Retail Payments Policy and Research

The Reserve Bank implements retail payments policy and undertakes research under its remit to maintain a safe, competitive and efficient payments system. Recent policy work has included an ongoing review of the regulatory framework for card payments and changes to access regimes for card systems. Research includes work related to digital currencies and a study into payments costs.

Review of Card Payments Regulation

In March 2015, the Reserve Bank commenced a review of the regulatory framework for card payments with the release of an issues paper, *Review of Card Payments Regulation*. A number of factors suggested that it was timely for the Board to review the regulatory arrangements for card payment systems, including aspects of the interchange fee system and surcharging practices that had raised concerns over recent years. The Financial System Inquiry (FSI) Final Report, which was released in December 2014, also made recommendations relevant to the Bank and its regulation of card payments.

The Bank indicated that it would be conducting a review nearly a year ahead of the release of the issues paper. In March 2014, its submission to the FSI noted that it would be reviewing aspects of the operation of the credit and debit interchange systems, and that it would also be reviewing the issuance of American Express companion cards by financial institutions and considering whether some change to the regulatory treatment of these cards (or those of any other scheme not currently designated) might be warranted. It also indicated that it would consider issues relating to surcharging.

The issues paper sought the views of stakeholders on a broad range of topics, noting that there were linkages between the different elements and that it would be important to take a holistic view of issues in the cards payment system. These topics included:

- the decline in transparency for some end users of the card systems, partly due to the increased complexity and the wider range of interchange fee categories
- the possibility for interchange fees to fall further, consistent with falls in overall resource costs and as was contemplated in the conclusions to a previous review of card reforms, conducted over 2007–08
- the possibility of changes to the specification of interchange fee benchmarks, for example: replacing weighted-average interchange caps with hard caps; more frequent observance of benchmarks to reduce the upward drift in interchange rates; and broadening interchange caps to capture a wider range of payments between card schemes and card issuers
- widespread perceptions that card surcharges remain excessive in some industries
- perceptions that the growth of companion card arrangements may indicate that the current regulatory system is not fully competitively neutral
- the potential need to clarify arrangements for cards offering access to more than one payment network (whether presented

physically or virtually via a wallet application) and more broadly for competing payment options in a single device or application.

The Bank received over 40 submissions in response to the issues paper and has consulted with a wide range of interested parties. Having received feedback via this process, the Board will consider the possible designation of some payment systems and whether to consult on specific changes to the regulatory framework.

Review of Card System Access Regimes

There have recently been two significant changes to the Access Regimes applying to card systems.

The Access Regimes applying to the MasterCard and Visa credit card systems and the Visa Debit system were varied effective from 1 January 2015, along with corresponding changes to the Banking Regulations. The changes are deregulatory in nature, giving the card systems greater flexibility to expand membership beyond existing participants. The Access Regimes were originally put in place to address concerns that the restrictive membership rules in place at the time did not strike the right balance between allowing new participants in those systems and controlling risks. However, following changes to the ownership of the schemes the Board judged that the schemes are likely to be more open to new types of participation, while the emergence of new business models is creating stronger interest in direct membership. Given these developments, the requirements of the Access Regimes might have been constraining new entry. Following changes to the Access Regimes, MasterCard and Visa have published Assessment Criteria on their websites for potential applicants seeking access to their respective systems, as required under the varied regimes. They are also required to report annually to the Bank on applications to participate received, new participants accepted and the reasons for any rejections. Although the revised access regimes have been operating for only just over half a year, the indications are that the expanded scope for new participants in the schemes appears to be working effectively, with a number of new participants admitted.

In addition, effective 1 September 2015, the Board has revoked the eftpos Access Regime. This was put in place in 2006 to ensure appropriate and effective access under the bilaterally negotiated connection arrangements that existed at the time. In November 2012, the Board had concluded that the eftpos Access Regime could be revoked once eftpos Payments Australia Limited had established suitable centrally determined access arrangements. With the implementation of the eftpos hub, prospective participants in the system will be able to gain access on common terms, via a single connection, avoiding the need to establish a series of bilateral connections. In February 2015, the Board determined that the suitable access arrangements were likely to have been achieved when three out of the four major banks had connected to the eftpos hub. With this condition met in August, the Board took the formal decision to revoke the Access Regime at its August meeting.

