

**INTRODUCTORY PAPER
FOR PAYMENTS SYSTEM REVIEW CONFERENCE**

Access & Innovation



National Australia Bank

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INTRODUCTION

The National Australia Bank (NAB) welcomes the opportunity to prepare a short paper to act as a discussion starter on Access and Innovation in respect of the Reserve Bank of Australia's (RBA's) regulatory reforms for the Payments System Review Conference.

After analysing stakeholder submissions to the RBA's Review, NAB believes that there should be more emphasis on discussing Innovation and in particular the role that interchange plays as it will have a more significant longer term public policy impact.

That is not to say that access is not important. It is. However, the access reforms to date have not generated a significant amount of comment from stakeholders in respect of the RBA's paper - *Reform of Australia's Payments System: Issues for the 2007/08 Review*.

Before moving on to innovation, NAB would like to begin with access.

Access

General

At the outset of the reform process, access was a major focus of the RBA's and the Australian Competition and Consumer Commission's (ACCC) October 2000 report on *Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access* (the Joint Study).

Based on the conclusions of the Joint Study, the RBA's main concern about access was that restricting access lessens competition resulting in less pressure on margins and interchange fees.

In particular the Joint Study states for credit cards:

“the provision of credit card services in Australia generates revenues well above average costs, particularly for financial institutions which are both significant card issuers and acquirers. In a competitive market, it would be expected that competition from new entrants would put downward pressure on these margins and on interchange fees.”

With EFTPOS the Joint Study states:

“the need to negotiate bilateral agreements for access, may provide established players with market power and make entry more expensive. For example, if a small issuer is unable to negotiate a bilateral arrangement with every acquirer it will need to use more expensive gateway arrangements to provide its customers with a debit card which has universal acceptance. This can give large acquirers power to charge interchange fees above cost and can raise the cost of access for new entrants. The large acquirers are also issuers and in competition with those institutions seeking to establish interchange arrangements.”

In this section NAB will:

- summarise the access reforms to date and the RBA's rationale for imposing them
- summarise the submissions received by the RBA for the current review
- discuss the issues raised.

Summary of access reforms to date and their rationale

The table below is an extract from the discussion paper *Reform of Australia's Payment System – Issues for the 2007/08 Review*.

SUMMARY OF ACCESS REFORMS

Reform Area	Description
Credit cards and scheme debit	<p>Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit taking institutions (ADIs).</p> <p>A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or vice versa.</p> <p>Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.</p>
EFTPOS	<p>The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently \$78,000 (ex GST).</p> <p>An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).</p>
EFTPOS access code	<p>Under the EFTPOS Access code developed by the Australian Payments Clearing Association (APCA), new and existing EFTPOS participants have specific rights to establish direct connections with other participants within a set time frame.</p>

With the introduction of the credit card access regime the RBA stated in their impact statement *Reform of Credit Card Schemes in Australia IV – Final Reforms and Regulation Impact statement (August 2002)* that in conjunction with their other reforms at the time the Access Regime would improve overall system efficiency by putting downward pressure on interchange fees, margins on acquiring services, interest margins on credit card borrowings and annual fees.

In the above document the RBA also stated that for EFTPOS the introduction of the Access Regime in conjunction with the Access Code would significantly improve access to Australia's EFTPOS System.

It is important to note that since the RBA’s incursion into credit card access reform the industry has shown willingness for voluntary reform with EFTPOS and ATMs.

