

## Competition and Efficiency

Since its last Report, the Board's pursuit of its mandate to promote competition and efficiency has centred on credit card schemes in Australia. The Board had begun to focus on these schemes when it undertook its initial stocktake of the safety and efficiency of the Australian payments system. Its work was given impetus by the findings of the Reserve Bank/ACCC study of interchange fees and conditions of entry in debit and credit card schemes, released in October 2000, which raised a number of public interest issues relating to competition and efficiency in credit card schemes. These issues have now been aired in extensive consultations with interested parties, culminating in the Board's decision to use its powers to promote reform in this area. The study also identified shortcomings in competition in ATM and debit card (EFTPOS) networks on which industry participants have taken time to focus, although useful work is now under way on ATM and EFTPOS interchange fee arrangements, with the Bank's involvement. In other areas, the Board has continued to work with industry participants to improve consumer safeguards in the direct debit system but acknowledges that

more ambitious projects to link payment arrangements to electronic commerce have made little headway.

### **Credit card schemes**

"Four party" credit card schemes, familiar to Australians as the Bankcard, MasterCard and Visa credit card schemes, operate under a set of regulations which their Australian members collectively determine or agree to enforce. Three particular regulations that raise public interest questions were highlighted by the study:

- the schemes have interchange fees set collectively by members that are otherwise competitors in providing credit card services to cardholders and merchants. The fees are paid to the credit card issuer by a merchant's financial institution (known as the acquirer) whenever that merchant accepts a credit card for payment. The study found that interchange fees, though an important influence on the fees facing credit cardholders and merchants, are not regularly reviewed on the basis of any formal methodologies and are higher than can be justified by costs;
- the international card schemes (MasterCard and Visa) have regulations that prevent

merchants recovering from cardholders the cost of accepting credit cards; and

- membership of the schemes is, broadly speaking, restricted in Australia to authorised deposit-taking institutions supervised by the Australian Prudential Regulation Authority (APRA). The study concluded that membership rules based on institutional status may be more restrictive than necessary to protect the safety and integrity of the schemes.

Release of the study was followed by a period of discussions with a range of parties, many of which made detailed submissions. Over this same period, public scrutiny of credit card schemes continued on a separate front with a review by the ACCC of the legal status of interchange fee arrangements under the *Trade Practices Act 1974*. The ACCC had earlier announced that it had formed the view that arrangements for the collective setting of credit card interchange fees were a breach of the Act and it had encouraged the credit card schemes and their members to seek formal authorisation of these arrangements. Proposals were subsequently submitted to the ACCC by a group of banks, but the ACCC concluded that the proposals did not address sufficiently a number of the deficiencies in credit card schemes identified in the study, including membership issues. In March 2001, the Chairman of the ACCC wrote to the Governor of the Reserve Bank recommending that the Board consider using its powers to achieve

reform of the credit card schemes in Australia in the public interest.

Before determining its position, the Board considered the views of parties likely to be affected, including the credit card schemes, their members, retailers and consumers. It also noted the ACCC's judgment that the authorisation process was unlikely to meet competition and efficiency concerns, in an appropriate time frame. The Board gave particular weight, of course, to the clear mandate that had been given to it by the Government only three years earlier, to act in the interests of the Australian community as a whole. Against this background, the Board decided that it would be appropriate to use the formal powers available to it to promote competition and efficiency.

