

## **SUBMISSION TO RESERVE BANK**

### **REFORM OF CARD PAYMENTS SYSTEMS**

**PETER MAIR: APRIL 2005**

#### **A. THE BOTTOM LINE**

Looking to smooth the transition to some end game, the Bank's consultation document is apparently offering to do another deal, proposing to let stand a small (five cents) interchange fee for EFTPOS transactions and a more substantial fee (fifteen cents) for VisaDebit transactions.

Retailers and Visa are additionally pressured to 'do a deal' by veiled threats (welcome promises) to 'abolish all interchange fees' following the scheduled review of credit card interchange fees in 2007.

Unfortunately, as elaborated elsewhere<sup>\*</sup>, the form guide says the Reserve Bank can't be trusted to keep its word. The wisdom of abolishing all interchange fees is clear enough but, as this is the second time the Bank has offered to do this, there can be no confidence that the Bank will do so in 2007 any more than it did in 2002. On the contrary, the form guide suggests the Bank would do nothing more in 2007 if implementing these piecemeal proposals dissipates pressure for further reform.

My great fear is that the community is being readied for another compromise that will see issuers of Eftpos debit cards allowed to take an interchange fee of some 20 cents or more: and nothing done to limit banks also charging separately for this business either explicitly, as transaction fees and annual account fees, or as charges inherent in required minimum balances for limited access to 'free' transactions.

If the Bank were anyway serious about 'abolishing all interchange fees' as it should – and as it first promised to do in 2001 – it would do it now without further delay. Taking this single, now twice-promised, step – effectively abolishing interchange fees in credit card schemes – would underwrite efficiency in the retail payments system effectively while the misguided policy decisions so far implemented, or now proposed, will not.

I believe the Bank is now obliged to take this step. I do not believe the Bank is entitled to argue, in court, an entitlement to make these further temporary and piecemeal changes.

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<sup>\*</sup> *Throw the switch now*: article in May 2005 issue of CFO magazine and available at [cfoweb.com.au](http://cfoweb.com.au)

## B. SUPPORTING POINTS

The following points support the call to abolish all interchange fees forthwith.

### 1. What is the Bank really saying?

We still do not know what the Bank said, or meant to say, in some 30 pages of text. Did the Bank mean to say that, on reflection, effectively abolishing interchange fees from all existing network payment schemes is the appropriate basic policy? If so, and I hope it is so, could the Bank now say this clearly?

The consultation document comes across as a discursive ramble reflecting clichéd and muddled thinking underlying claims to be ‘gradualist’; ‘evolutionary’ and ‘pragmatic’. Offering short-term palliatives again delays effective action.

A glimmer of ‘principle’ and its practical consequence is in the final sentence in the chapter dealing with interchange fees:

*It is the Bank’s intention to examine the arrangements for both debit and credit card systems, as part of this (2007) review, with a view to considering whether the arrangements in the different payments systems should be put on a more consistent basis.*

While no reader could guess what this implied, an article in The Age the following day included these helpful comments:

*..... Within two years it is probable that the fees banks and retailers pay themselves for credit card, Eftpos and other electronic transactions will be abolished.*

*The RBA ..... has indicated its interest in examining whether to shift the whole payments system over to a zero interchange fee environment*

----- and later (dismissing the pending court challenge to the Bank’s powers)

*..... The RBA could ... begin the process anew without altering its view about the desirability of .... ultimately, abolishing all interchange fees for existing payment systems.*

In short, in an article of a few hundred words a media commentator was able to say clearly the next day, three times, what the RBA itself did not say clearly once in a document of some thousands of words.

Perhaps just to balance things up, this same article also included the comments: *the draft standards do not remove the anomalies or mis-pricing ....; that doesn't remove the misalignment of costs and fees....; the current system is messy and inconsistent and the draft standards don't really do much about that ...* -- all after the Bank has been on the job for six years.

Some other media and editorial comment at the time had a disconcerting lack of objectivity suggesting the Bank had been using the phone to sell story lines, not just answering the phone and responding to inquiries.

Modern media-management ploys can usually be let spin through to the keeper. It is, however, disappointing to some that a major public agency, like the Bank, did not put its position openly and fully and with sufficient clarity and candour to obviate the need for supplementary 'off the record' briefings. What is it that the Bank could not say directly and why?

## **2. A failure to investigate fully**

The pending court challenge to the RBA's proposal to set Eftpos interchange fees is important but, nonetheless, a diversion made necessary by the RBA not having set right some payments policy basics.

For most, a few moments reflection will suggest that the reasoning behind the plan to deport VisaDebit (VD) applies equally to the basic credit card product for which the compulsory 'free credit' is, in practice, a fiction for most cardholders.