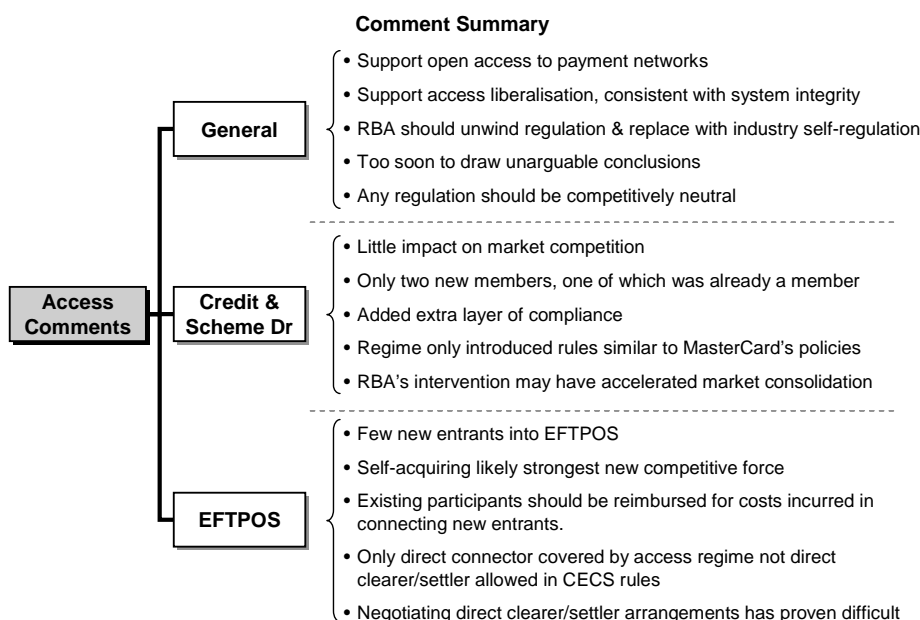
Summary of submissions received

In the current review discussion paper the RBA asked three questions about access:

- What has been the effect of changes to access arrangements?
- What is the effectiveness of existing arrangements?
- If the current regulatory approach is retained, what changes, if any, should be made to access regimes?

Only 9 out of 25 submissions received made substantial comment about access. The key access issues are summarised in the table below.

ACCESS SUBMISSION HIGH LEVEL COMMENT SUMMARY



Discussion of access issues raised

Based on the comments received, NAB believes the two key themes that warrant further consideration are:

- replacing the existing access arrangement with an entirely voluntary self-regulatory regime
- extending the EFTPOS access mechanism beyond direct connectors to cover direct clearer and settler relationships.

Access self-regulation

As stated above, EFTPOS access is already subject to voluntary industry self-regulation in that EFTPOS participants already have specific rights to establish direct connections with other participants within a set timeframe. The RBA, with agreement from the industry, used their powers as a practical way to set caps for direct connection cost reimbursement and interchange fees.

It is conceivable that either through the creation of a scheme for EFTPOS which is currently being explored by the industry or by utilising some other means the RBA's Access Regime could be withdrawn and replaced with another entirely self-regulatory mechanism that could achieve desirable outcomes.

Credit and Scheme Debit Card access could also be examined to see whether the RBA's Access Regime could be withdrawn and replaced with voluntary self-regulation. In fact as MasterCard stated in their response, "MasterCard's rules, before the introduction of the Access Regime, had permitted regulated and supervised financial institutions to participate in the MasterCard system."

To achieve the unwinding of the RBA's Access Regimes as described above NAB endorses the approach proposed by APCA in their submission. Their approach is for the industry and the RBA to engage in "*a co-regulatory process (self-regulation with active appropriate public policy oversight) that will give the RBA confidence to unwind its existing direct regulation (Access Regimes and Standards) within a reasonable transitional timeframe.*"

Merit of extending EFTPOS access mechanism to direct clearer/settlers

The concept of a direct clearer/settler was not envisaged in the industry's creation of the existing EFTPOS access mechanisms. NAB believes that consideration should be given to the public policy merits of extending the EFTPOS access mechanism to cover direct clearer/settlers as part of the overall approach to developing a co-regulatory environment as proposed by APCA in its submission.

Innovation

General

In the RBA's current discussion paper they sought comment in two key areas of innovation:

The first under the general heading of "The effect of interchange fee reforms on financial institutions" was "the effect of the reforms on product innovation;". The second under the general heading "The effect of the reforms on the competitive position of different payment systems" was "any effects of the reforms on product innovation."