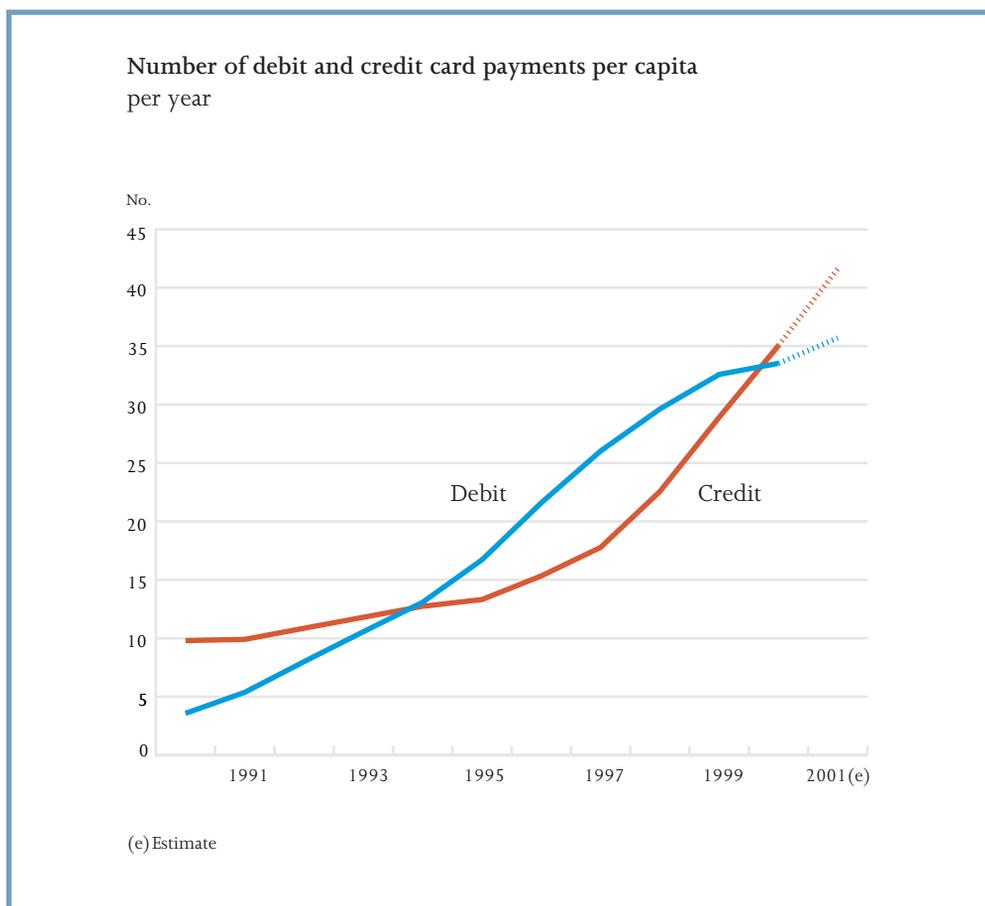
That process began on 12 April 2001 when the Reserve Bank designated the Bankcard, MasterCard and Visa credit card schemes in Australia as payment systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*. The Bank announced that it would proceed to establish, in the public interest, a standard for the setting of interchange fees and, if necessary, a standard for merchant pricing of credit card purchases, as well as a regime for access to these credit card schemes. The Bank did not designate the "three party" card schemes in Australia, American Express and Diners Club, which do not have collectively determined interchange fees nor restrictions on access enforced by

existing members. They do, however, impose restrictions on the freedom of merchants to recover credit and charge card costs from their cardholders, and the Bank confirmed that any decisions it took in this area would apply to all card schemes in Australia.

Following designation, the Reserve Bank undertook a detailed evaluation of whether the main restrictions established by the credit card schemes are in the public interest. As it has from the outset, it gave high priority to the consultation process, receiving views on the operation of credit card schemes in Australia in formal submissions and across the table in a series of meetings, some of which lasted many hours. Over 30 separate organisations have contributed to this process. A commissioned report by an international expert in network economics also helped the Bank assess the various submissions.

Three key features of the credit card market in Australia have provided the context for the Bank's deliberations. The first is the strong

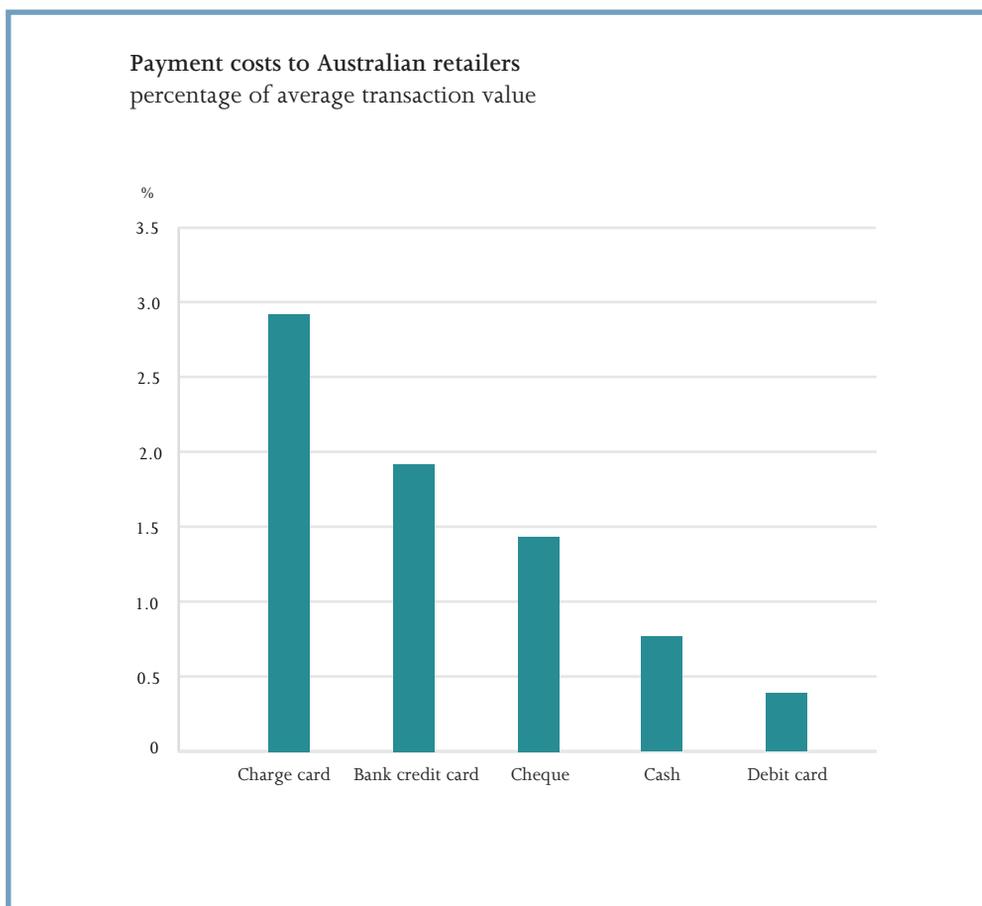
growth in credit card usage over recent years. When the study was published, credit cards had just overtaken debit cards as the main non-cash means of payment for the first time since 1994, and this diverging trend has continued. The second is that credit card services are more costly to provide than most other payment instruments. Recent data show that, from a merchant's perspective, credit card transactions cost several times as much as debit cards. The third feature of credit card schemes, however, is that they are organised so that those who ultimately meet the costs are not necessarily those who enjoy the benefits. In Australia, the costs of credit card schemes are borne by credit cardholders using the revolving line of credit, who pay interest rates significantly above rates on other forms of unsecured lending, and by the community generally, to whom merchants pass on their credit card costs. The group of cardholders (known as "transactors") who settle their credit card account in full each month contribute very little directly to costs.



