

Reform of the Australian Payments System

The Payments System Board was established in 1998 in response to the recommendations of the Wallis Inquiry into Australia's financial system. In the payments area, the Inquiry focussed primarily on the scope for gains in the efficiency of the system rather than improvements in its safety and stability. This reflected, in large part, the fact that the main safety and stability issues had been addressed through the 1990s. In particular, the real-time gross settlement (RTGS) system for high-value payments between banks was virtually complete by the time the Inquiry reported, and was in operation when the Board first met in August 1998. The RTGS system settles a range of high-value payments, including large-value securities transactions, on a delivery-versus-payment basis, and accounts for around 90 per cent of the value of settlements between banks.

In contrast, at the time that the Board first met, relatively little attention had been paid to the efficiency of the payments system. In particular, in its early meetings the Board noted the paucity of data on the use of various means of payment and the costs of providing and using them. This was despite the considerable aggregate cost to the community of making payments. While precise estimates of these costs are not available, a conservative estimate would be ½ per cent of GDP, or \$4 billion annually. In many cases, these costs go unobserved by the consumers of goods and services, often being borne in the first instance by merchants and financial institutions before being passed onto consumers in the form of higher prices.

Given the considerable resources that go into making payments there is a strong public interest in ensuring that Australia's payments system – and of necessity the individual systems that comprise it – operates in a competitive and efficient manner. The efficiency of the retail payments system is particularly important given that over 10 million non-cash payments are made each day. Given this large number, small gains in efficiency at the individual transaction level can add up to substantial gains at the aggregate level.

In its early deliberations, the Board noted that a useful starting point for evaluating the efficiency of the system was to consider whether the relative prices that individuals face when choosing amongst payment methods reflect the relative costs to society of those methods. If the price charged is below the cost to society of providing a particular method of payment, that method is likely to be overused. Similarly, if the price is above cost, then the payment method is likely to be underused.

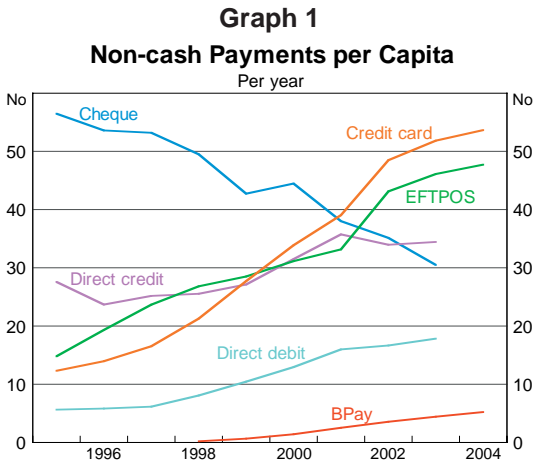
Accordingly, much of the Board's work has been focussed on understanding the relative prices for using different payment methods and the relative costs of these methods. When prices do not reflect costs it is often a sign that competitive forces are not working adequately or that, at the least, analysis is needed to clarify whether the system is working competitively and efficiently. Two issues have received particular attention. The first of these is the relationships amongst different payment systems and the factors that make one payment system more

attractive to use than another. The second is the nature of the competitive forces within any given payment system.

Relationships Amongst Payment Systems

The Australian non-cash payments system is made up of a number of separate payment systems. These include:

- the debit and credit card payment systems predominantly used for retail payments by consumers;
- direct credits and debits to bank accounts used by both consumers and businesses;
- the cheque payment system that, today, is mainly used by businesses; and
- the RTGS system primarily used by banks for settlement of money market and foreign exchange transactions.



Source: ABS, APCA, BPay, RBA

Over time the use of these different payment systems has changed substantially (Graph 1). The use of credit cards has grown particularly strongly, as has EFTPOS, albeit less rapidly than that of credit cards. In contrast, the use of cheques has declined, displaced, at least in the case of bill payments, by direct credits, direct debits, credit cards and BPay.