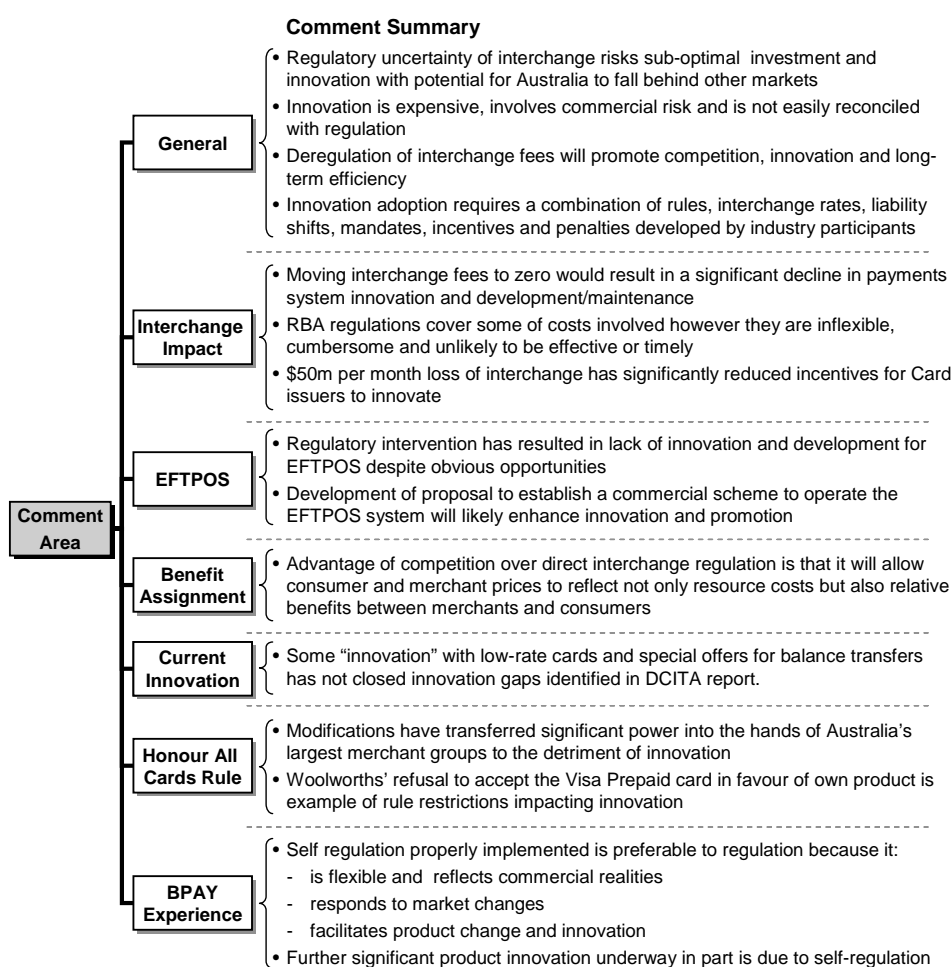
In this section NAB will:

- summarise the submissions to the questions above received by the RBA for the current review
- discuss the issues that arise
- discuss how interchange regulation is inhibiting innovation of “new” types of payment methods and how it should be rectified

Summary of submissions received

There were a significant number of submissions to the RBA around the problems that the RBA’s intervention has caused with innovation. NAB has summarised them below.

SUMMARY OF INNOVATION COMMENTS MADE



Discussion of access issues raised

From the above summary it is clear that industry participants believe that the RBA’s interventions have indeed put innovation at risk and that deregulation, particularly of interchange, will go a long way to resolving the situation.

ACIL Tasman's submission on behalf of American Express supports the above views and contends, based on Productivity Commission statements, that regulators are likely to set prices sub-optimally for innovation. They say:

"One concern expressed regarding price regulation is the difficulty of collecting information to undertake the task of setting an efficient price in a non-competitive market. According to the Productivity Commission:

"this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment."