Source: Reserve Bank of Australia *Bulletin* and ABS Catalogue No. 3101.0

The recent growth of the credit card market in Australia is a clear illustration, if one were needed, of the potency of price incentives in the retail payments system. Consumers using a debit card (EFTPOS) generally pay a transaction fee to their financial institution (beyond a fee-free threshold) for accessing their own funds; “transactors” using a credit card pay no transaction fees, and may be paid in the form of loyalty points, for using the funds of their financial institution. Banks and other deposit-taking institutions promote the credit card

most actively because it is the payment instrument for which they receive the highest return, even though it is one of the most expensive for merchants to accept. The Board’s concern about this structure of price incentives, which it had noted in the study, is that it is not the result of normal competitive processes. Rather, it is the consequence of the restrictions imposed by the credit card schemes and their members and the fact that it is the same group of banks and other deposit-taking institutions that sets the fee



Source: Australian Retailers Association

### ATM, debit card and credit card costs

per \$100 transaction, \$

	Acquirer	Issuer	Total cost	Costs passed to cardholder
Foreign ATM <sup>a</sup>	0.49	0.21 <sup>b</sup>	0.70 <sup>b</sup>	1.40
Own ATM <sup>a</sup>	0.49	0.21 <sup>b</sup>	0.70 <sup>b</sup>	0.65
Debit card <sup>a</sup>	0.26	0.21	0.47	0.50
Credit card	0.43	1.58	2.01	-0.42 to -1.04 <sup>c</sup>

a For transactions beyond the fee-free threshold.

b Does not allow for a difference in switching costs between own ATM and foreign ATM withdrawals.

c Includes costs of interest-free period and loyalty points.

Source: Reserve Bank of Australia and Australian Competition and Consumer Commission (2000) and Reserve Bank of Australia, *Bulletin*, July 2001.

structures for credit cards and the other main payment instruments in Australia.

In its review of *interchange fee* arrangements, the Reserve Bank considered whether such fees are needed in credit card networks and whether card scheme members, acting in their own self-interest, will collectively set the “right” interchange fees from the community’s perspective. Interchange fees are a type of transfer payment that enables credit card issuers to recover some of their costs from acquirers and, in turn, from merchants. Revenues from interchange fees allow credit card issuers to “subsidise” cardholders to use their credit cards, by charging them less than the cost of the credit card payment services they use or by offering rebates in the form of loyalty points. The burden of this subsidy ultimately falls on the community through higher prices for goods and services. This subsidy, it is claimed, is needed to ensure that credit card networks reach their optimum size, with commensurate benefits for society in the form of lower cost payments and higher levels of consumption. The Bank was unconvinced by these claims and by claims that the forces of competition ensure that interchange fees evolve in a manner consistent with the public interest.

The Bank concluded that, while there may be a case for issuers to pass some of their costs onto merchants through interchange fees, current arrangements for the collective setting of interchange fees are not in the public interest. It has proposed a standard that provides an objective and transparent method of determining interchange fees in the

designated credit card schemes, based on the costs of specific credit card payment services provided to merchants.

