



RESERVE
BANK
of
AUSTRALIA

PAYMENTS SYSTEM BOARD

ANNUAL REPORT 2005

Reserve Bank

Payments System Board

It is the duty of the Payments System Board to ensure, within the limits of its powers, that:

- the Bank's payments system policy is directed to the greatest advantage of the people of Australia;
- the powers of the Bank which deal with the payments system, set out in the *Payment Systems (Regulation) Act 1998* and the *Payment Systems and Netting Act 1998*, are exercised in a way that, in the Board's opinion, will best contribute to controlling risk in the financial system; promoting the efficiency of the payments system; and promoting competition in the market for payment services, consistent with the overall stability of the financial system; and
- the powers of the Bank which deal with clearing and settlement facilities, set out in Part 7.3 of the *Corporations Act 2001*, are exercised in a way that, in the Board's opinion, will best contribute to the overall stability of the financial system.

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ANNUAL REPORT 2005

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Reserve Bank

Introduction

The Payments System Board was established in 1998 with a legislative mandate to promote efficiency, competition and stability in the Australian payments system. Since its establishment, much of the Board's time has been taken up with the first two elements of this mandate. While stability issues have also been addressed, the process of promoting efficiency and competition has proved to be more difficult and time consuming than that of promoting stability. In part, this reflects the fact that changes to the payments system that promote overall competition and efficiency have been opposed by those who see their commercial interests as being adversely affected by the reforms.

The Board has largely focused on two central issues. The first is the promotion of price signals to users of payment services that encourage efficient payment choices. This has largely, although not exclusively, involved the regulation of interchange fees. And the second is the removal of various restrictions in the payments system that effectively limit entry and stifle competition.

In addressing these issues, the Bank has undertaken a number of major studies and has also undertaken extensive consultation with industry. At various stages since the Board was established, the Bank has sought public comment on the need for reform of the credit card systems, the EFTPOS system, the Visa Debit system and the ATM system. It has also considered the public interest case for regulation of the American Express, Diners Club and BPAY payment systems. Where the Bank calls for submissions from the public, the submissions received are published on the Bank's website and the Bank has announced and explained its decisions either in media releases or the publication of reports.

Interchange Fees and Efficient Price Signals

The Bank has sought to promote price signals to users of payment services that encourage efficient choices by those users. Of particular importance are the signals facing consumers, for in most situations, once a merchant has decided what payment methods the business will accept, it is the consumer who decides what method will be used for any particular purchase.

At a relatively early stage in its investigations, the Bank identified what appeared to be a distortion in the pricing of card payment services to consumers. In particular, for many cardholders, the effective per-transaction price they faced for using a credit card was significantly lower than for using an EFTPOS card, despite the credit card system having considerably higher operating costs. One result of this was that by the late 1990s, the use of credit cards was growing extremely rapidly, as consumers found it more attractive to use credit cards, rather than debit cards, to pay for goods and services. In a similar fashion, consumers were being offered lower per-transaction prices on debit card transactions through the Visa Debit system than through the EFTPOS system, despite the Visa Debit system having higher operating costs.

When the Bank examined why the higher-cost payment systems were being offered to consumers at lower per-transaction prices, one of the central factors that it identified was the existence of interchange fees. These are fees that are paid between the cardholder's bank and the merchant's bank every time a payment is made with a Bankcard, MasterCard or Visa credit card, or made with an EFTPOS or Visa Debit card or through BPAY.

In the credit card and Visa Debit systems, the fee is paid from the merchant's bank to the cardholder's bank. Prior to the Bank's reforms, this fee averaged around 0.95 per cent of the transaction value. In contrast, in the EFTPOS system the fee flows the other way – that is, from the cardholder's bank to the merchant's bank – and averages around 20 cents per transaction.

Not surprisingly, these fees have had a significant influence on pricing to cardholders. With banks that issue cards receiving almost \$1 in interchange revenue for every \$100 spent by one of their cardholders on credit cards (prior to the reforms), but having to make a payment of around 20 cents every time an EFTPOS card was used, it was not surprising that per-transaction credit card prices were considerably below per-transaction EFTPOS prices. The result was that the EFTPOS system was being underutilised.

Table 1: Reform of Card Payments

CREDIT CARDS

Joint Study announced	Joint Study released	Bankcard, MasterCard and Visa designated Draft standards and access regimes released	Final standards and access regimes released MasterCard and Visa mount legal challenge
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DEBIT CARDS

Joint Study announced	Joint Study released		EFTPOS industry working group formed EFTPOS discussion paper released
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1999

2000

2001

2002

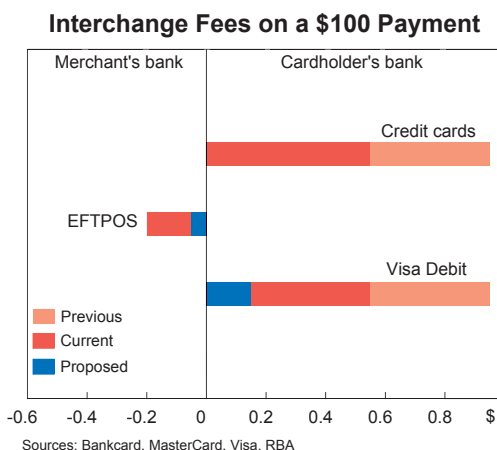
For many cardholders, the effective per-transaction charge for using a credit card was, and remains, negative, due to a combination of interest-free credit and reward points. Issuers of credit cards cover the cost of this effective per-transaction subsidy through a combination of annual fees, interest earnings from those cardholders who do not pay the balance by the due date, and from interchange fees. While in the first instance, the interchange fees are paid by the merchant's bank, they are passed onto the merchant through the fee that is charged for providing credit card services. In turn, merchants pass this fee through to consumers in the form of higher prices for goods and services. The end result has been that non-users of credit cards, including users of the EFTPOS system, have been subsidising those using credit cards by being charged higher prices for the goods and services that they buy.

After examining the various justifications for interchange fees, the Bank came to the conclusion that the overall efficiency of the payments system would be improved by a lowering of interchange fees in both the credit card and EFTPOS systems. By lowering these fees, relative prices that consumers faced when choosing among various payment methods would more closely reflect the relative resource costs involved in making those payments. While the Bank has viewed the reforms to the credit and debit card systems as a package, the reforms have been proposed and implemented at different times. In large part, this reflects the need for the Bank to pursue voluntary reform before it uses its regulatory powers, but legal challenges have also delayed reforms (see Table 1 for a summary of the reform process).

<p>No surcharge rule abolished</p> <p>Case by MasterCard and Visa heard</p> <p>APRA announces regulatory arrangements for Specialist Credit Card Institutions (SCCIs)</p> <p>Case by MasterCard and Visa dismissed</p> <p>Interchange standard comes into effect</p> <p>Merchant service fees fall</p>	<p>Access regime comes into force</p> <p>Merchant service fees published</p> <p>First SCCI announced</p>	<p>Steering restrictions removed in three-party schemes</p> <p>Common interchange benchmark proposed</p> <p>Market shares published</p>
<p>Banks seek ACCC authorisation of zero interchange in EFTPOS</p> <p>Banks and APCA to address access to the EFTPOS system</p> <p>EFTPOS authorisation granted</p> <p>Authorisation appealed by merchants</p>	<p>Visa Debit designated</p> <p>EFTPOS authorisation overturned by ACT</p> <p>EFTPOS designated</p> <p>EFTPOS designation challenged by merchants</p>	<p>Draft standards for EFTPOS and Visa Debit released</p> <p>Merchants' EFTPOS designation challenge heard</p> <p>Access code for EFTPOS agreed</p> <p>Access regime imposed on Visa Debit system</p>
<p>2003</p>	<p>2004</p>	<p>2005</p>

In the case of credit cards, it became clear at a relatively early stage that voluntary reform of interchange fees was unlikely to occur. Reflecting this, the Bank used its powers under the *Payment Systems (Regulation) Act 1998* to set a standard that has cut interchange fees substantially in the Bankcard, MasterCard and Visa systems.¹ The standard, together with the Bank's other regulation of the credit card systems, were subject to legal challenge by MasterCard and Visa in the Federal Court in mid 2003. The challenges were unsuccessful and MasterCard and Visa were ordered to pay the Bank's costs.

Graph 1



The interchange standard, which came into effect from the end of October 2003, led to a reduction in average interchange fees in the credit card system of around 40 basis points; from 0.95 per cent of the transaction value to 0.54 per cent (see Graph 1). The credit card reforms, and their effects, are discussed in detail in the second chapter of this Report.

In contrast to the credit card system, industry participants in the EFTPOS system, after much discussion, agreed to voluntary reform. In particular, in early 2003 a group of banks and other financial institutions took a proposal to the Australian Competition and Consumer Commission (ACCC) to set these fees to zero. The proposal was authorised by the ACCC in December 2003, but the authorisation was subsequently overturned by the Australian Competition Tribunal (ACT) following an appeal of the decision by a group of merchants.

After considering the ACT's judgment, the Board, however, remained of the view that a lowering of interchange fees in the EFTPOS system was in the public interest. Given this assessment, and the fact that the voluntary reform process had reached the end of the road, the Board designated the EFTPOS system in September 2004², and subsequently released a draft standard³ that, if implemented, would have the effect of lowering average interchange fees in the EFTPOS system from around 20 cents to around 5 cents.

Like the credit card regulations, the decision to designate the EFTPOS system has been challenged in the Federal Court. On this occasion, the challenge has come from a group of merchants, concerned that a reduction in interchange fees in the EFTPOS system would increase their costs of accepting EFTPOS or, in some cases, reduce the revenue flow that they receive from their acquirer every time an EFTPOS card is used in their business. The hearing was held in mid 2005, and at the time of writing the judge had reserved his decision. The Bank has indicated that

1. See Media Release 2002-15 (27 August 2002).

2. See Media Release 2004-08 (9 September 2004).

3. See Media Release 2005-02 (24 February 2005).

it will not make any final decisions regarding the regulation of interchange fees in the EFTPOS system until the outcome of the case is known.

The Bank has also proposed reducing interchange fees in the Visa Debit system.⁴ These fees are the same as those in the Visa credit card system and thus fell when credit card interchange fees were reduced. The Bank, however, sees no justification for the same interchange fees to apply in both the Visa credit and debit systems. Moreover, it has been concerned at the potential for users of debit cards to migrate, over time, from the EFTPOS system to the Visa Debit system, simply because the different interchange fees allow financial institutions to offer more attractive pricing of Visa Debit to cardholders.