### **(i) VisaDebit has visa revoked**

Setting aside the semantics about its possible role as a 'debit card', the VisaDebit card is promoted by its issuers (mainly small banks) to be misused in credit-card mode: allowing users no 'free' credit, VD generates the same high interchange fees as if it did. Though known to be an offensively contrived product for a decade or more, VD was allowed to take hold in Australia – cossetting the appearance of competition conjured by 'small banks' issuing cards.

Being fundamentally indefensible, time has caught up with VD: its visa effectively withdrawn.

The VD episode has been a sad reflection on all involved: the face-saving proposal to throw a transitory, 15 cent, sop to the small minded issuers of VD underscores the point. Presumably MasterCard will now put aside its mooted plan for a comparable product.

## **(ii) The irony of it all**

Visa employees would be forgiven for not understanding ‘what did we do wrong?’ A working knowledge of the economics of a credit card scheme shows how the basic credit card game is played identically to the VDrort. In essence, ‘no one’ ever gets free credit even in the schemes that appear to allow it and, for which appearance, the RBA allows the interchange fee for credit card transactions to be heavily loaded with a ‘cost’ that is typically notional.

That is the irony: if a substantial interchange fee for VD is ‘not on’ then the same analysis (properly done) would conclude that it is ‘not on’ either for mainstream credit card transactions.

One would never give the RBA reason for wasting more time ‘investigating’ bank card schemes but one can lament its failure to properly assess banks’ ‘eligible costs’ in operating credit card schemes.

If the Reserve Bank studied a representative sample of account relationships between banks and their credit-card customers it would find that customers able to pay their credit card bills ‘by the due date’ generally hold the funds in a transaction account on which no interest is payable. It would have found the costs banks claim as the ‘cost of free credit’, and load into interchange fees, is typically more than matched by funds held by credit-card customers in interest-free transaction accounts. It would have found that the ‘costs’ are typically more apparent than real.

Of course there are instances where particular customers benefit from ‘free credit’ on credit card purchases but they would be of little consequence in the overall scheme of things. The RBA would certainly not find adequate justification for allowing the general eligibility of ‘free credit’ as a cost of operating a credit card scheme.

I ask the RBA to accept the commonsense of the point made – a commonsense too long denied a community. And in case anyone is wondering, surveys suggesting credit card users value the ‘interest free period’ hold no water if customers do not realize that they ‘never’ actually benefit from the apparent concession: the ignorance of customers does not legitimise deceptive practices designed to deceive and succeeding. The illusion of ‘free credit’ is an instrument of exploitation.

## **(iii) the game is surely up**

The essential point about the functional equivalence of credit cards and Eftpos cards will be driven home when small banks react to the loss of VisaDebit by issuing credit cards on special terms: credit limits lower than required minimum deposit account balances coupled with the agreed automatic monthly debit of any accumulated credit card debt. This structure will see small banks still getting the kickbacks from credit card interchange fees but still not allowing net credit.

A proper analysis of the situation with debit and credit cards might also extend to an explanation of why some features of credit cards do not extend to debit cards and Eftpos transactions. There is no good reason why debit cards cannot be used ‘over the phone or internet’ and have chargeback protections for non-performance by retailers. Is there an agreement among banks to offer these features only in credit card schemes?

More generally regulatory authorizations of cost based fees opens the door to the overstatement and contrivance of sham costs. Quite apart from the of costs for interest free credit being notional, there are problems with the Bank (page 21) condoning costs for fraud arising in signature based authorizations when fraud-free PIN authorization is readily available. Similarly, given the small share of overseas transactions in total credit card business, it is a bit rough to add additional ‘global handling costs’ to all transactions (page 21).

### **3. No reasonable excuse**

There is no plausible excuse for the unreasonable delay – over six years now – and the Reserve Bank still not delivering a sound basic policy framework to promote efficiency in Australia’s card payments systems.

Inclined to portray its contribution as ‘a painful and painstaking fight on behalf of the community’ and ‘a daunting task involving an enormous amount of research and consultation’, the Reserve Bank offers no explanation for the saga of ineffectiveness that unfolded as it fumbled the reform process. Previously casting the Bank’s inclination to self-congratulation as akin to little Jack Horner – one could fairly add a postscript ‘all thumbs and no plums’.

All of the basic policy positions that the RBA is grudgingly coming to accept (some for the second time) were clearly set out in policy discussion papers published in Australia and the UK some five or six years ago.

An Australian discussion paper *The Australian Payments System: some unresolved issues* published in April 1999<sup>♥</sup> clearly explained both the need for abolishing interchange fees of any substance for credit card schemes and the affront presented by VisaDebit. That paper envisioned a policy framework fostering Eftpos transactions using debit cards augmented, as appropriate, with a line of credit and protected against fraud by PIN authorization. Delivered six years ago, publicly, it collated material of which the Bank was already well aware, privately, for some years prior to that.