The Bank also assessed *restrictions on merchant pricing* imposed by the international card schemes, which prevent merchants recovering from cardholders the costs of accepting these credit cards. As a consequence, merchants pass their credit card costs onto all consumers – not just those using credit cards – in the form of higher prices of goods and services. Though some other countries have prohibited such restrictions on anti-competitive grounds, the schemes claim that merchants benefit from these restrictions because they preserve the subsidy to credit cardholders and, hence, their willingness to use credit cards. Merchants themselves, however, argue strongly against the restrictions. The restrictions have a number of adverse consequences, principally that they suppress the price signals that normally guide markets to an efficient use of resources.

The Bank concluded that restrictions on merchant pricing are not in the public interest: in no other market can suppliers of a widely-used input promote that input over others by preventing merchants passing its cost onto final customers. The Bank has therefore proposed a standard for merchant pricing that prohibits credit card schemes and their members from preventing merchants recovering from cardholders the costs of accepting credit cards.

Finally, the Reserve Bank examined

*restrictions on entry* to the credit card schemes which, broadly speaking, rely on prudential supervision by APRA as a screening device to determine eligibility for membership. The Bank acknowledged that some minimum entry standards can be justified because credit card issuing and acquiring does generate risks. At the same time, however, current barriers to entry deny access to non-financial institutions that may have the skills, financial substance and distribution networks to provide the spark for more intense competition in the credit card market – as did specialist mortgage originators in the residential mortgage market some years earlier.

The Bank concluded that scheme restrictions on entry, and some additional restrictions on the range and scale of activities that members may undertake, unduly restrict competition. It has proposed an access regime that liberalises access to the credit card schemes by allowing non-financial institutions of substance to become eligible to enter these schemes in their own right. Such institutions will need to be authorised and supervised by APRA and will need to meet ongoing prudential standards no less strict than those currently imposed by APRA for given types of risks. The draft access regime will make credit card issuing and acquiring open to greater competition, while preserving the comfort and cost savings provided to the schemes by APRA's involvement.

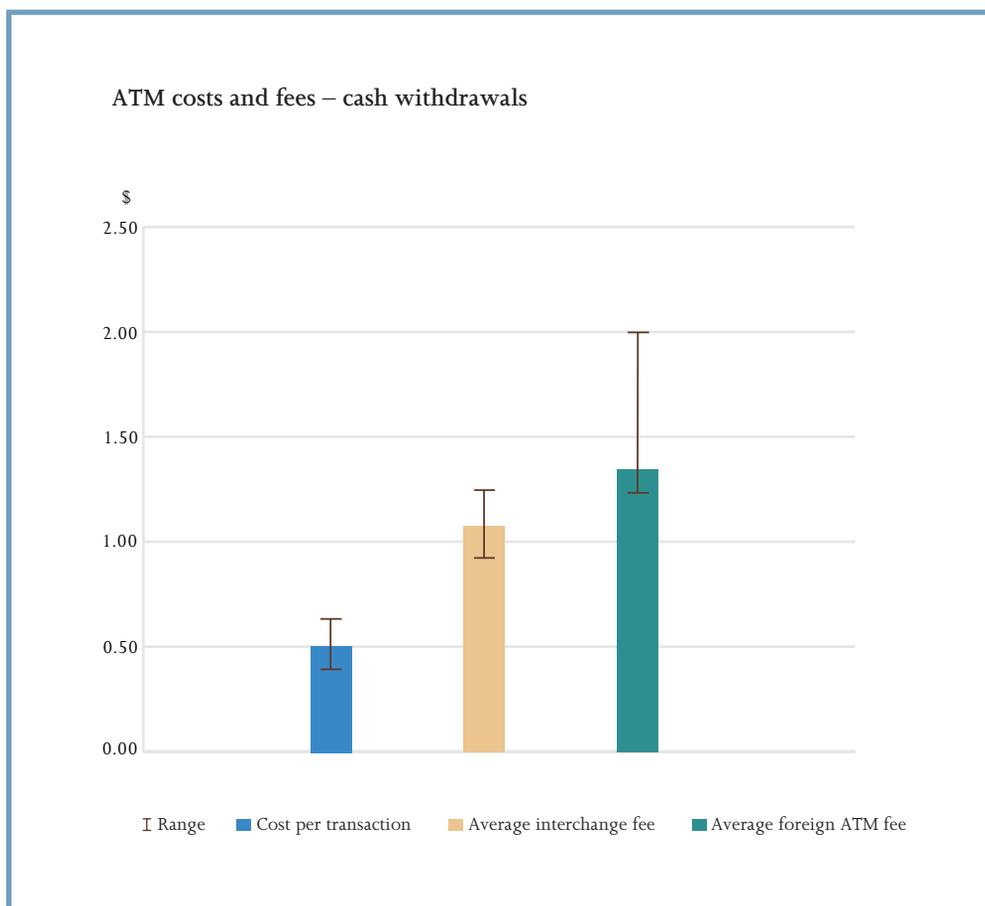
After a detailed assessment of the issues by the Board, the Bank released a Consultation Document in December 2001 outlining its proposed reforms to the designated credit card

schemes in Australia. It also published the commissioned report by the international expert and two volumes of submissions that parties were prepared to put on the public record. A further round of consultations with interested parties will take place before the reform measures are finalised. The Bank is also consulting with American Express and Diners Club as to why they should not also be required to meet the proposed standard on merchant pricing.