Given the relationship between EFTPOS and Visa Debit, the Bank has indicated that it will not make any final decisions about interchange fees in the Visa Debit system until the outcome of the current court case challenging designation of the EFTPOS system is known. The Board's proposed reforms to both the EFTPOS and Visa Debit systems are explained more fully in the third chapter of this Report.

Over the past year, the Bank has also considered the case for regulating the payments between American Express and the banks that issue American Express cards, given that these payments have some of the characteristics of interchange fees. It concluded that, at this stage, there was not a strong public policy justification for such regulation.⁵ In particular, it judged that reducing these payments would not lead to a reduction in the fees that American Express charges merchants. This is in contrast to the situation in the Bankcard, MasterCard and Visa schemes, where regulation of interchange fees led to an immediate reduction in the fees charged to merchants for accepting these cards.

The Bank also considered the case for regulating interchange fees in the BPAY system. It concluded that reducing these fees through regulation would be likely to lead to an increase in the price charged to consumers for using the BPAY system. In the Board's view, one effect of such a change in pricing would have been a shift away from BPAY towards other methods of bill payment, including credit card payments directly to billers, cheques and over-the-counter cash payments. Given the current relative prices and resource costs of the alternative payment methods, the Bank's view is that such a shift could not be said to be in the public interest. As a consequence, it concluded that there is currently not a strong case to regulate the interchange fees in the BPAY system. The BPAY system is discussed in more detail in the fourth chapter of this Report in the context of a broader discussion of the bill payments market in Australia.

In examining the case for regulation of interchange fees in the various payment systems, the Board has been conscious that these fees are not subject to the normal forces of competition. In the credit card systems, the fees are centrally set and, as experience in the United States has illustrated, competition between the schemes can force fees up, not down, even though costs might be falling. By increasing its interchange fee, a scheme can offer more revenue to issuers, who are then able to offer larger rewards to cardholders, and thus attract more business. Similarly, in the EFTPOS system, while interchange fees are bilaterally determined, they are

4. See Media Release 2005-02 (24 February 2005).

5. See Media Release 2005-02 (24 February 2005).

subject to little competition, and, in most cases, have been unchanged for many years, despite significant changes in costs.

With interchange fees not subject to normal competitive forces and having a major effect on pricing of some payment services to cardholders, the Bank will continue to monitor their effects on the Australian payments system. When, in August 2002, it announced its reforms to the credit card system, the Bank indicated that it would undertake a major review of credit and debit card schemes in Australia after five years. That process will commence in the second half of 2007 and will include an examination of the interchange fees in the credit card schemes, the debit card schemes and the BPAY system.

Restrictions in Payment Systems

As well as the misalignment of relative prices and costs, the Bank identified a number of restrictions imposed by the card schemes and financial institutions that effectively limited competition and innovation. These restrictions can be classified under three broad headings: those that restrict access to a payment system; those that restrict merchants' actions when accepting particular means of payment; and those that restrict information about the payment systems.

Restrictions on access

The Bank has spent considerable effort investigating the rules of the various payment systems, as well as aspects of the payment systems' architecture, that might act as barriers to entry by new participants. In many markets, new entrants are the source of the increased competition and innovation that can generate more efficient outcomes over time.

The credit card schemes had longstanding rules that have had the effect of limiting participation to banks, building societies and credit unions. Visa, for example, limited membership to those institutions that were authorised to take demand deposits, while MasterCard required that a member be a financial institution authorised to engage in financial transactions.

In assessing the effects of these rules, the Bank accepted that the schemes had a legitimate need to control membership to protect existing members from the financial and operational risks that could arise from new members joining the scheme. Existing members need to be confident, for example, that a new card issuer will be able to pay acquirers whenever the issuer's cardholders use their credit cards. Despite this, in the Bank's view, the membership rules were unnecessarily restrictive, limiting the entry of institutions that might specialise in credit card issuing or acquiring.

In response, the Bank and the Australian Prudential Regulation Authority (APRA) worked together to develop more appropriate access arrangements.

The first step in this process was the creation by APRA of a new class of Authorised Deposit-taking Institution (ADI) known as a Specialist Credit Card Institution (SCCI). SCCIs are ADIs under the *Banking Act 1959* but may only perform those activities associated with credit card issuing and/or acquiring. APRA has also indicated that it has no objection to SCCIs undertaking debit card acquiring. SCCIs are supervised by APRA and are required to meet prudential requirements consistent with the risks they incur.

The second step in the process was the Bank imposing an access regime under the *Payment Systems (Regulation) Act 1998* that required that credit card schemes not discriminate between SCCIs and other ADIs when considering applications for membership. This access regime came into force in February 2004.⁶ Since then, APRA has authorised four SCCIs, three of which already issued credit cards in Australia through an overseas affiliate (and one of which has since returned its authority). The fourth SCCI is currently seeking membership of the credit card schemes in order to provide credit card services to merchants.

The Bank's access regime also required the schemes to remove two other rules that had the potential to limit competition.

The first were the rules that penalised scheme members if they concentrated on providing credit card services to merchants rather than issuing cards. Given that the business of dealing with cardholders is quite different to that of dealing with merchants, these rules represented a potentially important barrier to the introduction of new business practices and technology by specialists on the merchant side of the market. The second were the rules that imposed a blanket ban on merchants joining the schemes to 'self acquire' their own transactions.

The Bank has also had a longstanding concern about access to the EFTPOS system, although the nature of the concern is different to that in the credit card system and emerges largely because the system is built around a series of bilateral linkages. If a new participant wishes to join the system (and not use the services of an existing 'gateway') it needs to conduct negotiations with each of the existing principal participants (of which there are currently nine). Each of these participants is likely to be a competitor with the new entrant and has little incentive to establish a connection within a reasonable time frame and at a reasonable cost.

Accordingly, the Bank has been working with members of the Australian Payments Clearing Association (APCA) on the development of an access code that would provide greater certainty and transparency regarding the process for joining the system. APCA's members have now agreed to a code that: places a reasonable cap on the price of establishing a connection to existing participants; establishes a clear timetable for the testing of connections; and removes a previously proposed requirement that entrants must meet a minimum volume before the new arrangements would be applicable.

Restrictions on merchants

At an early stage in its investigations into competition in the payments system, the Bank noted a number of restrictions imposed on merchants by the international credit card schemes and the schemes operated by American Express and Diners Club. These restrictions had the effect of limiting the ability of merchants to negotiate effectively with the card schemes about the terms under which the cards were accepted and/or limiting the ability of merchants to send appropriate price signals to consumers about the costs of various payment methods.

The first of these rules to be examined were the so-called 'no surcharge' rules. These rules were imposed by all schemes, with the exception of Bankcard, and prohibited merchants from charging a fee to cardholders who paid with a credit or charge card. They meant that merchants

6. See Media Release 2004-02 (23 February 2004).

had limited ability to signal to cardholders the relative costs of various payment methods, and hence had limited ability to induce cardholders to use cheaper forms of payment. The rules also weakened merchants' negotiating power with acquirers, for they were unable to use the threat of imposing a charge when negotiating the level of their merchant service fee. MasterCard and Visa were not prepared to voluntarily remove the no surcharge rule and so the Bank required them to do so using its powers under the *Payment Systems (Regulation) Act 1998*. In contrast, American Express and Diners Club removed the rules voluntarily after discussions with the Bank.

A second restriction, with similar side effects to that of the no surcharge rule, were clauses in American Express' merchant contracts that had the effect of prohibiting merchants from steering customers away from American Express towards less expensive means of payment. Following discussions with the Bank, American Express agreed to remove these clauses. Merchants are now free to say to customers that, while they do accept American Express or Diners Club cards, they would prefer to be paid by a less expensive means of payment.

A third restriction on merchants – in this case imposed by Visa – requires that if a merchant accepts Visa credit cards it also accept Visa Debit cards (the so-called 'honour all cards' rule), and, at present, the same interchange fee applies to both credit and debit cards. MasterCard has a similar rule but currently does not have a debit card product in Australia. The honour all cards rule has received heightened scrutiny in recent years and, in addition to the Board's investigations, has been the subject of legal proceedings in the United States and an investigation by the European Union.

While the Bank recognises that there may be some benefits to this rule, on balance, its preliminary view is that this tying arrangement is not in the public interest, as it effectively limits competition and forces merchants to take a payment method they might not otherwise accept, and at a price that they have limited ability to negotiate. These concerns are reinforced by experience in the United States, where the combination of higher interchange fees and the honour all cards rule has enabled Visa Debit and the similar MasterCard product to significantly increase their market shares at the expense of alternative debit products that are cheaper for merchants to accept.

Visa has opposed removal of this restriction and so the Bank has issued a draft standard that, if implemented, would require the rule to be removed.⁷ The Board does not propose the removal of the rule that requires merchants to accept credit cards from all issuers of a particular scheme once the merchant has decided to accept any credit cards issued under that scheme.

Restrictions on information

Throughout the reform process the Bank has sometimes found it difficult to obtain information, and a number of participants have been strongly opposed to the publication of certain information. In the Bank's view, competition in the payments system, as well as analysis of developments in the system, are promoted by public disclosure of timely and accurate information. Accordingly, the Bank has promoted greater transparency in the Australian payments system.

7. See Media Release 2005-02 (24 February 2005).

The Bank has focused on three types of data – interchange fees, merchant service fees and market shares.

As part of its regulation of interchange fees in the credit card systems, the Bank has required that the regulated schemes publish on their websites all interchange fees set by the schemes. For some time, the Bank had also been encouraging BPAY to disclose publicly its interchange fees. After initial reluctance, BPAY recently agreed to the Board's requests and its interchange fees have been published on its website since 1 September 2005.

The Bank has also commenced publishing data on average fees charged to merchants. American Express and Diners Club agreed to the Bank's request for them to publish their average merchant service fees on their websites and have done so since September 2004. These data, together with back data supplied by American Express and Diners Club, are now being published in the Bank's *Bulletin*. The Bank is also publishing data on the average merchant service fees charged by banks in the Bankcard, MasterCard and Visa systems.

Finally, the Bank has secured the agreement of American Express and Diners Club to publish their combined market share of the credit and charge card market. These data, together with the combined market share of the Bankcard, MasterCard and Visa schemes are also published in the Bank's *Bulletin*.

Collectively, these data will provide a factual basis for public analysis of the competitive position of the three-party schemes relative to the four-party schemes. They will also provide merchants with better information when deciding what payment methods to accept.