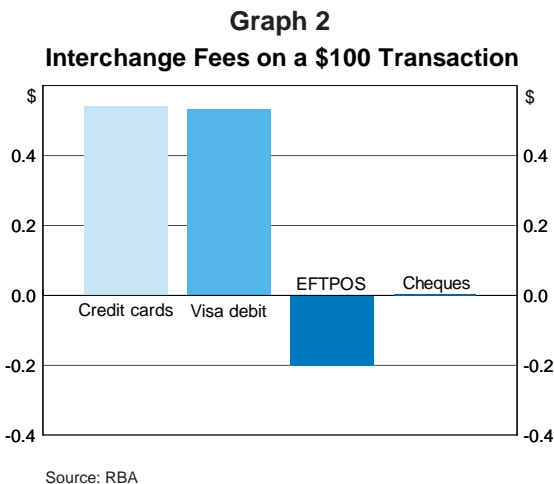
For many payments, individuals clearly have a choice about which payment method to use. For instance, to pay for a trolley of groceries at a supermarket checkout,

credit cards and debit cards can be used along with cash, more or less interchangeably. Similarly, cheques, credit cards, direct debits, direct credits and BPay can all be used to pay most household bills. Given this abundance of choice, no one payment system can be considered in isolation from others. As an example, as banks have gradually increased the price charged to their customers for using cheques to more accurately reflect the costs of processing, the use of other payment methods has increased and the number of cheques written has declined.

A number of factors influence the choice of payment method. These include the convenience and security of the method, as well as whether a receipt is required. Another important factor is the price. For some payment methods, prices largely reflect the resource costs of the institutions offering the service. This has increasingly become the case with cheques and it is also largely the case with the direct entry system. In a number of other payment systems, however, the price charged for each transaction bears little resemblance to the underlying costs of making that transaction. Perhaps the clearest example is credit cards. For many individuals,

once they have decided to hold a credit card, the effective price of using the card to make a payment is negative; that is, they are effectively paid by their financial institution to use the card through the combination of interest-free credit and reward points. In contrast, there are real resource costs to society in processing a credit card payment.

An important factor influencing the prices charged for a number of payment methods is the interchange fee – the fee paid between banks each time a payment is made using the method. In Australia, interchange fees currently exist in the credit card, debit card and BPay payment systems (Graph 2). In the case of credit cards and scheme-based debit cards the fee is paid to the cardholder’s bank and is based on the size of the payment. In the case of EFTPOS it is paid to the merchant’s bank and is typically a flat fee (i.e., not based on the value of the transaction). In BPay, the fee is paid by the merchant’s bank to the payer’s bank. BPay has provided details of its interchange fees to the Reserve Bank but has not consented to their publication at this stage.



Whatever the form, size or direction of interchange fees, they increase the net costs of the bank paying the fees, and reduce the net costs of the bank receiving them. This can create an incentive for banks receiving interchange fees to charge customers a price lower than the underlying cost of providing the payment service, and an incentive for banks paying interchange fees to charge their customers more than the underlying cost of providing the service. In this way, interchange fees alter the usually direct link between costs and prices on both sides of a payment system.

Given the importance that interchange fees play in determining the prices that individuals and merchants face for using and accepting various payment methods, the Board has spent considerable time examining whether they are subject to normal competitive pressures. It has also considered the underlying rationale for these fees.

Quite early on the Board came to the view that interchange fees are subject to little, if any, competitive pressure when they are set by the members, or management, of a payment network and apply to all members of that network. In the case of credit cards, all banks in the scheme pay the same interchange fees and this is reflected in the fees that merchants face. Merchants cannot force interchange fees lower by the threat of moving from one bank to another for supply of the scheme’s credit card services.