### **ATM networks**

Interchange fees are also a feature of ATM networks in Australia. In this case, the fees are paid by the card issuer to the financial institution which owns the ATM, and they are designed to reimburse the ATM owner for costs incurred in providing a cash dispensing service to the issuer's customers. Unlike credit card arrangements, interchange fees in ATM networks are determined by bilateral negotiation but they share the same feature of having been quite rigid over many years.

The study investigated whether ATM interchange fees reflected the costs of providing ATM services to customers and found that they did not. Interchange fees for cash withdrawals average \$1.03 per transaction, double the cost of providing this service, which averages around \$0.49. Card issuers normally pass these fees onto their cardholders – and often add their own charge – whenever they use another institution's ATM through “foreign ATM fees”, which average around \$1.35 per transaction. As a



Source: Cannex Australia & Reserve Bank of Australia

consequence, cardholders using another institution's ATM are paying considerably more than the cost of providing the service.

The study concluded that competitive forces are not working to bring interchange fees and foreign ATM fees more into line with costs. Financial institutions as a whole receive a flow of net revenue from foreign ATM fees and have little incentive to negotiate lower interchange fees; the bilateral nature of interchange fee negotiations was also a source of inertia.

Against this background, the study considered an alternative pricing regime – that of “direct charging” – that would encourage competition and greater transparency in the pricing of ATM services. Under this regime, there would be a direct relationship between the ATM owner and cardholders wishing to withdraw cash. The ATM owner would charge customers of other financial institutions a transaction fee which would be clearly posted at each ATM. That fee would be debited to the cardholder's account along with the cash withdrawal, and the

resulting amounts settled between card issuers and ATM owners as at present.

Responses to the study indicated a willingness on the part of many participants in the ATM system to consider more efficient and transparent pricing arrangements. In July 2001, the Bank convened a meeting of interested parties, including financial institutions and operators of independent ATM networks, to explore options for reform. In undertaking this role, the Bank has liaised closely with the ACCC to ensure that there is no unintentional infringement of provisions of the *Trade Practices Act 1974* which prohibit competitors agreeing on practices that might lessen competition. The meeting led to the formation of a working group, chaired by the Bank, to canvass alternatives to current ATM interchange fee arrangements and analyse their costs and benefits. The Board hopes that the working group will release a report on its findings, for public discussion, in the first half of 2002.

### **Debit card payment networks**

In Australia, interchange fees for proprietary debit card (EFTPOS) payments are negotiated bilaterally and are paid by the card issuer to the acquirer. This direction of interchange flows is unique. In other countries the flow is to the card issuer, or there are no interchange fees at all: the most heavily used debit card payment systems – in Canada and the Netherlands – have developed without interchange fees while a recent proposal by banks to introduce interchange fees in the German debit card system was rejected by competition authorities.

The study concluded that, on the basis of the current cost structure, there was no convincing case for an interchange fee in Australia's debit card payment system, in either direction.

In last year's Report, the Board noted that interchange fee arrangements for debit cards have been in place for a decade and are under no strong competitive pressure to change. That view was confirmed by the initially muted response of industry participants to the study's findings. Subsequently, as the Bank's review of the credit card market proceeded, several submissions argued that debit card interchange fees should be reformed at the same time as those for credit cards, so that consumers and merchants can face more efficient prices for both payment instruments. The Board agrees that this is a desirable objective but it would emphasise that, under the present co-regulatory arrangements, the initiative for reform in the debit card market is, in the first instance, in the hands of industry participants. The release of the Consultation Document is likely to prompt further consideration of debit card issues and the Bank has now begun to work with industry participants to consider options for change.

The Board remains concerned about interchange fee arrangements in one particular debit card product – the Visa-branded debit card. The study noted that issuers of this card earn credit card interchange fees for what are essentially debit card transactions. The Bank has advised Visa and issuing members that this practice imposes an inappropriate burden of

costs on merchants and has no place in the Australian payments system. In the Board's view, two steps are necessary to deal with this issue. On the technical level, Visa debit card transactions need to be identified separately from Visa credit card transactions at point-of-sale, as they are in other countries. On the pricing level, card issuers will need to demonstrate that a case can be made for a collectively set interchange fee for Visa debit card transactions that would meet the appropriate public interest test.