Innovation in the Australian Payments System

As the Bank has considered issues of competition and efficiency in the Australian payments system over recent years, it has become clear that in some cases innovation can happen quite quickly, while in others, it can be resisted by organisations that see advantage in delay. Similarly, there can be reluctance to embrace change that will result in new participants who might threaten the position of incumbents. The relative importance of bilateral payment linkages in Australia – ATMs, EFTPOS, cheques, direct entry – and the governance of those systems raise particular problems whenever questions of change and new investment arise. In the period ahead, the Bank will be working with the industry to explore whether changes to current arrangements might promote a more efficient and dynamic payments system.

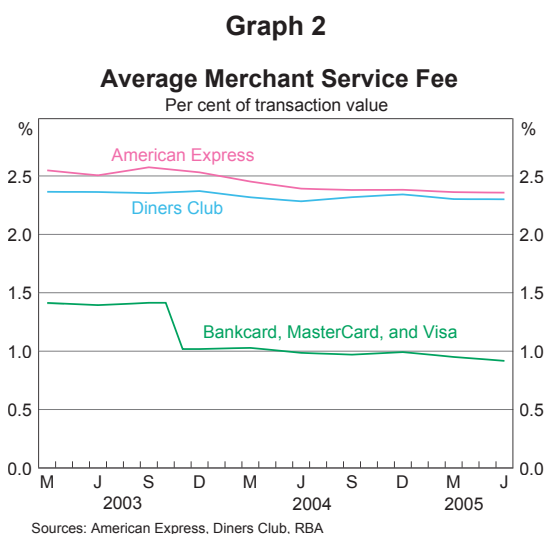
Credit and Charge Cards

The Bank designated the credit card schemes of Bankcard, MasterCard and Visa in April 2001. Following an extended period of consultation, the Bank then set standards relating to the so-called no surcharge rule and interchange fees and imposed an access regime on these schemes. The standards became effective from January 2003 and October 2003 respectively, while the access regime became effective from February 2004. Given the passage of time since the reforms were implemented, it is possible to make a preliminary assessment of their effects.

The most notable impact of the reforms has been a marked reduction in merchants' costs of accepting credit cards, which in turn, is flowing through into lower prices of goods and services for all consumers. As expected, the reforms have also prompted an increase in the effective price of credit card transactions and promoted greater competition, particularly in card issuing, but also in the provision of credit card services to merchants. Finally, the reforms have put some downward pressure on the average fees that American Express and Diners Club charge merchants although the decline in fees has been less than expected.

Merchants' Costs and Prices

Data collected by the Bank from financial institutions show that the average merchant service fee for credit cards in the June quarter 2005 was 0.92 per cent (see Graph 2). This compares with 1.40 per cent immediately prior to the standard on interchange fees becoming effective. It is also considerably lower than merchant fees in most other countries; in the United States, for example, the average fee in the Visa scheme in 2004 was 2.08 per cent.



The fall in the average merchant service fee since the reforms is significantly larger than the decline in the average interchange fee (0.48 of a percentage point compared to 0.40 of a percentage point). It suggests that, not only have banks fully passed through to merchants the fall in interchange fees, but the increased transparency and focus on these fees has led to greater competition amongst acquirers for merchant business. Acquiring margins in Australia are now comparable with those in the United States, where there is strong competition and considerable economies of scale.

The average merchant service fees charged by American Express and Diners Club have also fallen since the reforms came into effect. The reductions have, however, been smaller than those for Bankcard, MasterCard and Visa – in the case of American Express it has been around 0.15 to 0.20 of a percentage point to 2.36 per cent, while in the case of Diners Club it has only been around 0.05 of a percentage point to 2.3 per cent. The reasons for these relatively small declines are discussed in detail below.

Overall, the fall in merchant service fees in both the credit card and American Express and Diners Club schemes has meant that over the 12 months to June 2005, merchants' costs were around \$580 million lower than they otherwise would have been. This figure takes into account the fact that there has been a small increase in the combined market share of the higher-cost American Express and Diners Club schemes.

These lower merchant costs are feeding through into lower prices for goods and services (or smaller price increases than otherwise would have occurred). While merchants would undoubtedly have hoped that these lower costs translated into increased profits, competition means that just as the banks passed on their lower costs to merchants, so too must merchants pass on their lower costs to consumers. It is, however, not possible to monitor the speed and extent to which this is occurring, as the effect is relatively small compared to changes in the overall price level in the economy. The Bank estimates that when fully passed through, the Consumer Price Index (CPI) will be 0.1 to 0.2 percentage points lower than it otherwise would have been as a result of the reforms. There are no statistical techniques with fine enough calibration to separately identify this change against a background where the overall CPI increase is about 2.5 per cent. But the fact that it cannot be separately identified does not mean that it has not happened.

Price Signals

As noted in the introductory chapter of this Report, a major goal of the reforms was to promote more appropriate price signals to cardholders. As expected, this has been achieved both through merchants directly charging users of credit cards and a reduction in the value of reward points.

Surcharging

A number of private sector surveys indicate that around five per cent of merchants are imposing an explicit charge on those who use a credit card to pay. The surveys also suggest that a considerable number of merchants are considering introducing such a charge. Most of those firms that already charge impose the same fee for all credit and charge cards, although some do charge more for American Express and Diners Club, reflecting the higher cost to merchants of accepting these cards.

Examples of firms charging can be found in many industries, including telecommunications, restaurants, bars, travel agents, airlines, whitegoods and electrical retailers and removalists. Some of these firms operate in highly competitive industries and have low margins. They recognise that credit cards are a convenient way for their customers to pay for goods and services, but they do not want to carry the extra cost of accepting credit cards. Imposing a charge allows them to accept credit cards, with the customer then free to choose whether the value they receive

from using the card exceeds the cost of doing so. Similarly, a number of organisations such as schools, clubs and societies, and government authorities now permit payment with a credit card, imposing a charge on customers using this form of payment.

Despite some merchants charging for credit cards, many merchants remain reluctant to do so. In part, this reflects the long history during which they were prevented from levying such a charge by restrictions imposed by the credit and charge card schemes. These restrictions created a system in which cardholders expected to be able to pay the same price regardless of the method of payment chosen, irrespective of the cost to the merchant. This expectation is now breaking down, and, in time, the extent of surcharging is likely to increase. The Bank encourages all merchants to actively consider differential charging based on their costs of accepting various payment methods. Ultimately, such an approach is likely to work in the best interests of all users of the payments system, with consumers choosing between various payment methods based on effective prices that reflect the underlying costs of providing the various payment methods.

Reward schemes

A related impact of the reforms has been a reduction in the value of reward points, and an increase in annual fees. In 2003, a cardholder with a card issued by one of the four largest banks would have had to spend an average of \$12 400 to receive a \$100 shopping voucher; today

they would have to spend \$15 100 (Table 2). Using these figures as a guide suggests the value of reward points has fallen from over 0.80 per cent of the amount spent, to around 0.65 per cent currently. In addition, most card issuers have increased the average annual fee for having a credit card with a reward scheme, and many have placed a cap on the reward points that can be earned.

Table 2: Credit Card Rewards

	Average spending required for \$100 voucher (\$)	Benefit to cardholder as a proportion of spending (bp)
2003	12 400	81
2004	14 400	69
2005	15 100	66

Sources: Banks' websites. ANZ Telstra/Rewards Visa card, Commonwealth Bank MasterCard Awards card, National Australia Bank Visa Gold card and Westpac Altitude MasterCard.

Price signals and the use of credit cards

While these changes have increased the price of credit card transactions relative to debit card transactions, many cardholders typically still face a negative price for credit card transactions due to the combination of interest-free credit and reward points. However, where a surcharge is imposed, cardholders now typically face a positive price, although the exact price depends upon the size of the surcharge and the value of any reward points and interest-free period.

While experience suggests that payment patterns change only slowly over time in response to changes in relative prices, growth in credit card spending does appear to have slowed over the past year relative to spending on debit cards. Between 1998 and 2000, the number of credit card transactions grew at an annual rate averaging around 30 per cent, compared to average growth of 10 per cent in the number of debit card transactions. Growth rates then converged between 2002 and 2004, with the number of credit and debit card transactions both growing at around 10 per cent per annum. More recently, the number of credit card transactions has been

growing slightly more slowly than the number of debit card transactions (Graph 3).

Overall, the number of credit card transactions in Australia still exceeds the number of debit card transactions by a small margin, although the value of spending on credit cards is more than twice that on debit cards, reflecting the larger average value of a credit card transaction.

A common benchmark interchange fee

Concerns by some industry participants about the impact of small differences in interchange fees between the main credit card schemes show how important relative prices and costs can be in influencing outcomes in the payments system.

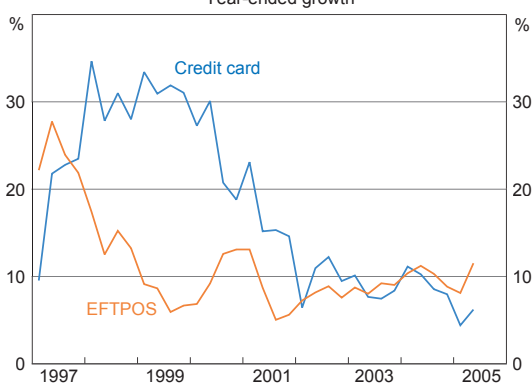
Under current arrangements, interchange fees in each scheme are capped on the basis of a benchmark determined by eligible costs incurred by issuers in that scheme. When the benchmarks were calculated, costs were lowest in the Bankcard system and highest in the MasterCard system, and this is reflected in the interchange fees in these systems (see Table 3). In particular, the interchange fees in the MasterCard system are currently two basis points higher than those in the Visa system.

Over the past year, a number of industry participants have noted that this two basis point difference could be giving MasterCard a competitive advantage in attracting issuers, particularly if it was not offset by higher costs. Data available to the Bank suggested that this may have been the case, with at least part of the higher MasterCard benchmark reflecting the particular characteristics of its issuers' portfolios at the time the benchmarks were calculated.

In response, in July 2005 the Bank sought public comment on whether a common benchmark fee across all three systems would improve the efficiency of the system. After considering the submissions put to it, the Bank released a draft revised interchange standard that would have the effect of establishing a common benchmark that would apply across all

Graph 3

Number of Card Payments
Year-ended growth



Source: RBA

Table 3: Interchange Fees, August 2005
Per cent of transaction value

	Bankcard	MasterCard	Visa
Standard	0.49	0.62	0.60
Electronic	0.49	0.46	0.44

The electronic rate applies to transactions where the card is swiped and the signature verified. The standard rate applies to most other transactions, including those using manual processing and those over the internet or telephone. MasterCard and Visa also have separate interchange fees for commercial cards. Sources: Bankcard, MasterCard and Visa websites.

three schemes, with the benchmark retaining the existing definition of eligible costs. The Bank is still consulting on the proposed change.

