

# STATEMENT TO PARLIAMENTARY COMMITTEE – THE AUSTRALIAN PAYMENTS SYSTEM

*Opening Statement by Dr Philip Lowe,  
Assistant Governor (Financial System), in testimony  
to the House of Representatives Standing Committee  
on Economics, Finance and Public Administration,  
Sydney, 15 May 2006.*

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It is a pleasure to be here today in front of the Committee to discuss the Australian payments system. I would like to say at the outset that the Reserve Bank very much welcomes the Committee's interest in payments system issues, and appreciates the time that the Committee has given to reviewing the Bank's reforms.

In my opening remarks I thought I could usefully do two things. The first is to provide an overview of the main reforms and their rationale, and the second is to provide a summary of their main effects to date.

## **Overview of Reforms**

As you are no doubt aware, the Reserve Bank's current role in the payments system was established by the Government following the Wallis Inquiry into the financial system. The Inquiry concluded that there was considerable room for both competition and efficiency in the Australian payments system to be improved. It also concluded that a separate Board should be established within the Reserve Bank to address the three issues of efficiency, competition and stability in the payments system.

Since its establishment, the Payments System Board has addressed each of these issues, although the work improving competition and efficiency has attracted the most attention (a summary of the Board's various decisions is provided in an Attachment). This work has examined five aspects of the payments system. These are:

- i. interchange fees;
- ii. the restrictions imposed by card schemes on merchants;
- iii. access arrangements;
- iv. the availability of information; and
- v. the governance and architecture of the system.

Before I touch briefly on each of these, I would like to make three general points about the reform process.

The first is that the Payments System Board has a strong preference for industry-based solutions, and has explored these wherever possible. In some cases, changes that promote the efficiency of the system have been achieved without regulation, while in others they have not. The use of regulation is perhaps not surprising given the significant, and often opposing, commercial interests that are sometimes at stake, and the legal hurdles that can arise in voluntary reform.

The second point is that the Bank has consulted widely before using its powers. This consultation has been very useful and has led to a number of significant changes in proposed regulations. While we may not always agree with views put to us, we very much value the ongoing dialogue with the industry and users of the payments system.

The third is that in considering reforms, the Bank has always had a whole-of-system focus. We have been particularly concerned not just with how an individual system operates, but with the potential for substitution between the various individual systems.

I would now like to turn to the five specific aspects of the reform process that I mentioned a moment ago.

## **Interchange fees**

The first, and most controversial, of these is interchange fees. These fees are payable between financial institutions and are not transparent to either cardholders or merchants, but they have a pervasive influence on the prices that financial institutions charge for payment services. These fees are not subject to normal competitive pressures and, in the Bank's view, had been set in a way that was distorting payment patterns in Australia.

Prior to the reforms, the structure of these fees meant that cardholders were often charged by their financial institution to make an EFTPOS transaction, but often received quite large per-transaction subsidies, through reward points and interest-free credit, when making a credit card transaction. As a result, we had the rather anomalous situation in which cardholders were being charged significantly more to use the relatively low-cost payment system. We could see no convincing reason why this was the case.

Given this assessment, the Bank has reduced interchange fees in the credit card system and the two debit card systems. The reforms to the credit card system in 2003 saw interchange fees fall from around 0.95 per cent of the transaction value to around 0.55 per cent. More recently, three weeks ago, the Bank announced reforms that will see interchange fees in the EFTPOS system – which flow in the opposite direction to the credit card system – fall from around 20 cents a transaction to around 5 cents. Interchange fees in the Visa Debit system – which flow in the same direction as the credit card system – will also fall significantly.

The lowering of credit card interchange fees has, as expected, prompted a change in price signals. The prospective changes to the debit card systems will have a similar effect. The fall in debit card interchange fees will also substantially reduce the risk that the Visa Debit system (and its MasterCard equivalent) might eventually drive out the EFTPOS system, simply because the structure of interchange fees made it much more attractive for financial institutions to offer and promote the Visa Debit system. I would like to make it clear though that the Bank's regulation of various interchange fees is not motivated by a desire to protect the EFTPOS system, or by a desire to reduce credit card debt, or by a desire to see greater use of the lowest-cost method of payment. Rather, it reflects the view that the efficiency of the overall system is promoted by

the various payment methods competing on their merits, rather than through interchange fees, which themselves are not subject to competition.