International experience suggests that interchange fees set in this way can potentially be used to improve the position of a payment system with respect to other payment systems. A higher interchange fee paid to the issuer allows the issuer to reduce the effective price faced

by the cardholder (perhaps through a more generous reward scheme) and, thus, encourages use of the card. It also increases the costs to merchants of accepting the card. If merchants are not prepared to (or able to) pass the higher charges on to customers using the cards, or cease accepting the cards, the forces constraining the use of interchange fees as a competitive weapon by the scheme can be relatively weak.

When the fees are *bilaterally* set, as they are in Australia's EFTPOS system, the dynamics of competition are different, but, again, normal competitive forces tend to be weak or absent. In general, neither acquirers nor issuers are willing, or able, to initiate a process of competition over the interchange fee.

The main reason for this on the issuing side is that an issuer cannot credibly threaten to end a current interchange agreement with an acquirer if lower interchange fees are not agreed to. Ending the agreement would mean that the issuer's cardholders were not able to use their cards at merchants serviced by the acquirer. For most issuers, this would be seen as unacceptable. Similarly, an acquirer attempting to expand its business would have difficulty doing so if it were to offer, or agree to, a lower interchange fee. If the acquirer were receiving less revenue from interchange payments than its competitors, it would be unlikely to be able to offer merchants as competitive pricing as other acquirers. Accepting a lower fee can hurt, not improve, the competitive position of acquirers.

The one qualification to this arises from the possibility of large merchants bypassing their acquirers and connecting directly to issuers. Under such an arrangement both issuer and merchant can be better off by sharing any margin earned by the merchant's existing acquirer. However, the gains to be achieved from this source are limited. Only large merchants are likely to be able to undertake such negotiations and once the merchant has established a direct connection with the issuers there is likely to be little further competitive pressure on interchange fees.

These considerations suggest that one cannot have confidence that bilaterally set interchange fees will reflect normal competitive pressures. The rigidity of interchange fees in the EFTPOS payment system over the 1980s and 1990s supports this conclusion.

It is important to note that although interchange fees are not subject to normal competitive pressures, their existence does not necessarily reduce the efficiency of the payments system. Nonetheless, because interchange fees break the normal link between costs and prices, the reasons for their existence and magnitude need to be analysed. In some payment systems, interchange fees may be necessary to ensure that all the parties are prepared to participate to provide the service. For instance, in a credit card system, if issuers cannot recover all their costs from cardholders an interchange fee paid by the merchant's bank might be necessary to make the issuers' participation in the system viable. In theory, one could calculate the socially optimal interchange fee taking into account the full range of factors that influence the demand and supply for various payment instruments. In practice, this has not proved to be possible. Current models of payment systems are not sufficiently advanced to be applied in this way, and the data available are insufficient for use in even those simple models that are available.

The Board accepts that there may be a public benefit from interchange fees in some payment systems. Whether or not a particular fee enhances the efficiency of the system needs to be assessed on a case-by-case basis, taking into account the totality of the payments system.

Competition Within Payment Systems

In terms of the competitive forces within a given payment system, the Board has focussed primarily on the issue of access to the payment system.

Financial institutions that want to provide facilities for making and receiving payments to their customers need to establish arrangements for exchanging payment instructions between institutions. Because of the efficiencies they bring, these arrangements are usually established co-operatively between the participants, so that all financial institutions participating in the payment system meet the same standards, and payments can be exchanged between all members of the system without the need for special arrangements between particular institutions. This can require the adoption of common procedures and technical standards and controls over access.

One factor influencing the extent of competition within a payment system is the ease of access to the system. Accordingly, the Board has given a high priority to identifying and addressing inappropriate restrictions on entry to a range of payment systems.

The Reform Process

Given the initial paucity of data and analysis, an early action of the Board was a comprehensive study of credit card, debit card and ATM systems, conducted jointly with the Australian Competition and Consumer Commission (ACCC). This study, *Debit and credit card schemes in Australia, a study of interchange fees and access* (the Joint Study), was published in October 2000. It emphasised both the substitutability of individual payment systems and the need for a system-wide approach when analysing them. The Joint Study:

- detailed publicly for the first time the interchange fees then applying in the credit card, debit card and ATM systems;
- collected data from the issuers and acquirers in these systems on their costs of providing these services and published them in aggregate form;
- analysed the effects of the incentives created by these arrangements on payment system use and efficiency; and
- sought explanations from the participants in the various payment systems about their rationale for the various interchange fees.