### **Direct debits**

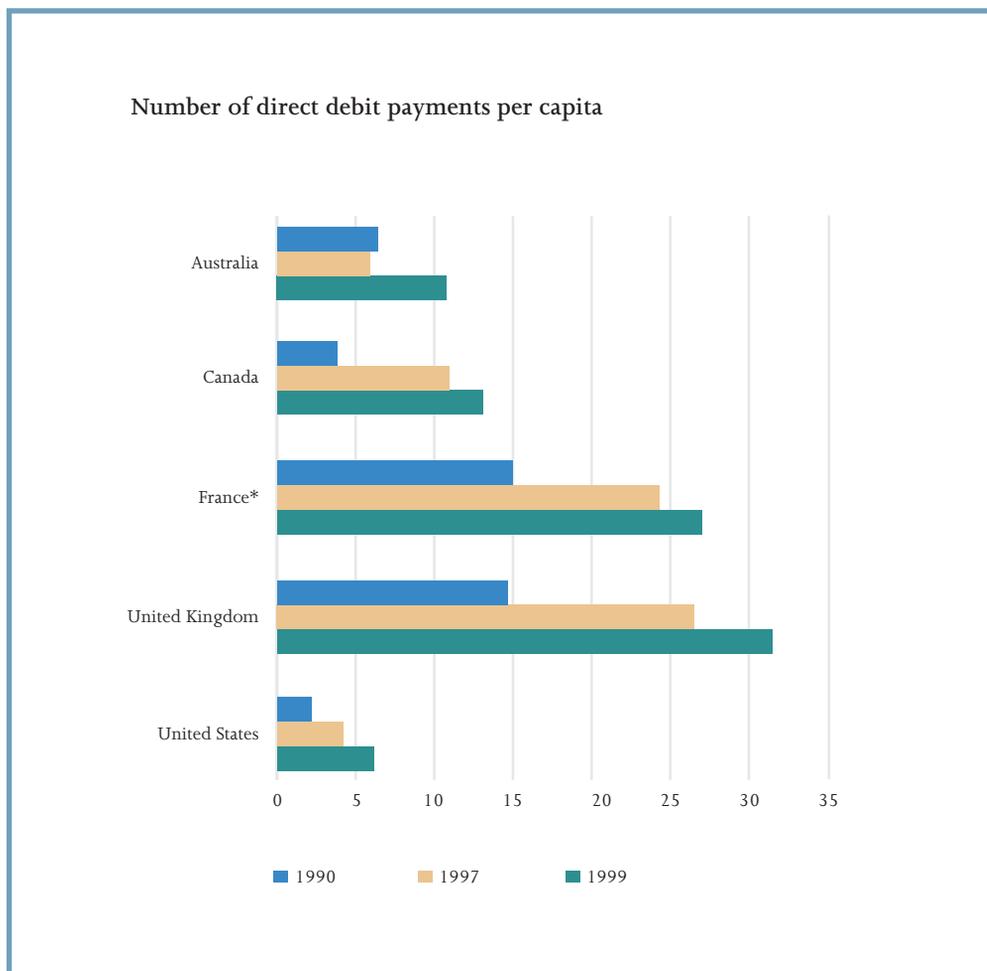
The Board has been keen to encourage greater use of direct debits as a very efficient means of paying regular bills or recurring obligations. Compared with countries which have similar retail payments systems, Australians have been cautious about adopting this means of payment, although usage has grown in recent years. The Board's focus has been the development of safeguards that would give Australian consumers greater confidence that they will be able to stop any incorrect payments under direct debit arrangements.

The Board's work with billing organisations resulted in the Charter for Direct Debit Customers, first published in last year's Report, which guarantees service levels for retail customers. Over 30 billing organisations committed to the Charter from the outset and that list has now been augmented by Brisbane City Council and Integral Energy.

The Charter confirms that customers will be given adequate notice of debits to be made to

their accounts and will be able to stop the debit if they believe that they have been incorrectly billed, provided they give the required notice. However, there is no guarantee of a refund if the bill is disputed after payment. These safeguards, though a very useful first step, fall short of the "direct debit guarantee" arrangements which have operated successfully in the United Kingdom for many years. These arrangements provide that if a customer claims a mistake was made in having a direct debit made to their account, their financial institution will refund them immediately, and the refund is not limited by amount or time. Although refunds are initially paid by the financial institutions, they are borne by the billers under an indemnity.

Since the Charter was published, two developments have turned the spotlight onto direct debits and the importance of consumer safeguards. The first was a review of the Code of Banking Practice (the Viney report) conducted for the Australian Bankers' Association (ABA), which concluded that current arrangements did not provide sufficient protection to customers of financial institutions paying by direct debit. The report recommended that greater protection, including a guaranteed refund, be included in the Code of Banking Practice. The second development arose out of the difficulties which faced a number of customers of One.Tel, the telecommunications company, where they tried to stop direct debit payments and cancel direct debit authorities after that company collapsed. Community concerns on this score were taken up by the Government with the ABA and One.Tel's liquidator.