I might also note that this interest in interchange fees is not confined to Australia. Over the past few years, these fees have been subject to regulatory investigation in a wide range of countries, including the United Kingdom, Spain, Switzerland, Israel, Mexico, Germany and the Netherlands. And in the United States, these fees have been, and continue to be, subject to numerous court cases. In each of these countries, the concerns are essentially the same as those expressed in Australia. Namely, that interchange fees are not determined in normal competitive markets, and that the levels at which they have been set are not typically in the best interests of the community at large.

### **Restrictions on merchants**

The second issue is the restrictions on merchants. Quite early on in the Bank's work, we became concerned that various restrictions imposed by the card schemes on merchants were effectively eliminating or dulling price signals to cardholders. These included:

- i. the restriction that prevented merchants from passing onto cardholders the additional costs associated with a credit card payment (the no surcharge rule);
- ii. the restriction that required a merchant to accept Visa Debit cards if it accepted Visa credit cards (the honour all cards rule); and
- iii. the restriction that prohibited a merchant who accepted American Express cards from steering customers to less expensive forms of payment (the no steering rule).

All three of these restrictions either have been, or will shortly be, removed. Again, as with regulation of interchange fees, these reforms provide the basis for more soundly based competition in the payments system.

### **Access**

The third issue is access. Over the years, the Reserve Bank has heard many complaints about how hard it has been for potential entrants to join parts of the Australian payments system. Given this, the Payments System Board has been keen to ensure that inappropriate barriers to entry are removed. In general, the Board's work in this area has proceeded more smoothly than reform of interchange fees, with the Bank and industry working co-operatively on a number of issues.

The first step in improving access was the introduction of an access regime for the credit card schemes. This was done with considerable input from industry. Prior to this regime being put in place, membership of the schemes was restricted to banks, building societies and credit unions, with penalties applying if a scheme member specialised in providing credit card services to merchants.

More recently, the Bank announced an access regime for the EFTPOS system, with this regime co-existing with the EFTPOS Access Code developed by APCA and its members. This outcome represents a successful example of the Bank and the industry working together, and it is a model that we hope will be used again. The Bank has also been working with APCA to improve access arrangements, including their transparency, to a number of the payments clearing streams.

## Transparency of information

The fourth issue is the transparency of information. When the Bank started its work, data on interchange fees, merchant service fees and market shares were often treated in the same way as state secrets. Amongst other things, members of the credit card schemes were not permitted to disclose interchange fees to merchants. This general lack of transparency worked to the advantage of the card schemes and their members, but to the disadvantage of cardholders and merchants.

Today, things are much more transparent. All interchange fees are now publicly disclosed, and the Bank collects and publishes data on average merchant service fees and on the market shares of the various types of credit card schemes. This improved flow of information is providing the basis for better and more informed decisions by cardholders and, particularly, merchants.

## Governance and technology

The final issue is the governance and architecture of a number of Australia's individual payment systems. While Australia was once recognised for having leading-edge payments system technology, I think it is fair to say that this is no longer the case. In a number of countries, there have been greater efforts to update the underlying architecture of the payments system and more options are being offered to consumers and businesses.

We have spent some time trying to understand why this is so and whether it is a problem. While we have further work to do, Australia's payments system is notable for its heavy reliance on bilateral, rather than multilateral, contracts, and, with the exception of the credit card schemes and BPay, the lack of strong central entities that develop and promote particular payment methods. Whether alternative arrangements would promote more innovation is an open, but an important question.

The Bank's general approach in this area has been to raise the questions of whether the current architecture and governance arrangements are conducive to the ongoing development of the system. Our hope is that in doing so, there will be greater industry focus on these issues, since these issues are ultimately best dealt with by industry rather than by regulation. Recently, we have seen some steps in this direction, and we hope that this will continue.

## Effects of Reforms

I would now like to turn to the effects of the various reforms.

Perhaps the most notable impact has been a marked reduction in merchants' costs of accepting credit cards. The average merchant service fee for the MasterCard and Visa schemes is now around 0.9 per cent of the transaction value, down from 1.4 per cent immediately prior to the reforms. Based on the current levels of credit card spending this represents a saving to merchants of around \$700 million per year.