Competition

As noted above, the increased transparency of interchange fees and merchant service fees has contributed to greater competition among existing institutions in the provision of credit card services to merchants. In addition, MoneySwitch, the first organisation seeking to specialise in the provision of acquiring services (including both credit and debit card acquiring) to merchants was authorised by APRA as an SCCI in March 2005.

MoneySwitch is now in the process of applying for membership of the MasterCard and Visa schemes under the Bank's access regimes. At an early stage in the application process, Visa indicated to the Bank that its international rules might prevent it accepting MoneySwitch's application, since the Bank's credit card access regime, which overrides Visa's international rules in Australia, strictly only applies to Visa credit cards and not Visa Debit cards. Such an outcome would have been clearly contrary to the intent of the Bank's reforms. In response, the Bank imposed an access regime on the Visa Debit system in late August 2005. Further details are provided in the following chapter.

The impact of the Bank's reforms on competition can also be seen on the issuing side of the credit card market. In particular, the fall in interchange revenue has encouraged issuers to re-evaluate their business models. Previously, many issuers competed for cardholders by offering attractive reward schemes, but following the reforms, competition has focused much more on interest rates. This reflects the fact that the attractiveness to issuers of cardholders who do not pay interest, and who redeem reward points, has been significantly reduced by the cut in interchange fees. In some cases, credit card issuers have responded by encouraging these customers to move to American Express and Diners Club and, as noted above, they have also devalued or capped reward points.

In contrast, the relative attractiveness of those cardholders who regularly pay interest has increased. In response, some issuers have sought to attract these cardholders by offering them much lower interest rates. Some of the new entrants, including Virgin and Aussie Home Loans, have targeted market segments – youth and home buyers – that are more likely to be interest-rate sensitive than are those cardholders who typically pay off by the due date, and so pay no interest. Some of the major banks have also recently introduced low-rate cards.

Of the new non-bank entrants, only GE Money has elected to become an SCCI. Both Virgin and Aussie Home Loans have instead entered the market in partnership with an existing bank. While neither organisation took up the opportunity of joining the credit card schemes in their own right, their ability to do so no doubt increased their bargaining power *vis-a-vis* their bank partners.

Overall, consumers are benefiting from this greater competition and lower merchant costs, although outcomes vary considerably across consumers. One group of consumers clearly better off are those who regularly borrow on their credit cards. They are now able to obtain a card with an interest rate of 10 to 13 per cent, rather than the 16 to 18 per cent payable on traditional cards. For many consumers the resulting savings can run into hundreds of dollars

per year. These consumers are also benefiting from their share of the \$580 million in merchant savings.

Consumers who do not use credit cards at all are also benefiting from the reforms as they are paying lower prices for goods and services than would otherwise have been the case. For many years, these consumers have helped subsidise the generous reward points of the credit card issuers through paying higher prices for goods and services. The reforms have helped unwind some of this subsidy.

Finally, those cardholders who accumulate large numbers of reward points have, as expected, seen the value of reward points cut and/or annual fees for belonging to a rewards scheme increase. These cardholders are clearly not getting the same benefits as before, although like other consumers, they are benefiting from lower merchant costs. In the Bank's view, the cut in reward points, the increase in annual fees and the use of credit card surcharges are important steps towards better aligning relative prices and costs, and thus making the payments system work in the best interest of all its users.

American Express and Diners Club

As noted above, the fees that American Express and Diners Club charge merchants have fallen over the past few years, but not by as much as merchant fees in the other schemes. This outcome reflects not only differences in regulation, but also importantly the differences in the competitive dynamics in the regulated credit card schemes and those in the American Express/Diners Club schemes.

In the Bankcard, MasterCard and Visa schemes, there is considerable competition among institutions in the acquiring of transactions from merchants. As a result, if a merchant is not satisfied with the fee being offered by its acquirer for transactions on cards issued under these schemes, it can go to any one of a number of other institutions to seek a better deal. Aiding in this process are brokers who will help merchants identify the banks prepared to offer them a lower merchant service fee.

In contrast, the competitive dynamics are quite different in the American Express/Diners Club schemes. A merchant unhappy with the fee being charged by one of the schemes can only negotiate with that scheme; it is simply unable to turn to another acquirer in the hope of obtaining a better deal, as the schemes are the sole acquirers for transactions on their own cards.

Despite facing no competition in acquiring their own transactions, these schemes do compete with the credit card schemes for merchant acceptance. As a result, the competitive discipline on the schemes arises out of their desire to have their cards widely accepted by merchants, rather than as a result of competition between acquirers. Over time, as merchant service fees for credit cards have trended down, this competitive pressure has seen the fees charged by American Express/Diners Club also fall.

The fact that this decline in fees has been less than that in the credit card schemes has led to periodic calls for the Bank to regulate American Express and Diners Club in the same way as it regulated the other schemes. At the time the credit card schemes were regulated, it was,

however, simply not possible to regulate American Express and Diners Club in the same way, as there were no interchange fees in these schemes. Instead, the Bank has sought to address the market power that American Express and Diners Club have as a result of being the sole suppliers of their particular services to merchants. It has focused on improving the information available to merchants and on requiring the removal of restrictions that limit the ability of merchants to negotiate effectively with the schemes.

While the Bank has not formally regulated American Express and Diners Club, these schemes have voluntarily agreed to make a number of changes after discussions with the Bank. In 2002, they agreed to remove the no surcharge clauses from their merchant contracts and in 2005 to remove anti-steering provisions from their contracts. The schemes have also agreed to publish their average merchant fees and their combined market share. As a result of these changes, merchants now have a greater range of options, and better information, when negotiating with American Express and Diners Club. They also have much greater scope to steer customers through both price and non-price means to cheaper forms of payment.

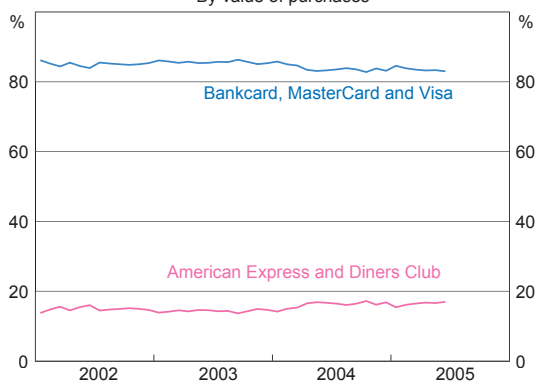
To date, these greater freedoms have had only a limited impact on average fees charged by American Express and Diners Club. In time though, as merchants become more comfortable with using these options, the Bank expects that these fees will come under greater downward pressure as merchants question whether the value they receive from accepting American Express and Diners Club is worth the current margin they pay on these cards.

Because of their higher merchant fees, these schemes have always been able to give cardholders greater rewards for using their cards than are typically provided by issuers of Bankcard, MasterCard or Visa cards. Partly in response, there has been an increase in the combined market share of these schemes over the past couple of years. In the financial year prior to lower interchange fees coming into effect (2002/2003) these schemes accounted for 14.6 per cent of the total transaction value. Over the past financial year, the comparable figure is 16.5 per cent (Graph 4).

This increase was largely concentrated in the second quarter of 2004 and was coincident

Graph 4

Market Shares
By value of purchases



Source: RBA

with the issuance of American Express credit cards by two of the major Australian banks. When these cards were first issued, the Bank considered whether the payments by American Express to its partner banks should be subject to regulation in a similar fashion to that of interchange fees in the credit card system. After detailed analysis, it concluded that there was not a strong case to do so.

This conclusion reflected a number of factors. The first was that a reduction in these payments through regulation would be unlikely

to cause a decline in American Express' merchant fees. This is the contrary of the situation with the credit card schemes where regulation of interchange fees saw merchant fees decline immediately. This difference reflects the fact that, as mentioned above, American Express is the sole acquirer of transactions on its cards. This means that unlike in the credit card schemes, the causation runs from merchant service fees to interchange fees, not the other way around.

A second consideration was that if the Bank regulated interchange payments to the partner bank, it was likely that other forms of payment would emerge to take their place. One possible response would have then been to regulate all payments between American Express and its partner banks, including marketing and product support payments. Such regulation would then also be required in the Bankcard, MasterCard and Visa schemes. The Bank's view is that such extensive regulation at this time is not in the public interest, especially when it would have had no impact on the incentives for American Express to issue its own cards.

While in an ideal world regulation would be competitively neutral, designing such regulations is problematic when the various card schemes have different structures and are subject to different competitive dynamics. The Bank's approach has been to focus its efforts on those areas where it has judged that competition is not working appropriately. For the credit card schemes this has primarily involved the regulation of interchange fees, while for American Express and Diners Club it has primarily involved ensuring that merchants are not unnecessarily restricted in their negotiations with the schemes. This approach has delivered significant benefits for consumers, and these benefits are likely to grow through time as merchants use the full range of tools now available to them.

Debit Cards

During the year, the Bank released three draft standards applying to the debit card systems operating in Australia, and imposed an access regime on the Visa Debit system. As with the credit card reforms, the proposed standards and the access regime are aimed at promoting both more appropriate price signals and competition in the Australian payments system.

Improving Price Signals

As discussed in the introductory chapter, for many people the effective per-transaction price of using the EFTPOS system is higher than that for using either the credit card system or the Visa Debit system. In large part, this reflects the interchange fees in these systems. In the EFTPOS system, these fees are paid by the cardholder's bank to the merchant's bank. In contrast, a transaction on the same deposit account, but routed through the Visa Debit system, results in a payment by the merchant's bank to the cardholder's bank. The same is true for credit card transactions.

The result of these fees is that the net cost to issuers of an EFTPOS transaction is higher than that for a Visa Debit transaction, even though the funds may have been drawn from the same deposit account. For an EFTPOS transaction, the issuer bears its own resource costs *plus* an average interchange fee of around 20 cents paid to the merchant's bank. In the case of Visa Debit, the issuer bears its own resource costs but *receives* a payment, equivalent on average, to around 0.55 per cent of the transaction value. This difference in fees can make it more attractive to financial institutions to issue and promote Visa Debit cards rather than EFTPOS cards. Those institutions that currently offer both products typically offer more attractive pricing to cardholders for Visa Debit transactions than for EFTPOS transactions, and they also encourage cardholders to push the 'credit' button at the point of sale (and so route the transaction through the Visa Debit system) rather than press the 'cheque' or 'savings' button (and thus route the transaction through the EFTPOS system).