Digital Currencies

The Board and the Reserve Bank monitor developments in payments technology; notable among these in recent years has been the emergence of 'digital currencies' and 'distributed ledger' technology. A 'digital currency' is a digital representation of value that is able to be used as a medium of exchange, designed to replicate some of the features of cash, but in an electronic form. The most prominent of these is Bitcoin, although there are hundreds of other implementations of the concept. Most digital currency transactions occur via changes in a distributed ledger. Rather than there being a central trusted entity to control a single version of an electronic ledger recording ownership of assets, the ledger is decentralised and replicated across all (or a majority of) participants in the network, with protocols established to determine how changes to the ledger occur and how these are validated. Alongside the development of digital currencies and their associated ledgers has been the growth of digital currency intermediaries that offer various services to end users. These services may include 'digital wallets', enabling access to and storage of digital currency units, as well as exchange facilities to convert sovereign currencies into digital currencies and vice-versa.

In November 2014, the Bank made a submission to the Senate Economic References Committee Inquiry into Digital Currency.[5] The submission outlined the key features of digital currencies and noted that the concept of a decentralised ledger represented an innovation with potentially broad applications for a modern economy. The submission noted that while digital currencies are currently used – to a limited extent – as a means of payment, they tend not to be widely held as a store of value and are almost never used as a unit of account. The submission stated that, while the Bank would continue to monitor digital currencies, currently they did not appear to present any issues for the Bank to address from a payments system, monetary policy or financial stability perspective.

Bank staff have liaised with counterparts in other organisations domestically and internationally on digital currency issues and have also met with a range of entities in the 'fintech' sector. In its submission to the Senate Committee, the Bank observed that the international character of digital currency systems might mean that regulatory action, if required, might need to be suitably coordinated. It noted that from a payments perspective one vehicle for such coordination would be through the Committee on Payments and Market Infrastructure at the Bank for International Settlements, of which the Bank is a member (see 'Liaison Activity').

2014 Payment Costs Study

In 2014, the Reserve Bank conducted a comprehensive study of the costs borne by merchants, financial institutions and individuals in the use of different payment methods.[6] This study updated and extended similar work previously undertaken as part of the 2007/08 review of the Bank's payment system reforms.[7]

The Bank considered it timely to conduct this study given the significant changes in the Australian payments landscape over recent years. These include changes in technology, payments functionality, issuing arrangements and patterns of use and pricing of payment methods. The information collected enables the Bank to better understand how the costs of different payment methods have changed since 2007, thereby enhancing the Bank's analysis of retail payments issues. It also provides benchmarks against which financial institutions and merchants can compare their own cost structures and may help promote public understanding of the costs associated with different payment methods.

To conduct the study, detailed cost data were collected from 16 financial institutions and from 17 large merchants and billers. In addition, the study separately surveyed 260 small- and medium-sized merchants to provide information about how the costs borne by smaller merchants differ from those borne by larger merchants. In aggregate, the study captured data from the vast majority of transaction and credit card accounts in Australia and a significant proportion of retail sales and billing activity during 2013.

5 See RBA (2014), Submission to the Inquiry into Digital Currency, Submission to the Senate Economics References Committee, November. Available at <http://www.rba.gov.au/publications/submissions/inquiry-digital-currency-2014-11.pdf>.

6 See Stewart *et al* (2014), 'The Evolution of Payment Costs in Australia', RBA Research Discussion Paper No 2014-14. Available at <http://www.rba.gov.au/publications/rdp/2014/2014-14.html>.

7 See Schwartz *et al* (2007), 'Payment Costs in Australia', available at <http://www.rba.gov.au/payments-system/resources/publications/payments-au/paymts-sys-rev-conf/2007/7-payment-costs.pdf>.