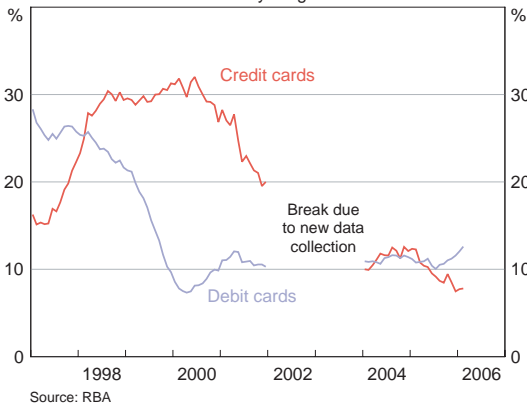
I know a lot of people believe that this cost saving has not been passed onto consumers but instead has flowed through to merchants' profits. This is not a view that we share, and it is one that sits uncomfortably with the normal dynamics of a competitive marketplace. If firms have lower costs, eventually prices too will be lower. Unfortunately, it is not possible to measure these price changes and their timing, particularly given other more significant changes in firms' costs

and prices that are going on all the time. But an inability to measure the change does not mean it is not occurring.

A second significant effect of the reforms has been a change in price signals to holders of credit cards. The value of reward programs has been cut, some merchants have introduced surcharges, and annual fees have been increased. From our perspective, these are welcome developments.

On average, the value of reward points on those cards that offer points has fallen from around 0.8 per cent of the amount spent to around 0.65 per cent. In terms of surcharging, survey evidence suggests that less than 5 per cent of merchants levy an explicit charge on credit cards. Surcharging is still relatively uncommon in most retail stores, but it is being increasingly seen in a range of industries, including some in which competition is very strong.

**Graph 1**  
Value of Transactions  
Year-on-year growth



These various changes in prices appear to be having an effect on payment patterns, although it is difficult to disentangle the various effects. Spending on credit cards over the year to February was around 8 per cent higher than in the previous year, around the slowest growth since we began collecting data in the early 1990s. In contrast, spending on debit cards was 13 per cent higher, around its fastest rate since 1999 (see Graph 1).

Another change is the growth of low-rate credit cards, with the cut in interchange fees prompting many issuers to re-examine their credit card products. With less interchange revenue available, some issuers are now attempting to attract cardholders by offering lower interest rates, rather than generous reward points. As a result, a range of credit cards are now available with ongoing interest rates as low as 8.99 per cent, well down on the rates of 16–18 per cent applying on almost all cards a few years ago. For many people, this represents a saving of hundreds of dollars a year.

In discussing the effects of the reforms, I would also like to address two issues that you are likely to hear about today or tomorrow.

The first of these is that the Bank should have just required the removal of the no surcharge rule and not regulated interchange fees. Those that have put this view have argued that such an approach would have been sufficient to establish appropriate price signals to cardholders, by merchants charging for credit card transactions. The Bank did consider this argument long and hard, but decided in the end that simply removing the no surcharge rule was unlikely to be enough. The main reason was that the long history during which merchants had been prevented from surcharging had contributed to a culture in which there was considerable customer

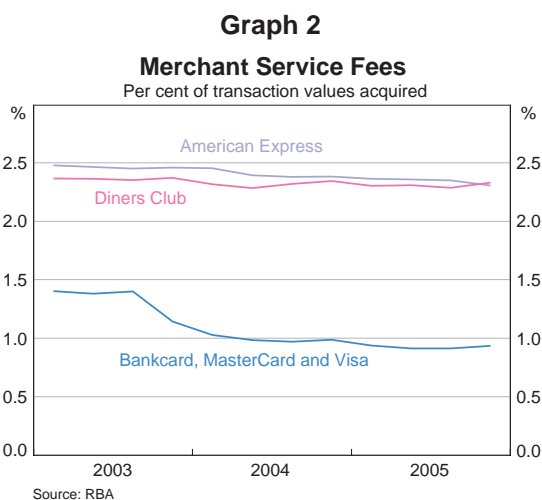
resistance to doing so. Given this culture, we judged that it was unlikely that surcharging would become commonplace within any reasonable time, and thus just removing the no surcharge rule was unlikely to establish more appropriate price signals. I think the evidence on surcharging so far is consistent with this judgment.