While currently only a relatively limited number of financial institutions issue Visa Debit cards, the Board has been concerned that, should regulatory certainty be given to the current arrangements, the Visa Debit system could grow considerably at the expense of the EFTPOS system. The experience in the United States is consistent with this concern. There, higher interchange fees and the honour all cards rule have enabled Visa Debit and the similar MasterCard product to significantly increase their market shares at the expense of alternative PIN-based debit products (similar to the Australian EFTPOS system). A significant spur to this was the higher revenue banks could earn by issuing scheme-based debit cards over other debit cards. Eventually, the PIN-based networks were forced to increase their interchange fees to counter the loss of market share to the scheme-based systems with higher interchange fees (Graph 5). The net result was that these higher interchange fees were passed on to merchants accepting the cards. If the same outcome were to occur in Australia, merchants' total costs of accepting debit cards would be considerably higher than is now the case.

The Bank has also been concerned that the interchange fee on Visa Debit transactions is the same as that on Visa credit transactions. It sees no justification for this, given that issuers of Visa Debit cards do not offer cardholders interest-free credit.

Designation of EFTPOS and Visa Debit

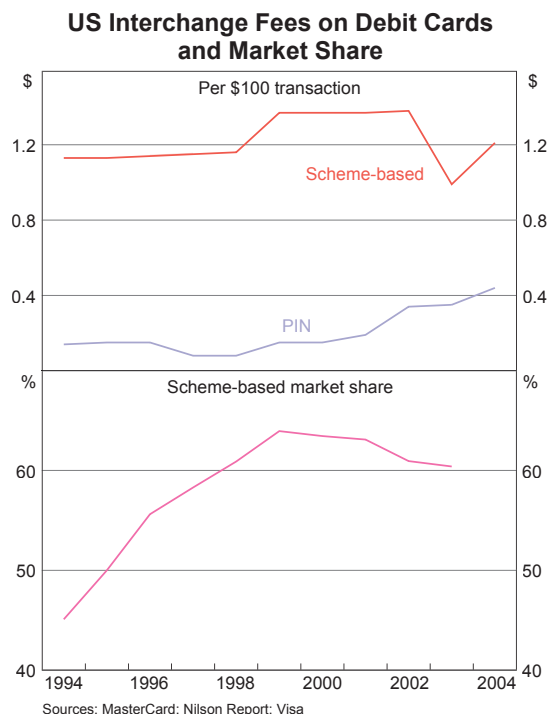
The process of improving price signals in the EFTPOS and Visa Debit systems has been protracted. Following the publication of the Joint Study in 2000, the Bank pursued voluntary reform of the Visa Debit system with Visa and the institutions that issue the cards. Much of the discussion took place between Visa and the Bank, with Visa making a number of submissions on voluntary reforms it was prepared to implement and putting arguments in defence of

its existing arrangements. Although some progress was made, discussions were complicated by the fact that issuing institutions could not discuss what would amount to the collective setting of interchange fees and the discussions were not transparent. Furthermore, there remained a number of areas where the Bank and Visa could not reach agreement. The Bank ultimately reached the conclusion that designation of the Visa Debit system was in the public interest. This decision was influenced, in part, by the fact that designation would allow for transparent and broadly based consultation on possible reforms – a situation that had been difficult to achieve previously. In February 2004, the Bank designated the Visa Debit system.

Similarly, the Bank had encouraged the industry to examine options for reform of EFTPOS interchange fees. An industry group was set up in 2002 and developed a proposal to set these fees to zero. This proposal was put to the Australian Competition and Consumer Commission (ACCC) for authorisation in February 2003, and the ACCC authorised the application in December 2003. This decision was, however, overturned by the Australian Competition Tribunal (ACT) in May 2004 after an appeal by a number of merchants.

Following the ACT's decision, the Bank invited submissions from interested parties on whether it would be in the public interest for it to designate the EFTPOS payment system under the *Payment Systems (Regulation) Act 1998*. Following that process, the Board concluded that designation was in the public interest, and on 9 September 2004 the Bank designated the EFTPOS system. A group of retailers then challenged the legality of the designation decision,

Graph 5



with the case being heard in the Federal Court during May and June 2005. At the time of writing, a decision was pending.

Draft standards for EFTPOS and Visa Debit

The Board has been of the view that the reform process should not stop completely while legal challenges were being decided. Accordingly, it released a consultation document in February 2005, setting out draft standards that would constrain interchange fees in the EFTPOS and Visa Debit systems. In releasing this document, however, the Board indicated that it would not finalise any standards before the outcome of the court case was known and would consult further if the court's decision warranted doing so.

The draft standards recognise that establishing a consistent and rational set of interchange fees is complicated by two factors. The first is the starting point – interchange fees that flow in opposite directions in the EFTPOS and Visa Debit systems. The second is that substantive businesses have been built around now longstanding interchange revenue flows and that changing their direction could be very disruptive. Accordingly, as a step towards more consistent and rational interchange fees in these systems, the draft standards propose moving interchange fees closer together, while leaving their directions of flow unchanged.

The proposed standard for EFTPOS interchange fees would limit these fees on the basis of eligible costs incurred by specified acquirers. These eligible costs are limited to the processing and switching costs of acquirers. The standard requires EFTPOS acquirers accounting for 90 per cent of EFTPOS transactions to provide the Bank with data on these costs, and proposes that the costs of the three most efficient acquirers be used to calculate the cap. Provided the interchange fee remains below the cap, individual issuers and acquirers would be free to negotiate bilaterally the interchange fee they pay or receive – just as they may do now. Based on data currently available to the Bank, this would be likely to result in an initial cap on interchange fees paid by an issuer to an acquirer of around five cents per transaction.

The proposed standard for Visa Debit interchange fees would limit these fees based on eligible costs of nominated issuers in the Visa system. The draft methodology proposes that the cap be based on the issuers' costs of processing and authorising transactions. It also proposed that there be a flat fee rather than an *ad valorem* fee (as is currently the case), reflecting the fact that the costs of processing and authorising debit card transactions are unrelated to the size of the transaction. Unlike the credit card interchange fee standard, the list of eligible costs does not include fraud costs or the cost of funding the interest-free period.

The draft methodology also proposes calculating the benchmark fee for Visa Debit using data collected for the calculation of the credit card benchmark fee, rather than conducting another survey to collect data on the costs of current issuers of Visa Debit cards. This approach would place less burden on issuers of Visa Debit cards and recognises that future issuers of Visa Debit cards may have different costs than the mostly small institutions that currently issue these cards. Based on data currently available to the Bank, the proposed methodology would result in a cap on interchange fees for Visa Debit of around 15 cents per transaction paid by an acquirer to an issuer.

Taken together, the draft standards would narrow the current differential in the interchange fees in the two systems on a transaction of average size from 60 cents to around 20 cents (Table 4).

Submissions on the draft standards were invited by 29 April 2005. The Bank received 14 submissions by 29 April; a further 4 submissions have been received since then. The Bank has held consultations with those making submissions who wished to do so and is currently considering the submissions.

Table 4: Proposed Changes to Debit Card Interchange Fees
Revenue to issuer: cents per transaction

	EFTPOS	Visa Debit*	Difference
Current	-20	+40	+60
Proposed	-5	+15	+20

*For transaction of average size.
Source: RBA

Competition

The Bank has also worked to increase competition in the EFTPOS and Visa Debit systems by making it easier for new issuers and acquirers to enter the market, and by removing restrictions imposed on merchants by the schemes.

Access to EFTPOS

Access to the EFTPOS system is complicated by the need for a new entrant who wishes to establish direct connections to bilaterally negotiate connections with other direct connectors. Under current arrangements there is no obligation on existing participants to connect to new entrants, and even if existing participants agree to connect, there is no standard time frame or charge for doing so. The Bank has been of the view for some time that these arrangements are unsatisfactory and that changes to access provisions are required to promote competition in the system. As with other aspects of the reform process, the Bank has had a preference for industry to develop more appropriate arrangements, rather than to have a regulatory solution imposed.

The industry has been working on developing an access code since 2003, when the ACCC approved the proposal to set interchange fees in the EFTPOS system at zero, conditional on improved access arrangements being put in place. This work has been undertaken by major participants in the EFTPOS system and co-ordinated by APCA. In January 2005, a draft EFTPOS access code was distributed by APCA to its members, including the Bank. The Bank then indicated that the code was unsatisfactory in a number of respects. Subsequently, the code has been amended and is now broadly acceptable to the Bank. When implemented, it will give certainty to new entrants regarding both the cost and timing of accessing the EFTPOS system.

Access to Visa Debit

There has also been a need to address technical aspects of access to the Visa Debit system. Prior to the creation of SCCIs and the Bank's access regime for the credit card schemes coming into force, Visa's rules had the effect of limiting membership in Australia to those institutions that were authorised by APRA to accept demand deposits. The Bank's credit card access regime had the effect of overriding these rules in Australia, allowing SCCIs to join the Visa system.

At the time this access regime was being developed, the Bank expected that an SCCI joining the Visa credit card system with the intention of acquiring credit card transactions would also be able to acquire Visa Debit transactions. Visa indicated, however, that since the access regime strictly applies only to the credit card system, its own rules may still preclude an SCCI from acquiring debit card transactions given that an SCCI cannot accept deposits.

The Bank formed the opinion that the current arrangements in the Visa Debit system were not in the public interest. If an SCCI is not able to acquire both Visa credit and debit card transactions, it may find it difficult to provide commercially competitive acquiring services. To rectify this situation the Bank proposed imposing an access regime on the Visa Debit system that was practically identical to the one already applying to the Visa credit card system. This proposal was released for public comment in July 2005. The Bank received three submissions, including one from Visa which supported the access regime. After considering the submissions, the Bank imposed the Access Regime in August 2005.

Removing restrictions on merchants

The Bank has also sought the removal of restrictions on merchants that limit competition and impair the efficiency of the payments system. While the Bank is not aware of any such restrictions in the EFTPOS system, such restrictions still exist in the Visa Debit system. In particular, merchants are not permitted to impose a surcharge on a cardholder who uses a Visa Debit card (the no surcharge rule) and must accept all Visa branded cards if they accept Visa credit cards (the honour all cards rule).