The Joint Study found that credit card interchange fees encouraged the provision of credit card services at effectively negative prices to consumers, while debit card interchange fees increased the cost to consumers of using the EFTPOS system. The study also found that the case for an interchange fee in debit card systems on the grounds of balancing issuers' and acquirers' costs was not strong, a conclusion supported by overseas experience.

The Joint Study concluded that '[a] major consequence of current interchange fee and access arrangements in Australia is that the credit card network has been encouraged to grow at the expense of a less costly alternative, the debit card'.¹ At the time the study was undertaken a cardholder's bank *received* an interchange payment averaging 0.95 per cent of the value of the transaction whenever a credit card was used to make a payment. In contrast, if the same purchase

¹ *Joint Study* p76.

had been made by EFTPOS, the cardholder's bank would have had to *pay* the merchant's bank around 20 cents.

Given the results of the Joint Study, subsequent deliberations and industry consultations, the Board came to the view that the efficiency of the payments system would be improved if the relative prices faced by consumers for using debit and credit cards were more in line with their relative costs. It also viewed the 'no surcharge' rule as detrimental to the efficient and competitive functioning of the credit card payment system. Furthermore, the Board came to the view that reform of the credit card schemes was unlikely to be achieved through a voluntary process.

Consequently, in April 2001, the Board exercised the Bank's formal powers under the *Payment Systems (Regulation) Act 1998*, designating the Bankcard, MasterCard and Visa credit card systems. Subsequently the Bank set standards regarding merchant pricing and interchange fees and introduced an access regime. Details of these developments are presented in the following chapter. The reforms came into effect over the course of 2003 and the early months of 2004.

These reforms were expected to lead to an adjustment in the effective price of credit card payments relative to the price of payments by debit card. It was, however, recognised that even after the reforms, the interchange arrangements would still create incentives for consumers to use credit cards and scheme debit cards such as Visa Debit, in preference to EFTPOS. Given this, the Board encouraged industry to review the interchange arrangements that apply to debit cards. The result was a proposal by the industry to abolish interchange fees in the EFTPOS system. This proposal was approved by the ACCC in December 2003, although the ACCC's decision was overturned by the Australian Competition Tribunal (ACT) on appeal.

After taking account of the ACT's decision, consultation with interested parties and other relevant information, the Bank designated the EFTPOS system in September 2004. In reaching the decision that designation was in the public interest, the Board took into account how EFTPOS interchange fees affect the totality of the payments system, and how the system is likely to evolve over the medium to long term. It judged that a further narrowing of the relative price and cost differential between credit and debit cards would be beneficial to the overall efficiency of the payments system.

Earlier in the year, the Bank also designated the Visa Debit card system. Currently, the same interchange fees apply to Visa Debit and credit cards, with the result that users of Visa Debit cards typically face lower prices than users of the EFTPOS system. An important lesson from the Wal-Mart case against MasterCard and Visa in the United States is that if the interchange fees for two debit card systems are significantly different from one another, the one with the higher interchange fee may ultimately grow at the expense of the one with the lower interchange fee. This is because the higher interchange fee can be used to subsidise cardholders. In the Australian context, if the interchange fees for Visa Debit and EFTPOS were to remain at current levels there would likely be a move away from the PIN-based EFTPOS system towards a signature-based debit card system with considerably higher fraud costs. This runs counter to initiatives around the world to improve security on card based payments and would be contrary to the promotion of the efficiency and stability of the payments system.

The Board is now proceeding to consider the desirability of setting standards for interchange fees for both the EFTPOS debit card system and the Visa Debit system.