\* 1990, 1997 and 1998

In response, the Australian Payments Clearing Association (APCA) moved quickly to introduce more streamlined procedures that allow customers to cancel direct debit authorities directly through their bank, building society or credit union. At the same time ASIC, which has responsibility for consumer issues in the financial sector, convened a round-table discussion on direct debits and consumer protection issues, in which the Bank took part.

The discussion highlighted that customers making payments by credit cards have refund rights similar to those under the UK direct debit guarantee but financial institutions and billers have not been prepared to offer the same guarantee for direct debits.

These two developments promise a further strengthening of consumer safeguards for direct debits. Customers can now quickly cancel direct debit authorisations and stop

## CHARTER FOR DIRECT DEBIT CUSTOMERS

### 1 Notification that payment is due

Where the amount of payment due varies from bill to bill (eg phone and electricity), we will always provide you with a bill at least 10 business days (or such time as agreed with you) before payment is due. On the due date, the amount will be debited from the account you have nominated at your financial institution.

Where the amount of payment due is “fixed” according to a pre-agreed arrangement (eg health insurance), we will always notify you at least 10 business days (or such time as agreed with you) before the due date if there is a change in the amount to be paid.

### 2 Direct debit guarantee

If you dispute any amount on a bill, or on a notification of payments due under a pre-agreed arrangement, and let us know at least 2 business days before payment is due, we guarantee we will not debit your account

for the amount in dispute until the dispute is resolved. This notice will allow us enough time to resolve the problem or to halt processing of the payment.

### 3 Change in payment method or cancellation

You may cancel the direct debit or change your nominated account by simply letting us know at least 2 business days (or such time as agreed with you) before payment is due.

### 4 Privacy

We will maintain strict control over the information you provide to us. We will act only on your instructions or those of your authorised representative.

### 5 Complaints

We will provide you with contact details for lodging complaints when the direct debit is established, and these details will be repeated on regular bills. We will respond to any complaint promptly.

individual payments through either their financial institution or the biller; financial institutions cannot deflect requests back to the biller. The ABA has also endorsed the Viney report, which includes the recommendation that the Code of Banking Practice include a clause that “banks will take all reasonable steps to facilitate the amendment of the APCA rules by no later than 1 July 2002 to provide for a direct debit guarantee with the principal

features of the UK guarantee, but subject to such limitations and conditions as are prudentially necessary”. The Board fully supports this recommendation and encourages APCA to bring it to fruition as soon as possible.

### Electronic commerce and the payments system

Electronic commerce will inevitably transform the payments landscape over time. Business-to-business e-commerce, in particular, has