The second issue is the claim that the Bank has given American Express a considerable advantage by regulating interchange fees in the MasterCard and Visa systems, but not regulating American Express. This has led to calls for the same regulatory treatment to be applied to all schemes. In practice, the only way in which this could have been done would have been to require just the removal of the no surcharge rule, and not regulate interchange fees at all. For reasons I discussed a moment ago, the Board did not think that would be an effective option.

It is important to recognise that the main reason that American Express can offer relatively high reward points has nothing to do with interchange fees, but rather stems from the relatively high price that American Express has been able to charge merchants for accepting its cards. With more merchant revenue per transaction, American Express, and its partner banks, have offered more generous rewards to cardholders, particularly those prepared to pay the high annual fee associated with premium cards. Given this assessment, the Bank has been keen to see that the bargaining between American Express and merchants is conducted in as competitive and open environment as possible.

In particular, the Bank has sought, and obtained, American Express's agreement to the removal of its no surcharge and no steering rules and the publication of a broader range of data useful to merchants. This approach is having some effect, with the average merchant service fee charged by American Express having fallen by around 20 basis points since the reforms were introduced (see Graph 2). There has also been an increase in marketing payments to some merchants, so that the decline in effective fees is somewhat larger than this.

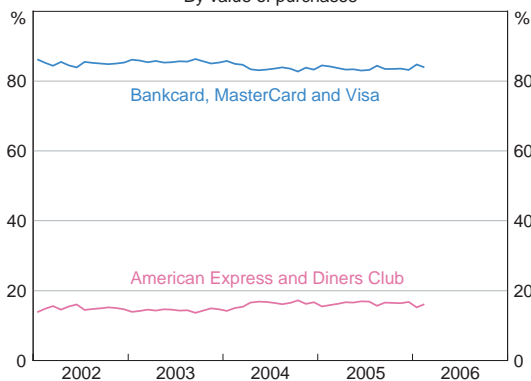
In the MasterCard and Visa schemes, the competition between acquirers meant that when interchange fees fell, so too did the fees charged to merchants. In contrast, in the American Express system there is no competition on the acquiring side; American Express is the sole acquirer. This means that the causation runs from merchant service fees to the fees to the partner banks, not the other way around as it does in the MasterCard and Visa schemes. To repeat the key point, it is the high merchant service fees in the American Express scheme that allow the generous rewards, not interchange fees as in the MasterCard and Visa schemes. The different regulatory responses reflect this point.



**Graph 3**

**Market Shares of Card Schemes**

By value of purchases



Source: RBA

None of this means that we are not monitoring the competitive landscape very closely. To date, the change in market shares has been small; the combined market share of American Express and Diners Club has increased from around 14 per cent of the value of all credit card transactions prior to the reforms, to around 16 per cent (Graph 3). Looking forward, we expect that competition will lead to a further decline in American Express's average merchant service fee, and in time, this will be reflected in the structure of the products that are offered.

In summary, the changes that we have seen to date are in the direction we expected. However, like other economic reforms that involve the unwinding of subsidies, not everybody is happy with the changes. Also, while the movement to less distorted price signals creates benefits for the community at large, these benefits tend to be less obvious than the higher prices paid by those previously receiving the subsidy.

In the payments system, the importance of getting relative prices right is perhaps best illustrated with the example of cheques. When people were not charged for writing cheques, they wrote lots of them and a tremendous amount of resources were used in their processing. Then, when banks did introduce a charge, people found other, more efficient, ways of making their payments. The result was that as a society we freed up considerable resources to use for things other than processing payments. While nobody who writes a cheque likes paying the charge, collectively we are better off facing lower prices for electronic payments than for cheque payments.

In this example, it was ultimately the normal forces of competition that were important in getting the price more in line with the costs of processing. And this is how things normally work. However, as I have said a number of times already, these normal forces of competition do not work on interchange fees. The fees that previously existed themselves generated strong incentives that encouraged the use of credit cards at the expense of the lower-cost EFTPOS system, and there was no market mechanism to correct the distortion. The same is true when comparing interchange fees in the EFTPOS and Visa Debit systems. In the absence of these normal competitive pressures, the Bank's reforms have promoted more appropriate price signals, and, as a result, are freeing up resources to be used where they are more highly valued. The reforms are also promoting competition, enhancing transparency and removing long-standing barriers to entry. While it will take a number of years for their full effects to be felt, they represent a significant step towards a more efficient payments system.