In the event the publication of that paper preceded the announcement, in June 1999, that the Reserve Bank (and ACCC) would conduct a study of bank transaction card schemes. The subsequent sequence of never-ending inquiries is only slowly wending its way to the same, inevitable, conclusions as that 1999 paper.

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<sup>♥</sup> available from the author on request 02 42 96 1910

The essential recommendations of the Australian discussion paper, for the reform of bank card schemes, were endorsed in the (Cruickshank) report of an independent public inquiry published in March 2000 in the UK.

A notable additional contribution of the UK review was the explanation given for the failure of the UK regulators to deal effectively with credit cards and other similarly evident problems. Cruickshank exposed a long-standing de facto 'regulatory contract' for the Bank of England to give privileges to banks in exchange for cooperation in policy-making: the privileges included barriers to the entry of new banks, high profits and permission to write their own rules against the wider public interest. This assessment correctly struck a very resonant chord in Australia.

The surprise in all this was not that sound recommendations were 'buried' by regulatory agencies and governments advised by them – the surprise was the accommodating weakness of defenses supposedly in place, in the media and political machinery, which has allowed such sound recommendations to be ignored for so long<sup>∞</sup>.

#### **4. What is the Bank really doing?**

The Reserve Bank's regulatory brief for payments policy is primarily about promoting efficiency in the retail payments system. Having failed to get about this task effectively – including in this consultation document – one is entitled to ask the Bank to explain what it is really doing and why.

Observing actual outcomes of the Bank's decisions implies some alternative agendas, perhaps:

- underwriting the comfortable profitability of the major commercial banks (and a quiet life at the Reserve Bank and APRA) by fostering banks' access to soft revenues associated with 'price setting' in network payment schemes and tax-avoiding bartering of transaction services more generally.
- fostering the illusion of competition for retail transaction services by propping up small banks (former building societies and credit unions) with excessive fees for VisaDebit transactions.
- impeding the development of electronic-money substitutes for conventional currency notes issued by the Bank (so protecting substantial 'seigniorage' profit accruing to the Bank).

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<sup>∞</sup> In this context – and six years on – it is disconcerting to see the relevant Assistant Governor saying recently that 'relatively little was known about interchange fees (in 1999) so there was a learning period and the reform process has been slower than anyone wanted'. The blatant excesses of the system were patently obvious to any intelligent observer of the system (see the 1997 Wallis Report) and the Bank was well aware of them long before 1999.

- overseeing the ‘juggling’ and ‘balancing’ of costs and revenues among weaker and stronger players in a retail banking industry rendered grossly inefficient (but unreasonably profitable) by operating as a cartel with small-bank dependants, operating as a caricature of the competitive cost-price model touted by the Bank as its policy objective.

## 5. Reality denied

The ongoing discontinuity between what the Reserve Bank says it is doing, and what the Australian community actually gets, further erodes confidence in the integrity of the Bank’s reform proposals and policy development processes: any ‘process’ that produces such policy proposals is defective.

The following litany of (paraphrased) points, and counterpoints, from the consultation document is illustrative of the Bank blandly saying and accepting things quite contrary to any observable or likely reality:

### (i) general

- In six years of claimed dedicated research, aimed at understanding the ‘down and dirty’ mechanics of how the retail payments system works, the RBA has never managed to get to grips with the efficiency sapping distortions (and profiteering) inherent in the entrenched practice for banks to require customers to maintain substantial minimum balances on which no interest is paid – and then use (part of) the earnings on those free balances to provide ‘free services’ on transaction accounts. The consultation document is no exception – there is scant recognition and no scrutiny of the hidden cost recovery processes for the ‘limited number of free Eftpos transactions’ typically available to customers.
- Much the same shortcoming underlies comments that the proposed ‘reforms’ to Eftpos are ‘consistent with recent changes in the credit card market and the general trend towards cost-based pricing (page 24): prices are either effectively cost-based or not and ‘or not’ (and never likely will be) is the inevitable consequence of the arrangements condoned by the Bank.
- While extolling the virtues of coordinating the development of the payments system as a whole, the Bank continues to offer disjointed and piecemeal reform proposals, fairly described by others as a real ‘dog’s breakfast’.
- The standard homily from the Bank, on the importance for efficiency of a properly working pricing mechanism, currently has no practical application in the payments system and it continues to be frustrated by the Bank accommodating the entrenched unfair trade practices which ensure the homily never will have practical application. Indeed the RBA proposals for Eftpos interchange are predicated on the basis that, if implemented, the incidence of effective prices being charged would be

further eroded. The Bank's plan would see even more cross-subsidised transactions, the cost of which is secretly recovered in revenues contributed by merchants inflating retail prices – a process inimical to 'effective prices reflecting costs'.