The results suggest that the 'resource costs' of the payments system (the economic costs incurred by participants to 'produce' payments) have fallen as a percentage of GDP since 2006, from around 0.80 per cent to 0.54 per cent. This primarily reflects a fall in per transaction costs across most payment methods. Financial institutions incur the majority (two-thirds) of resource costs, with the remainder incurred by merchants.

On a per transaction basis, direct debit remains the lowest-cost payment instrument, while cheques remain the most expensive. At the point of sale, payments using cash, eftpos and contactless MasterCard and Visa debit cards have broadly similar costs for transactions under about $20; above $20, eftpos is the lowest-cost payment method. The study also revealed that the resource costs associated with card payments have changed with the advent of contactless payments, mainly reflecting shorter tender times. Contactless card payments are estimated to incur 10 to 20 per cent lower resource costs than a comparable contact-based card transaction.

The relationship between resource and 'private costs' (where fees and other transfers between sectors are included) varies significantly across instruments. The greater share of private costs is borne by merchants, who typically pay a net transfer to the financial sector (for example, via a merchant service fee) to use payment services, although these costs are generally passed on to consumers either in the prices of goods and services or via a surcharge. Where a surcharge is not applied, typically only a small proportion of the payment cost is explicit to the consumer. Further, consumers face a similar explicit cost for credit card payments and debit card payments despite the higher cost of credit cards to the economy. Although consumers pay fees to hold credit cards, they also receive significant incentives to use them to make purchases, owing to the provision of rewards points and an interest-free period.

Finally, the study suggests that small businesses incur higher payment costs than large merchants. In part, this is because smaller merchants do not benefit from the economies of scale that can be achieved by large merchants due to their larger payment volumes. In addition, merchant service fees are higher for small businesses.

Operational Incidents in Retail Payment Systems

In November 2012, the Reserve Bank published a report setting out the Board's conclusions from an informal consultation on operational incidents in retail payment systems. The report concluded that, at least for the time being, the Bank's role should be limited to monitoring retail operational incidents and collecting related data. In support of this role, from February 2012 the Bank has required Exchange Settlement Account holders to report significant retail payment incidents. To supplement this, from late 2013 the Bank commenced collecting quarterly statistics on all retail payment incidents. The Bank has also collected additional information on the system architecture supporting participants' retail payment activities to assist in its review of incident reports.

Over 2014/15, the Board was kept informed of significant incidents and trends both within and between institutions. The data collected to date confirm some of the findings in the November 2012 report. A large proportion of significant incidents over the past year were caused by changes or upgrades to existing systems, with software/application failures also an important root cause of incidents. The channel most affected by significant incidents was online banking. However, emerging payment channels (e.g. mobile banking and payments) were also increasingly impacted by such incidents.

Since reporting began, the Bank has provided aggregate statistics to the Australian Payments Clearing Association (APCA) for review by the APCA

Board. The Bank and APCA are in discussion on how aggregate information could be disclosed to industry participants. Such data could potentially be used for performance benchmarking.

International Developments

In the past 12 months, a number of jurisdictions have seen initiatives focused on improving efficiency and competition in card payments through card regulation and improved regulatory frameworks. The trend towards speeding up retail payments through the introduction of new 'fast payment systems' also continues to gain momentum.

Card regulation

Several jurisdictions have sought to impose regulatory constraints on interchange fees, though at quite different levels. In Europe, new interchange fee regulation imposes a hard cap on credit card interchange fees of 30 basis points and a hard cap on debit interchange fees of 20 basis points. The interchange caps are scheduled to take effect from December 2015, although there is some flexibility for member states around the phasing in of the debit card cap. The new regulations also prohibit scheme rules that prevent merchants from steering customers towards a preferred payment method and rules that limit the choice of consumers and merchants in selecting the network they want to process a transaction.