Thank you. ☺

## ATTACHMENT: DECISIONS OF THE PAYMENTS SYSTEM BOARD

<b>Safety and Stability</b>		
<b>Date</b>	<b>Decision</b>	<b>Description</b>
<i>Payment systems</i>		
March 1999	Provision of legal certainty to RTGS payments.	Ensures the finality of payments made through the RTGS system by protecting them from the risk of a 'zero hour' interpretation by a court. Such an interpretation could date the insolvency of a bank at midnight on the day of insolvency, rendering void RTGS payments made between midnight and the time insolvency was declared.
November 1999, August 2004	Provision of legal certainty for payments netting arrangements.	Ensures that financial institutions' obligations under multilateral net settlement arrangements are limited to their net positions and that the administrator of an insolvent institution could not 'cherry pick' and insist on payment of all the obligations owed to it, without making any of the payments it owed.
August 2004	Legal certainty for cheque clearing.	Ensures that a financial institution that accepts a cheque deposit may treat the cheque as dishonoured if the institution on which it is drawn is unable to settle.
<i>Securities settlement systems</i>		
March 1999	Legal certainty for securities transfers.	Ensures that transfers of title to securities held in the Austraclear system cannot be challenged under the 'zero hour rule'.
May 2003, June 2005	Determination of Financial Stability Standards.	These standards are required to be complied with by the central counterparties and securities settlement systems operated by the Australian Stock Exchange and Sydney Futures Exchange.



## Competition and Efficiency

(continued next page)

Date	Decision	Description
March 1999	Eligibility for Exchange Settlement Accounts.	Broadened eligibility for Exchange Settlement Accounts to include third-party providers of payments services and central counterparties.
June 2000, March 2004, August 2005, April 2006	Declarations that certain purchased payment facilities are not subject to the <i>Payment Systems (Regulation) Act 1998</i> .	Removed the need for these facilities to comply with the provisions of the Act.
<i>Interchange fees</i>		
August 2002, November 2005, April 2006	Interchange standards for credit card interchange fees.	Set benchmarks capping the weighted-average interchange fee in the Bankcard, MasterCard and Visa credit card systems.
April 2006	Interchange standard for EFTPOS system.	Set a benchmark which would place a cap and floor on interchange fees in the EFTPOS system.
April 2006	Announcement that if Visa does not agree to impose a cap on the weighted-average interchange fees for scheme debit systems, the Bank will move to do so. The Bank also announced it will consider similar arrangements for MasterCard.	Would set a benchmark capping weighted-average interchange fees in scheme debit systems.

## Competition and Efficiency

(continued)

Date	Decision	Description
<i>Merchant pricing and acceptance</i>		
August 2002	No surcharge standards for MasterCard and Visa.	Required removal of the rules in MasterCard and Visa credit card schemes that prevented merchants passing on the cost of accepting a credit card to cardholders.
August 2002	No surcharge undertakings received from American Express and Diners Club.	American Express and Diners Club provided enforceable undertakings to the Reserve Bank that they would remove the no surcharge rules in their schemes.
April 2006	Announcement that if Visa does not agree to remove the honour all cards rule in its system, the Bank will move to require it to do so. The Bank also announced it will consider similar arrangements for MasterCard.	Would remove the requirement imposed by the international card schemes that merchants wishing to accept credit cards must also accept the scheme's debit cards.
<i>Access</i>		
February 2004	Access Regimes for credit card schemes.	Requires credit card schemes to consider applications for participation by Specialist Credit Card Institutions on the same basis as applications from other authorised deposit-taking institutions. Also required removal of rules that discriminated against members that focused on acquiring rather than issuing.
August 2005	Access Regime for Visa Debit.	Imposes a similar Access Regime on the Visa Debit system to that imposed on the Visa credit card system.
April 2006	EFTPOS Access Regime announced, expected to be gazetted May 2006.	Places a cap on the amount that can be charged by existing participants in the EFTPOS system for establishing a new direct connection.