As part of the credit card reform process, the Bank required the credit card schemes to remove the no surcharge rule applying to credit card transactions. The Bank has now proposed a standard that would require that this restriction also be removed for Visa Debit transactions. As with the other reforms to the Visa Debit and EFTPOS systems, a final decision will not be made until after the outcome of the current case in the Federal Court is known.

The second restriction – the honour all cards rule – has two relevant aspects. The first is that it requires merchants to accept Visa cards regardless of which bank or financial institution issued the card. This might be best thought of as an ‘honour all issuers’ rule. The second is that it requires merchants to accept all products issued under the Visa brand. This might be best thought of as an ‘honour all products’ rule.

The Bank accepts that the honour all issuers aspect of the rule is in the public interest. By insisting that merchants who accept Visa credit cards accept Visa-branded credit cards regardless of the issuer, the value of the network to cardholders and issuers is maximised. If merchants were allowed to selectively refuse cards issued by particular institutions, this could generate a need for bilateral negotiation between issuers and acquirers and, potentially, merchants. This would raise the costs of participating in the system and generally impair efficiency. Cardholders could also be directly disadvantaged by not knowing whether cards issued by their financial institution would be accepted at any given merchant.

In contrast to the honour all issuers aspect of the rule, the Bank has formed the preliminary view that the honour all products aspect is not in the public interest. Accordingly, in February

2005 it released a draft standard which would have the effect of requiring the removal of this rule.

Those industry participants who support the rule have advanced two main arguments. The first is that it can provide a cost-effective way for the schemes to offer multiple card products and the second is that it encourages the development of new products by ensuring a ready-made acceptance network. In contrast, merchants, who oppose the rule, have indicated to the Bank that they would rather not accept the Visa Debit card on its current terms, yet they are forced to accept it as a condition of accepting Visa credit cards. A consequence of the forced acceptance is that competitive forces cannot bear independently upon the price of, or acceptance of, the product. In particular, merchants currently pay the same fees for transactions using Visa Debit cards as they do for Visa credit cards. This is despite Visa Debit not offering interest-free credit to the cardholder.

In the Bank's view, the tying of Visa credit and debit cards has diminished normal competitive forces, and distorted the competitive positions of the Visa Debit and EFTPOS systems. For domestic point-of-sale transactions, which represent the largest segment of card-based transactions, the Visa Debit and EFTPOS system are interchangeable – all that is required is the pressing of a different button at the terminal. Visa Debit, however, has a competitive advantage over EFTPOS because merchants are forced to accept the card when they make the decision to accept Visa credit cards and the interchange fee arrangements mean that issuers have an incentive to issue and promote Visa Debit over EFTPOS. In the Bank's view, the efficiency of the overall Australian payments system is likely to be enhanced if cardholders and merchants are in a position to evaluate freely the benefits provided by Visa Debit against the costs and make acceptance decisions based upon that evaluation. The honour all products rule significantly restricts this possibility.

Bill Payments and Automated Teller Machines

Bill Payments

In addition to the actual and proposed reforms of credit and debit cards, the Bank has spent considerable time examining various aspects of the bill payments market.

The Bank's initial focus was on the direct debit system and its use for the payment of household and commercial bills. While many billers prefer to be paid through this system because of its relatively low cost, many bill payers had expressed reluctance to use the direct debit system. In response, the Bank worked with the bill payments industry to address consumers' main concern – namely, the perceived risks in giving billers automatic access to their bank accounts. As a result of this work a direct debits charter for billers was agreed. The charter set out the service levels that a biller should meet, including: how and when notification of the payment will be given; how payers could change or cancel direct debit authorities; how privacy and complaints would be handled; and how payment could be stopped if the amount was disputed. The Bank's work in this area was reported in the 1999 and 2000 Payments System Board's Annual Reports. Since then, the number of direct debits per head has almost doubled from around 11 per head per annum in 2000 to around 19 in 2005.

More recently, in the second half of 2004, the Bank undertook a survey of 40 billers to obtain a more comprehensive picture of how households pay bills and the various costs to billers. The focus of the survey was the bills paid by a typical household including council rates, insurance premiums, and water, electricity, gas and telephone bills, although the data obtained also included some commercial bill payments that could not be separated from household bills. The survey was based on 2003 data, with the surveyed billers collecting over 291 million payments in that year totalling \$162 billion. The survey asked billers for information on the number and value of bill payments received through a number of different methods and for information

on the total value of fees paid to bill collection agents. The distribution of the surveyed billers across industries is shown in Table 5.

Most billers provide customers with a wide variety of ways to make payments. These can be classified into two broad groups: those where the payment is made direct to the biller and those where the payment is made through an agent.

Table 5: Survey Respondents

Industry	Billers surveyed	Number of bills % of total
Councils	4	1
Financial services	5	8
Government	10	14
Telecommunications	5	49
Utilities	15	25
Other	1	2
Total billers	40	100

Source: RBA

There are typically a number of different ways that payments can be made directly to a biller. If the biller has a street-front location, payments can sometimes be made over the counter. In such cases, billers might decide to accept cash, cheque, EFTPOS or credit/charge cards. An alternative method is the use of credit or charge cards over the telephone or internet. Some billers also provide bank account details to allow payers to send direct credits from internet banking packages. Finally, some customers provide their billers with direct debit authorities, allowing the biller to initiate a debit to the customer's account on the day the bill is due.

A number of different agency arrangements are also available. Australia Post is by far the largest agent, providing customers with the opportunity to pay bills over the counter at its numerous branches and electronically via its POSTbillpay internet service. Bill Express offers a similar over-the-counter service, allowing customers to pay bills at newsagents. BPAY also offers an electronic bill payment service, with customers using the telephone or internet to make payments from their deposit account or credit card account to billers. Another alternative is a locked box service which, on behalf of the biller, collects cheques that are sent through the mail. The service is often operated by a financial institution, which then processes the cheque payments on the biller's behalf.

Although the secrecy provisions of the *Reserve Bank Act 1959* limit the information that can be published from the survey, the results suggest that for many billers the main way in which bills are paid is over-the-counter payments collected by a third party. Of the 40 billers surveyed, 23 reported that this was the most frequent method of payment used by their customers (see Table 6, which shows for each method of payment, the number of billers for which the method is the most commonly used, as well as the second and third most commonly used).

Those billers reporting that over-the-counter payment through third parties was the most common form of payment, typically reported that these payments accounted for more than a third of all bills paid. Utility companies, as well as some telephone companies, general insurers and some government agencies (primarily for one-off tax payments such as stamp duty on property transactions) reported frequent use of this method by their customers. Often these payments are made by cash.

A quarter of firms reported that a credit card payment direct to them was the most common way in which bills were paid. For these

Table 6: Use of Bill Payment Methods

Method	Rank of importance – number of billers		
	1	2	3
Direct to biller			
Cash	2	2	2
Cheque	1	4	3
Credit card or charge card	10	12	7
EFTPOS	0	0	0
Direct credit	0	1	1
Direct debit	3	5	6
Through an agent			
Third party over-the-counter	23	8	3
BPAY	0	7	16
Locked box	1	1	2
Total	40	40	40

Source: RBA

billers, credit card payments commonly accounted for around 20 per cent of all payments. Credit card payments were particularly important for telephone companies, utilities and general insurers. They were also important for some government departments, such as traffic authorities.

Of the remaining payment methods, BPAY was often cited as one of the more frequently used payment methods; many billers reported that it was the second or third most common method of payment. Cheque payments, both directly to billers and through locked box facilities, and cash payments directly to billers are important to only relatively few billers. These are mainly councils and government agencies such as offices of state revenue and traffic authorities with large branch networks.

A small number of billers reported that direct debits were the most important means of collecting payments. These include firms in the health insurance, superannuation and life insurance industries. For these firms, the payments are typically fixed amounts, known in advance, and made regularly. A number of other billers, with variable payments, also appear to have had some success with direct debits, including a cable TV company, a telephone company and a small number of utilities.

Costs of collecting bills

The survey also collected data on the fees that billers paid to agents for collecting bills on their behalf. Again, confidentiality restrictions prevent the reporting of fees charged by individual agents. However, it is possible to provide some idea of the range of fees for bill payment collection by agents.

Billers in the survey reported that fees paid to agents ranged from \$0.23 to \$1.69 per payment, depending on the biller and the agent. As a percentage of the average transaction size, the average fee paid by billers to agents was typically less than the average merchant service fee for credit card payments (currently 0.92 per cent). This suggests that, for many billers, the cost of going through an agent was likely to be less than the cost of taking a credit card payment directly. An exception to this is where bills are of low value.

Issues in bill payments

Overall, the survey results highlight a number of issues regarding bill payments in Australia.

The first is that over-the-counter bill payments, often by cash, remain a popular means of payment for many individuals. While not all billers offer such a payment facility, most do, often through an agent. In some cases, utilities are required by government to offer such a facility under the terms of their licences. One attraction of this method of payment to some customers is that a stamped receipt is typically provided. Another is that customers are not typically charged for making payments over the counter, although recently a number of firms have introduced a charge.

The second is that direct credits are not frequently used for bill payments. While many billers noted that this could be an efficient and low-cost way to collect bills, they also noted that it was currently difficult to collect bills this way. In particular, there is very little space allocated in direct entry files for the remittance details and this can make reconciliation difficult. This

problem is most acute for billers with large numbers of payments where manual reconciliation is difficult. Billers suggested that ‘standardising’ the file formats to make it mandatory to identify the payee and amount paid was the minimum change needed to improve efficiency for billers. Some billers were concerned that the banking industry appears reluctant to initiate improvements in the direct credit system that could improve its efficiency and make it more user friendly.

The third is that although many billers identified direct debits as being low cost and a preferred way of receiving payment, a number of others identified aspects of the system that are still causing them difficulties. Those that saw advantages to direct debits have used campaigns promoting this payment method at customer service centres and when customers make telephone payments. Others offer discounts to customers who pay by direct debit, while some councils are implementing marketing campaigns, including prize-based promotions, to promote usage. In contrast, other billers cited high dishonour fees charged by banks and the high back-office processing costs if a direct debit is rejected as reasons why payment by direct debit is an unattractive option. To avoid these costs, some billers have started to contact customers who have a history of difficulty in paying accounts to ensure there are sufficient funds available before manually initiating a direct debit. Manual intervention, however, offsets some of the cost advantages of automated direct debits.

In summary, the survey indicated that billers offer customers a large number of alternative ways of paying bills. Consumers remain attracted to making bill payments in a face-to-face environment but electronic bill payment methods, particularly credit cards and BPAY, have gained in popularity. With the increasing use of internet banking and the ability to use this method to pay bills, many billers would like to see changes made to the direct credit system to make this an easier way of receiving payments.