In Canada, Visa and MasterCard agreed to enter into voluntary undertakings to reduce interchange fees for credit card transactions to a weighted average of 1.50 per cent of transaction value for the next five years. Previously the average interchange rates for Visa and MasterCard were 1.61 per cent and 1.74 per cent respectively. Interchange fee regulation was also introduced in Malaysia and South Africa over the past year. The Malaysian regulation caps debit interchange fees at a weighted average of 0.21 per cent of transaction value, and credit interchange at a weighted average of 1.10 per cent of transaction value. The South African regulation sets interchange fees based on the level of security measures employed by each side of the transaction, with fees ranging from 1.41 to 1.89 per cent of transaction value for credit and 0.36 and 0.53 per cent for debit.

Regulatory frameworks

The United Kingdom's (UK) new Payment Systems Regulator (PSR) commenced full operation on 1 April 2015. Prior to this, two initial streams of work were undertaken. The PSR conducted a consultation outlining its proposed approach to regulating the UK's payment systems and seeking views from the industry on how to implement that approach. Separately, Her Majesty's Treasury (HM Treasury) conducted a consultation on the systems to be 'designated' to come under PSR oversight, and subsequently designated a range of retail payment systems, including the Faster Payments system, the ATM system and the Visa and MasterCard systems. The PSR has released a number of binding directions to interbank payment system operators on measures to improve governance and access, particularly to improve the representation of end-users' interests at the decision-making levels of payment system operators. It also announced that it will conduct market reviews into the ownership of payments infrastructure, and the current arrangements by which smaller payment providers gain indirect access to payment systems via the large banks. Finally, the PSR anticipates working with industry to establish a 'Payments Strategy Forum'.

In April 2015, the Canadian Government announced updates to the voluntary code of conduct governing credit and debit card payments in Canada. In addition to making the code of conduct applicable to payments made on mobile devices, the updates aim to improve transparency for merchants and consumers. For example, merchants must be informed of any changes to interchange rates and able to terminate a contract without penalty following such a change. Branding requirements will require that premium cards are more easily identifiable to merchants, while card issuers must inform consumers applying for premium cards that those cards can result in higher fees to merchants.

Fast payments

The trend towards payment options that allow end users to make real-time payments from any bank account to any other bank account continues to gain momentum. In the past year Denmark's banks launched a fast payment system known as RealTime 24/7 and the Dutch Payments Association announced plans to develop a fast payment system, which is expected to be operational by 2019. Following the release of its report, *Strategies for Improving the U.S. Payment System*, the Federal Reserve convened a taskforce on faster payments in April 2015 with the aim of advancing the industry towards a ubiquitous, safe and fast electronic solution for making a variety of business and consumer payments.

Digital currencies

Governments and central banks around the world continue to monitor digital currency developments. In the UK, HM Treasury commenced a consultation on digital currencies in September 2014. Among the findings in its March 2015 report, it observed that digital currencies could be useful in facilitating micropayments and cross-border transactions. However, the report noted that there are anti-money laundering (AML) concerns with the technology. The UK Government has since said it will look to conduct a full consultation on how to apply AML legislation to digital currencies.

In Europe, the European Central Bank has highlighted similar potential for digital currencies in payments, but added that they were 'inherently unstable'. The European Banking Authority (EBA) released a report in July 2014 suggesting that the benefits stemming from digital currencies were small given the existing and pending European Union initiatives aimed at improving transaction speeds and costs. The report also noted a range of risks associated with the use of digital currencies, including AML and financial security concerns. More recently, EBA released another report highlighting four possible scenarios for use of digital currencies: foreign exchange and remittance; real-time payments; documentary trade; and asset servicing.

Developments in North America have been more directly focused on regulation. In the United States, the New York Department of Financial Services released its 'BitLicense' regulations in June. Under the regulation, digital currency businesses had 45 days to apply for a licence if they wished to offer digital currency services in New York. The regulation is aimed at protecting consumers as well as guarding against money laundering. Licensees will have to keep track of the identities of the parties to all the digital currency transactions they handle.

A Canadian senate committee released its digital currency inquiry report in June. It suggests that the government adopt a 'light touch' regulatory framework around AML and counter-terrorism financing concerns to create an environment in which digital currency technologies can grow.