RBA and ACCC have ‘completely agreed’ that the RBA should have centralized (absolute) authority for regulating Australia’s retail payments system ‘to overcome the problems’ raises some hackles. Does the Bank have more general ideas about appropriate ‘centralisations’ of authority for public policy matters – or circumstances where perhaps some (competitive) interaction between public policy agencies may be beneficial in the public interest?

**(ix) getting rid of a fee**

The Governor’s comment in apparent exasperation (at page 31) that “this whole thing was about getting rid of a fee” is superficially inconsistent with the usual view that ‘users (explicitly) paying (full cost) prices’ is a good commercial discipline for ensuring efficient use of scarce resources. Did the Governor really feel that it would be best – or even possibly appropriate -- to bury the costs of banks operating the EFTPOS system in higher retail prices for all goods and services? What are the principles guiding the bank’s thinking on the price system and appropriate resource allocation in the retail payments system?

**(x) 55 days free credit**

About credit cards, the Governor commented (page 32) that ‘they are providing an expensive service ... for a start they are giving you 55 days free credit ..’. He could have gone on to say that most of the remaining eligible costs included in

the interchange fee for credit card transactions, reflect the costs of providing this '55 days free credit.'

A relevant next question, however, is whether the Reserve Bank has surveyed actual account relationships of credit card customers, who superficially get 'free credit', and measured the cost to the card issuer of any benefit the customers actually derive from the 'free credit' facility. Free credit can only be a cost-saving benefit to cardholders that both pay off the debt in full, and who don't hold a compensating deposit balance 'not earning interest' offsetting the debt. It is unlikely that any actual benefit of 'free credit' to customers measures up in any way close to the 'cost' the Reserve Bank still permits banks to recover in interchange fees for credit card transactions.

This issue is crucial to assessing the Reserve bank's claims to 'unqualified success' for the reforms imposed on credit card schemes. Another way of putting this key question is to ask if customers, now forced to take free credit, would object to it being valued (on the same basis as the banks 'costs') and deemed assessable taxable income in customers hands.

### **End piece**

I have limited the dissection of the Governor's evidence to ten points -- a brief litany suggesting some confusion in the Reserve Bank about how Australia's retail payments system works; about how its operational efficiency is best protected and promoted; about whether it compares favorably or not with world best practice and, to the extent it falls short what might be done to bridge the gap.

Peter Mair  
8 July 2004