As with access NAB contends that the co-regulatory process outlined by APCA would be the mechanism by which an approach could be developed for the RBA to withdraw from its existing interchange regulation.

Interchange regulation inhibiting innovation of "new" types of payment methods

Some industry participants have expressed a view that Australia runs the risk of falling behind the rest of the world because of its lack of innovation.

The RBA has also expressed its concerns as to whether Australia is failing to keep up with overseas developments. In a speech entitled *Presentation to Australian Bankers' Association and Australian Payments Clearing Association Forum on Payment Systems Evolution September 2006*, Phillip Lowe the RBA's Assistant Governor (Financial System) posed the issue as to:

"whether the development of payment products in Australia has been keeping pace with that abroad."

In this speech he also talked about developments in Business Products.

"There have been a number of recent developments overseas which appear to have improved the efficiency of electronic payments for business customers, particularly by upgrading the interface between the payments system and business accounting systems and facilitating better opportunities for straight-through processing for business-to-business (B2B) payments."

He went on to speak about 'Online Debit' being available in 13 countries but not in Australia.

NAB believes that the RBA interchange regulation not only impacts innovation with existing and derivative payment type/channels as per the submissions summarised above but also impacts innovation for substantially "new" methods of payments as well.

Large financial institutions need to choose from two broad approaches when it comes to developing "new" payment methods. Because of the nature of payments products they usually need to opt for either an industry based or "on-us" approach.

An example of an industry solution is BPAY View whereas examples of an on-us option are any number of payables or receivables products sold to large corporates.

More often than not, this is a difficult and complex decision to make, with many factors needing to be taken into account.

Some of these factors are:

- potential customer demand
- existing and potential market share
- pricing level versus customer benefit
- competitive advantage
- potential competitor response
- value of first mover advantage
- level of potential interchange

Innovation by its very nature is risky and can often result in poor commercial outcomes which fail to meet shareholder financial return objectives. To achieve these return objectives it is essential that the end-user pricing be such that the potential rewards offset the level of risk associated with the innovation.

In the past, decisions have resulted in both approaches being selected. However, since the RBA's cost based approach to interchange setting has been introduced, there is an industry concern that the level of reward required will not offset the risk involved as pricing will tend to commoditise too quickly.

On the other hand there is a view that "on-us" solutions provide first movers with a competitive advantage resulting in a greater level of control over pricing and the associated risk reward balance. The downside of this from a total industry perspective is that these types of models are not in the best interest of long term efficiency of the payments system.

Interchange set by the industry itself, has worked spectacularly well in the past properly matching the benefit, revenues and costs amongst the participants during start up. The initial Credit Card and EFTPOS networks are testament to this fact.

Even the RBA believes there are respectable arguments for interchange in new and developing networks. Dr Lowe stated at the *House Of Representatives Standing Committee On Economics, Finance And Public Administration (Hansard Reference: Review of the Reserve Bank and Payments System Board annual reports 2005 Tuesday, 16 May 2006 Sydney)* that:

"I think the issue here is whether an interchange fee is in the public interest. There are respectable arguments for why such a fee is in the public interest and promotes efficiency in the system. It helps develop the network."

If interchange is set too high with "new" payment methods, take up would decrease because either merchants or consumers would not use them. Only market forces are best able to determine the correct balance between the benefits and costs used to establish the level of interchange.

NAB believes that it is in the best interests of the long term efficiency of the payments system that interchange for “new” payment instruments should be competitively set and not regulated. The RBA could endorse this approach immediately and APCA’s co-regulatory process could be used to agree a self-regulatory basis that the industry could use to review the interchange fees when “new” payment methods had matured.

Issues for discussion

Based on this overview of the issues raised on access and innovation, the following key questions arise:

1. Has the right level of access already been achieved by the Reserve Bank’s regulatory intervention?
2. Can industry now take a greater self-regulatory role in ensuring access going forward?
3. How important is interchange in ensuring investment in innovation particularly for “new” payment methods?