- A complementary speech of the Reserve Bank Governor<sup>°</sup> said '*we favor a system that provides users with a wide choice of options (payment instruments) from a wide range of providers*'. Putting aside the neverland fiction of 'a wide range of providers', many would be hoping soon for a narrower range of options (instruments): cheques and credit cards are well beyond their use by date, and absorbing BPay and VisaDebit into the Eftpos and direct-entry system would correct other known aberrations. The Bank could then get to work on replacing the 'wampum' embodied in round pieces of metal and coloured pieces of paper with an efficient electronic currency that could also be used for low-cost internet purchases. The Bank seems to be looking ahead into a rear vision mirror.

## (ii) specific

- Saying that 'the Bank desires to reduce the current level of uncertainty ..... to facilitate business planning by financial institutions (page 3)' the Bank later makes everything uncertain, saying it will defer overriding decisions until after it conducts another review commencing in late 2007 (page 32).
- In contending that, because the pricing disparity will in future be less, the community will reduce the use of credit cards, for which users believe they are rewarded, and instead use Eftpos, for which users are charged (penalized), the Bank is asking the community to suspend commonsense (page 10).
- In saying '*there are some additional costs associated with a credit card due to the fact that these cards are usually issued as a stand alone product, rather than as part of an existing deposit account (page 22)*' the Bank seems not to appreciate that 'abolishing all interchange fees' would see these additional costs removed as credit cards were displaced by debit cards linked to a line of credit as well as a deposit account. This development would also remove the cost of 'fraud' associated with 'signature authorisation'.
- The simply insightful observation -- *institutions that issue VisaDebit cards actively encourage their customers to use VisaDebit instead of Eftpos .... the expensive system has been driving out the cheaper one (pages 22 and 23)* -- was equally true, and made repeatedly, over the past decade, but nothing was done to correct it.

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<sup>°</sup> Greshams Law of Payments: March 2005



- Offering the retailers 5 cents and banks with VD, 15 cents, has all the hallmarks of the Bank refereeing a dogfight and, in desperation, throwing bones to stop the barking. That is not the task the Parliament gave to the Bank, especially as the ‘bones’ the banks chew on are attached to arms and legs of ordinary people.
- A point worth labouring concerns the Bank’s claimed attachment (page 9) to practical benchmarks, such as ‘transparent’ prices for transaction services: where is there any practical evidence that the policies of the Bank support and encourage and deliver transparency of prices for any retail banking services – all the evidence is to the contrary and the current proposals will not help.

One could go on.

## **5. Blaming others**

One can only be amazed by the Bank’s inclination to blame others for not fixing problems for which the Bank was given specific responsibility, and authority, to fix itself. Instead we hear the Bank whining about banks ‘not cooperating’ and voluntarily agreeing to forego profits; about retailers being ‘greedy’ in not accepting a shoddy compromise on unrelated fee variations and international card schemes ‘charging too much’. This is really poor form for a national policy agency which could cut the nonsense at any time by giving the community a full and clear explanation of the problems and getting on with the job.

The RBA is inclined to hold merchants to be responsible for the community using credit cards (and VisaDebit cards). In saying things like ‘despite our efforts to empower the merchants, the merchants still act as if they are indifferent to how customers pay’, the RBA overlooks the advantage that powerful merchants gain when weaker merchants pay much higher merchant service fees than they can negotiate. The banking cartel may ‘cost’ the merchants but in costing some much more than others it further concentrates power in the major retailers.

Even at the more general level it is unreasonable for the Bank to expect retailers to charge separately for bank services, fees which the Bank does not favor banks charging explicitly, and risking political outcry, primarily because the Bank has not explained the situation properly to the community.

The RBA takes solace, without reason, in pointing out (page 22) how ‘the United states has a much worse system’ but does not say what representations it has made to the US authorities encouraging the leadership that the US can provide for the proper development of the payments system globally. [Conversely, the RBA never shows that many countries have retail payments systems far superior to ours in terms of efficiency, adaptability and fairness.]

The RBA, claiming a belief in ‘free markets’ and a reluctance to intervene, is inclined to blame its perception of some government-given brief to ‘pursue reform by voluntary negotiation among potential winners and losers’ – and then lament that ‘achieving industry consensus is frustratingly difficult’ and a reason for slow progress. This is hypocrisy: the Bank revels in an arrangement conducive to the circle work that has characterized payments policy work for decades. The RBA had a major say in the design of the governing legislation after a ‘lifetime’ of being played off a break by bankers promising to cooperate while feverishly working to find loopholes and otherwise frustrate a consensus being reached. Some of the stunts pulled by ‘consulting and cooperating’ banks are legendary. In any event, having now realized the importance of stamping regulatory authority on a recalcitrant industry, has the RBA approached the Treasurer for amended legislation – or does the scope for procrastination suit it?

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