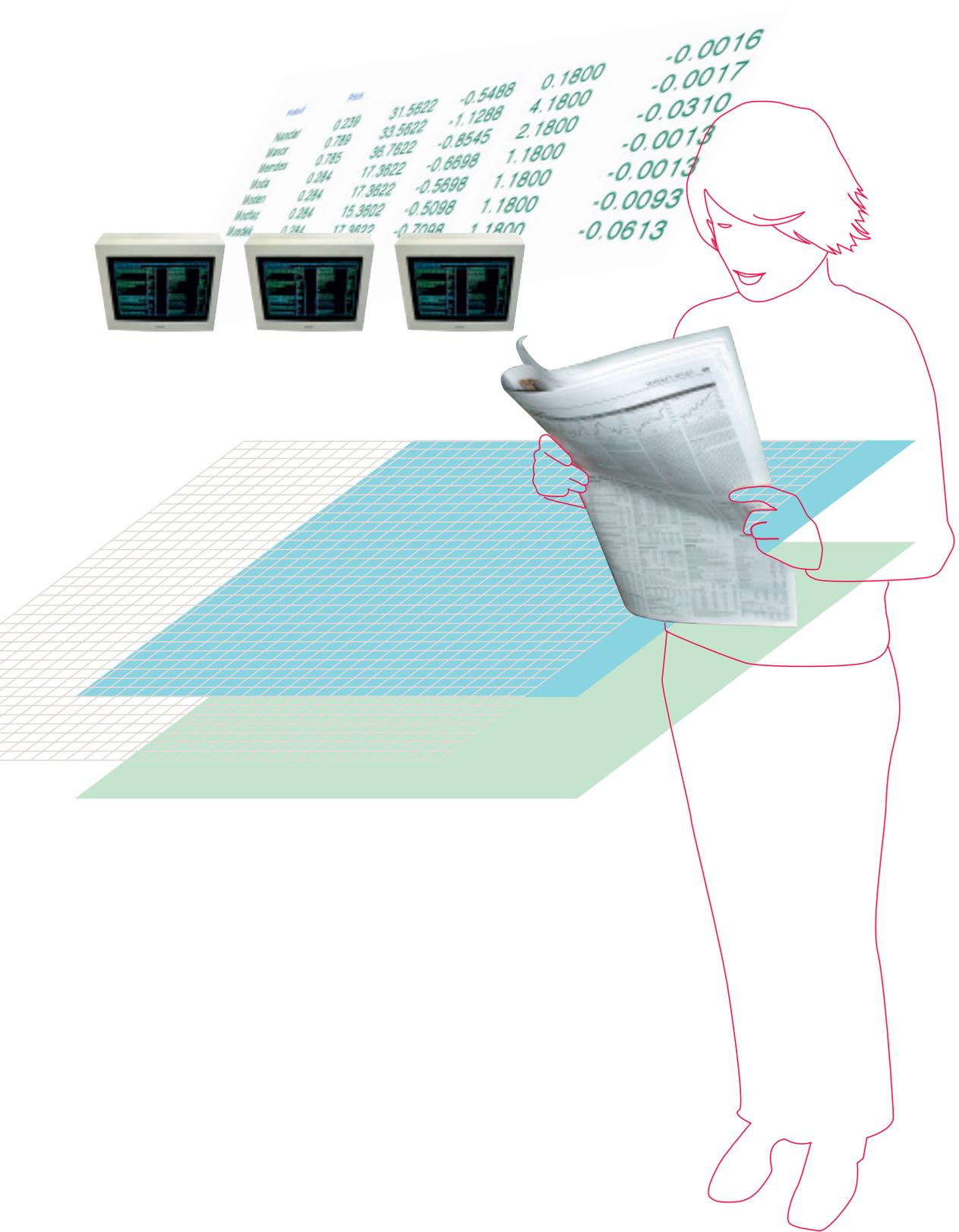
already established a substantial foothold in Australia and this is setting challenges for the associated payments processes. Businesses adopting this powerful technology at the ordering stage are looking for systems which also automate the payment and reconciliation legs. Systems are needed that can attach messages to payment instruments in a form that can be automatically captured by recipients, or that can reconcile payments data and invoices that are transmitted separately.

A year ago hopes were beginning to build, both in Australia and abroad, that traditional payment systems could be transformed to meet the demands of e-commerce. Australian banks were developing interfaces and software to strengthen links with their customers, although industry initiatives to establish standards and systems to improve the flow of information between financial institutions were only at the embryonic stage. Since then, the slowing in economic activity in major countries and the bursting of the dot.com bubble has robbed the various development efforts of momentum. Payment system initiatives to support e-commerce are being re-assessed and there is a reluctance to commit substantial resources to proprietary or industry-wide projects that aim to transform existing systems or develop new ones.

Even in this more difficult environment, however, there have been some steps forward. In the United States, the payment system operated by the New York Clearing House (known as CHIPS) has changed its orientation from one focussed on plain-vanilla payments

to settle the US dollar leg of foreign exchange transactions, to a much more flexible approach designed to support e-commerce. The key to the greater flexibility is improved message formats that allow a wide range of information to be exchanged in lock step with payment messages. In contrast, proposals to redevelop Australia's direct entry system to give it similar flexibility have so far borne no fruit. APCA has been considering how the direct entry system might be adapted to the needs of e-commerce but there appears no appetite for proposals involving new message formats. Efforts to enhance the security of messages across open networks, including the Internet, also remain largely at the development stage. These efforts have been aimed at establishing sound public key infrastructure (PKI) that allows transactors to establish their identity using certificates issued and managed by trusted third parties.

In the consumer area, a compelling case for smart cards and "electronic cash" remains elusive. These products are examples of purchased payment facilities, which consumers pay for in advance and use to make various types of payments; smart cards, as the name indicates, are card-based while electronic cash is network- or software-based. Cards for specific "closed" applications such as telephones, public transport and tollways have been the main market for purchased payment facilities in Australia, though cards with broader application, which have enjoyed a measure of success in some other countries, are also being introduced. However, very few countries have seen network-based schemes move beyond the trial stage.



Index	Value	Change	Value	Change
Nasdaq	0.230	31.5622	-0.5488	0.1800
S&P 500	0.788	33.5622	-1.1288	4.1800
DAX	0.785	35.7822	-0.8545	2.1800
Nikkei	0.284	17.3822	-0.6598	1.1800
Hong Kong	0.284	17.3822	-0.5898	1.1800
London	0.284	15.3802	-0.5098	1.1800
Madrid	0.284	17.3822	-0.7098	1.1800
Stock	0.284	17.3822	-0.7098	1.1800

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