BPAY

As part of its review of the bill payments industry, the Bank also recently examined the case for regulating interchange fees in the BPAY system. This follows the setting of a standard for interchange fees in the Bankcard, MasterCard and Visa credit card systems and the release of draft interchange standards for the EFTPOS and Visa Debit systems. BPAY is the only payment system in Australia that currently has an interchange fee that has not been subject to actual or proposed regulation.

BPAY was established in 1997 and is owned by a group of financial institutions in Australia, including the major banks. Customers of financial institutions participating in BPAY can make payments by telephone or internet to billers that sign up to BPAY. Payments typically are made from a deposit account, although they can be made from a credit card account if the biller allows. BPAY can also process some financial transactions where individuals are moving funds between accounts.

Since its establishment, BPAY has grown rapidly. In 2004, BPAY processed around 106 million transactions valued at around \$65 billion (Graph 6). While the number of BPAY’s transactions is still relatively small, the average transaction size is relatively large, at over \$600, and the total value of BPAY payments exceeds the total value of EFTPOS transactions.

Graph 6

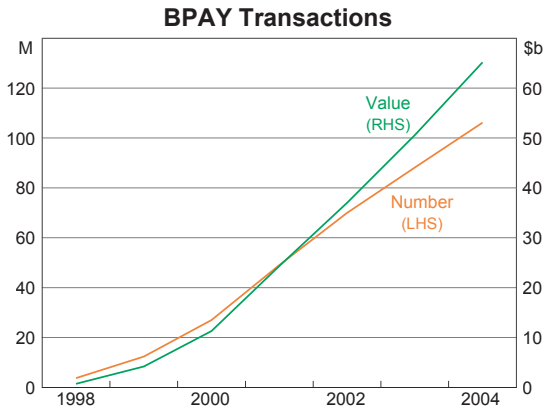


Table 7: BPAY Interchange Fees^a
Paid by biller's institution to payer's institution

	\$	% of transaction value
Capture reimbursement fees		
From deposit account	0.44	—
From credit card account	0.38	0.27
BPAY View fee ^b	0.04	—

a Excluding GST.
b Paid where payer's institution has implemented BPAY View.
Source: BPAY

Like the Bankcard, MasterCard and Visa systems, BPAY has interchange fees that are paid by the biller's bank to the payer's bank, with the fees being centrally set. The methodology for calculating the fees is similar, although not identical, to that used in the Bank's interchange standard for credit cards. The fees have been regularly reviewed and a consultant is employed periodically to calculate costs. Over time, as BPAY has grown, average transaction costs have declined and this has been reflected in lower interchange fees.

The current interchange fees are shown in Table 7. The capture reimbursement fee is paid by the biller's financial institution to the payer's financial institution. It is a flat fee and differs depending on whether the payment is from a deposit account or a credit card account. The fee for a transaction to a debit account has fallen from \$0.75 in 2002 to \$0.44 in 2005 (excluding GST). For a transaction to a credit card account the fee has fallen from \$0.67 in 2002 to \$0.38 in 2005. As well, an *ad valorem* fee is paid by the

biller's financial institution to the payer's financial institution whenever a BPAY payment is made from a credit card account. It is a percentage of the payment value and is paid *in addition* to the capture reimbursement fee. It has fallen from 0.80 per cent in 2002 to 0.27 per cent in 2005. In addition to the capture reimbursement fees described above, the biller's bank pays 4 cents per transaction to the payer's bank if the payer's bank has implemented BPAY View, an electronic bill presentation service.

In examining the case for regulating these fees, the Bank considered the likely effects of a reduction in interchange on the pricing of BPAY payments to consumers. It paid particular attention to the likely changes in the relative pricing of various bill payment methods, and thus to the extent to which various methods were likely to be used by consumers. It concluded that a decline in interchange fees, through regulation, would be likely to lead to a reduction in the price charged to billers for accepting payments through BPAY, but that it would also be likely to lead to an increase in the price charged to consumers for using the BPAY system.

One likely effect of such a change in pricing would have been a shift away from BPAY towards other methods of bill payment, including credit card payments directly to billers, cheques and over-the-counter cash payments. Given the current relative prices and resource costs of these alternative payment methods, the Bank's view is that such a shift could not have been said to be in the public interest. As a consequence, it has concluded that there is currently not a strong case to regulate the interchange fees in the BPAY system. In reaching this conclusion, it noted that BPAY's interchange fees had fallen through time and were projected to fall further as costs declined.

Although the Bank decided not to regulate BPAY's interchange fees, it had been encouraging BPAY for some time to publish its interchange fees. In May 2005 the Bank wrote to BPAY renewing its request for BPAY to publish its fees. The Bank indicated that if BPAY was unable to agree, then the Bank would consider designating BPAY as a first step to possibly setting a 'transparency' standard that would require publication of interchange fees. In response BPAY agreed to publish its interchange fees.

The Bank also examined BPAY's access rules. BPAY has wide membership among financial institutions although a relatively small number (mainly the largest banks) participate directly in the system; the rest participate through other members. This type of tiering in payment systems is common in Australia and around the world. It is often a rational response by smaller financial institutions to the costs inherent in direct participation in a payment system. The Bank is not aware that any financial institutions have been denied membership of BPAY, and is not aware of any non-financial institutions that have sought to join the scheme.

In announcing its decision not to regulate BPAY, the Bank noted that it will again review BPAY's interchange fee arrangements in 2007 as part of its review of all systems with interchange fees.

Automated Teller Machines

Over 2004/2005, the Bank has continued to monitor industry efforts to reform ATM pricing.

In June 2004, after an industry group had spent two years examining various options, the Bank called for submissions on whether it would be in the public interest to designate the ATM system with a view to considering whether or not to set a standard and/or impose an access regime. Although not unanimous, most participants expressed the view that the industry was close to developing a consensus view on the way forward and wanted the Bank to allow more time for a voluntary solution to be found. Since then, however, the industry has struggled to achieve consensus.

Like most ATM networks around the world, the Australian ATM system is built upon a system of interchange agreements. These agreements specify the arrangements under which cardholders from one bank can use another organisation's ATM to withdraw cash from their accounts. These agreements specify that the cardholder's bank has to pay the ATM owner an interchange fee which averages around \$1 per withdrawal for providing cash through the ATM. Typically, the bank that has to pay the interchange fee will recover the cost from its customer with a so-called 'foreign fee', averaging around \$1.50 per transaction, considerably above the typical interchange fee. Some institutions, however, elect not to charge a foreign fee and absorb

the interchange fee they have to pay whenever one of their customers uses another institution's ATM.

In Australia, several concerns have been identified with interchange arrangements for ATMs, prompting the industry's recent work.

One is that there are limited incentives for ATM owners to put ATMs in out-of-the-way locations. With an interchange fee averaging around \$1 per cash withdrawal, any locations where the cost of operating the ATM would be higher than \$1 per transaction is unlikely to be supplied with an ATM. This means that remote locations with high costs and a low number of withdrawals have no ATMs but cities have an abundance of them. A second concern is that the pricing to the consumer is often not as transparent as it might be. While financial institutions periodically notify cardholders of the fee for a foreign ATM transaction, the cardholder is not reminded of the fee at the point he/she is undertaking a transaction. A third is that there is limited competition in the pricing of ATM withdrawals. While providers of deposit accounts may choose to compete in terms of the foreign ATM fee that they charge their customers, there is little evidence this has occurred. More importantly, since the owners of ATMs do not directly charge those withdrawing the cash, there is little incentive for them to lower the price they charge the cardholder's bank.

The industry group has been looking at a number of proposals to address these concerns. One option would be to abolish interchange fees, and to allow ATM owners to charge directly those withdrawing cash. A variation on this could be that the ATM owner directly charges, with either the cardholder or his/her institution paying the charge. Another would be to allow a combination of interchange fees and direct charging in which ATM owners could join networks that pay interchange fees within the network but charge directly customers of financial institutions that are not members of the network.

If some form of direct charging were to be adopted, competition would be expected to increase as ATM owners competed for providing cash withdrawals, both in terms of price and location. In addition, prices could be made transparent by ATM owners notifying cardholders of the cost prior to making the withdrawal. Such a regime would also give ATM owners the ability to recover costs in high-cost locations, providing them with incentive to install ATMs in places that were previously not serviced by ATMs. Evidence from Canada and the United States, where direct charges have become more common, suggests that direct charging does encourage ATM owners to deploy more terminals.

Notwithstanding the advantages of a change to current arrangements, the industry has struggled to develop a model that is agreeable to all parties involved.

One concern is that it may be difficult for small financial institutions with a limited ATM network of their own to offer their cardholders a widespread network that is free to use. With a system of interchange fees, small institutions can allow their customers to use other institutions' ATMs but absorb the interchange fee, therefore allowing their customers free withdrawals. Under a direct charging regime this is more difficult as customers would see a charge up front. While this charge could be rebated to the cardholder, such an approach involving a charge and a rebate may generate an adverse customer reaction. Regional banks, credit unions and building societies have expressed concern about a direct-charging regime for this reason and would like the ability

to maintain interchange arrangements so that they can offer their customers a nationwide ATM service at a price that can compete with that of the nationwide banks.

A second concern is that where direct charging has been implemented in other countries it has often met with consumer opposition. This has been most evident in the United Kingdom where the major banks have elected not to direct charge customers for use of their ATMs even though they are permitted to do so (if they do not accept an interchange fee). To date, only the non-bank owners of ATMs have charged consumers directly. In total around 40 per cent of the ATMs in the United Kingdom now levy a charge, although these ATMs account for only about four per cent of total withdrawals through ATMs. In the United States, there has also been an adverse consumer reaction, with some state governments attempting to ban direct charging by ATM operators. The situation in the United States and Canada is complicated by the fact that consumers paying a direct charge to the ATM owner can also be levied a charge by their own bank since interchange fees remain. Consumers have reacted adversely to being levied two separate charges for the one withdrawal.

Access to the ATM system

Whatever model of charging for foreign ATMs emerges, there is a need to develop better access arrangements for direct connections between ATM owners and card issuers. As with the case in the EFTPOS system, current access arrangements do not promote competition and the Bank encourages the ATM industry to address this issue without further delay.

Purchased Payment Facilities

The Bank announced class exemptions for purchased payment facilities in 2004, where the total amounts involved were small or the number of entities to which payments could be made was limited. In 2005, the Bank decided that an electronic gift card proposed by Westfield for use only in its shopping centres should likewise not be subject to the *Payment Systems (Regulation) Act 1998* because of its limited nature and purpose. The Bank, in conjunction with the Australian Securities and Investments Commission (ASIC), is currently examining the possibility of widening its existing class exclusions so that the Act does not apply to any similar gift cards issued in the future.

Safety and Stability

The Reserve Bank has responsibility for the soundness of the systems through which financial institutions make payments and settle obligations of around \$150 billion each business day. These responsibilities are set out in three pieces of legislation. The *Reserve Bank Act 1959*, sets out the Payments System Board's responsibilities for the payments system and clearing and settlement facilities. The *Payment Systems (Regulation) Act 1998* gives the Bank powers to regulate the payments system. The *Corporations Act 2001*, gives the Bank responsibility for assessing clearing and settlement facilities' efforts to reduce systemic risk and to determine standards to ensure that these facilities conduct their affairs in a way that promotes financial stability.

Financial Stability Standards

The Bank issued Financial Stability Standards for Central Counterparties and Securities Settlement Facilities in 2003. The intent of the standards, as set out in the *Corporations Act 2001*, is to ensure that clearing and settlement facility licensees conduct their affairs in a way that causes or promotes the stability of the Australian financial system. Details of the standards have been discussed in previous Annual Reports.

The standards currently apply to four facilities; these are the central counterparties and securities settlement facilities operated by the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE). In the Bank's assessment, all four facilities now meet the relevant standards.

During the year, the Bank made a technical variation to the standard for securities settlement facilities in order to avoid unnecessary regulation of facilities which, due to their small size, are unlikely to have implications for the stability of the overall system. As a result of the variation, the standard only applies to licensees that settle transactions in financial products totalling more than \$100 million in a financial year. The Board approved the variation at its May meeting and it came into force on 1 June 2005.

Split of the National Guarantee Fund

As noted in last year's Report, the ASX's central counterparty, Australian Clearing House (ACH) was not in full compliance with Measure 7 of the Financial Stability Standard for Central Counterparties when the standards came into effect. Under this measure, ACH must ensure that, in all but the most extreme circumstances, it has sufficient liquid funds to settle its obligations in the event of the default of a participant. There were, however, doubts about ACH's capacity to do so given its reliance on resources from the National Guarantee Fund (NGF), which could have been subject to competing claims from investors. These claims meant that the exact funding available to ACH for clearing support in the event of a default was uncertain, as was how quickly funds could be accessed.

The Bank's view was that, to the extent ACH needed to rely on funds from the NGF to settle its obligations in the event of a participant defaulting, it did not meet the requirements of Measure 7. The Bank, however, granted ACH transitional relief from the standard pending more appropriate arrangements being put in place. This was achieved in March 2005 following the splitting of the NGF. To achieve the split, the Parliamentary Secretary to the Treasurer directed, under section 891A of the *Corporations Act 2001*, the transfer of \$71.5 million from the NGF to ACH. Under conditions attached to ACH's licence, these funds can only be used for clearing and settlement support and not for any other purpose without the consent of the Minister. ACH's claim on the NGF for clearing support funds was also removed.

This transfer of funds was effected at the end of March 2005, prior to the expiry of ACH's transitional relief from Measure 7 of the standard. At the same time, ASX provided additional funds to ACH in order to bring its available resources up to a level it considered consistent with the standard. It also put in place an emergency assessment power to allow participants to be levied when other resources are insufficient to cover a clearing loss.

Financial Sector Assessment Program

The Australian Government has volunteered to take part in the International Monetary Fund's (IMF) Financial Sector Assessment Program (FSAP), which aims to identify strengths and vulnerabilities in a country's financial system and to determine how key sources of risk are being managed. The IMF is aiming to complete Australia's FSAP by mid 2006, with visits by IMF staff and external experts in December 2005 and March/April 2006. Among other things, the assessment will focus on Australia's compliance with a range of international standards relating to the financial sector. These will include the *Core Principles for Systemically Important Payment Systems*, against which Australia's real-time gross settlement (RTGS) payment system will be assessed, the *Recommendations for Central Counterparties* and the *Recommendations for Securities Settlement Systems* (the Recommendations), against which the facilities operated by the ASX and SFE will be informally assessed.

As noted above, clearing and settlement facilities in Australia are subject to the Financial Stability Standards which came into force on 30 May 2003. While these standards address similar risks to those addressed in the Recommendations, there are variations in approach. The Recommendations, when read in conjunction with the relevant assessment methodology, are quite prescriptive and wide-ranging. They cover areas as disparate as communication procedures and efficiency – areas for which the Reserve Bank does not have responsibility under the *Corporations Act 2001*. The Financial Stability Standards, on the other hand, focus particularly on factors with potential to affect financial stability. Therefore, while it is likely that the IMF will assess some areas of the facilities' operations as not being in full observance of the Recommendations, this would not be inconsistent with them continuing to be in compliance with the Financial Stability Standards.

In preparation for the FSAP assessment, the Bank has undertaken a self-assessment of the RTGS system – the Reserve Bank Information and Transfer System (RITS) – against the *Core Principles for Systemically Important Payment Systems*.

The Core Principles were produced by the Bank for International Settlements' Committee on Payment and Settlement Systems (CPSS) in 2001. There are 10 core principles which cover a variety of elements contributing to the safety and efficiency of a system. Four responsibilities of the central bank in applying the Core Principles are also outlined. The Bank's assessment is that RITS performs well against the Core Principles, complying with all nine principles that are considered applicable, along with the four responsibilities of the central bank.⁸

The positive assessment of RITS reflects two factors. The first is that Australia has established a very sound legal framework for payment systems, based on the 1998 amendments to the *Reserve Bank Act 1959*, the *Payment Systems (Regulation) Act 1998* and the additional legal certainty provided by the *Payment Systems and Netting Act 1998*. The second is that when Australia developed its RTGS system, which was implemented in 1998, it was able to incorporate the best features of other systems that had been implemented in other countries throughout the 1990s. As a consequence, Australia's system is stable, sound and liquidity efficient.

Foreign Exchange Settlement Risk

Foreign exchange settlement risk is the risk that one party to a foreign exchange transaction will pay the currency it sold but not receive the currency it bought. Policymakers, both in Australia and internationally, have sought to ensure that these risks are understood and measured. The CPSS has established a Foreign Exchange Settlement Risk (FXSR) Sub-Group to assess strategies for reducing foreign exchange settlement risk. The Reserve Bank of Australia is a member of this group.

Currency	Joined CLS
Australian dollar	September 2002
Canadian dollar	September 2002
Euro	September 2002
Japanese yen	September 2002
Pound sterling	September 2002
Swiss franc	September 2002
US dollar	September 2002
Danish krone	September 2003
Norwegian krone	September 2003
Singapore dollar	September 2003
Swedish krona	September 2003
Hong Kong dollar	December 2004
Korean won	December 2004
New Zealand dollar	December 2004
South African rand	December 2004

Source: CLS Bank

There are several methods by which foreign exchange settlement risk can be reduced. One solution is provided by Continuous Linked Settlement (CLS) Bank which is a special purpose bank with the aim of eliminating foreign exchange settlement risk in transactions between eligible currencies. The FXSR Sub-Group provides a forum through which co-operative oversight of CLS Bank is undertaken.

CLS eliminates foreign exchange settlement risk by participating in individual currencies' payment systems and linking both legs of a foreign currency transaction, which are settled simultaneously across its books. CLS has been

8. Core Principle V – Settlement in Multilateral Netting Systems is not applicable since RITS is not a multilateral netting system.

described in more detail in previous Payments System Board Annual Reports.

The Australian dollar has been included in CLS since it began operations in September 2002. In December 2004, four additional currencies were included in CLS – the Hong Kong dollar, Korean won, New Zealand dollar and South African rand. This brings the number of currencies settling in CLS to fifteen (Table 8).

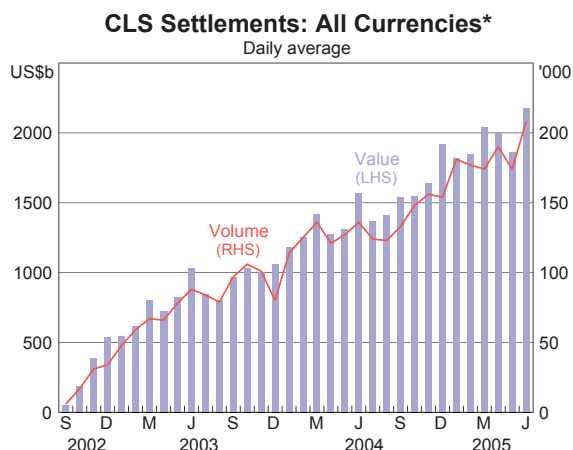
Since it commenced operations, transactions in CLS have grown strongly. In all eligible currencies in 2004/2005, there were around 162 000 transactions per day, with a total value of nearly US\$1.8 trillion (Graph 7). There were almost 6 000 Australian dollar transactions per day in 2004/2005, with a value of around A\$83 billion – up by around 60 per cent from 2003/2004 (Graph 8).

Operational Resilience of the Financial System

While each organisation in the financial system has responsibility for ensuring the resilience of its operations in the face of accidental or man-made disruption, there are a number of areas where a co-ordinated approach can be useful. To this end, the Bank has been working closely with the Banking

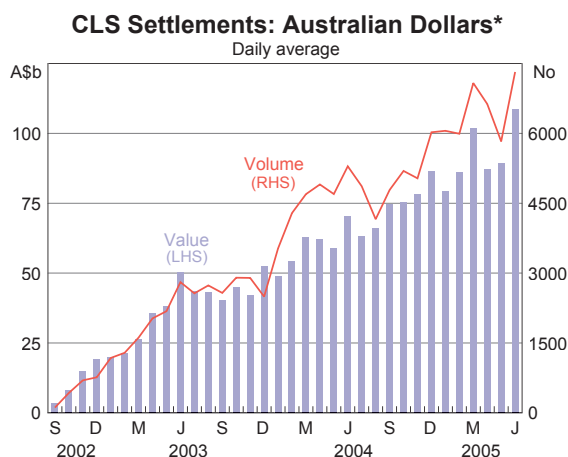
and Financial Infrastructure Advisory Group (BFAG), which is one of a number of similar industry groups set up by the Attorney-General’s Department. The Group is focusing its efforts on identifying common vulnerabilities – such as those to telecoms infrastructure, utilities and equipment vendors – and devising a means to mitigate the resulting risk. It is also working on ensuring the co-ordination of operational responses to a disruption and identifying industry benchmarks for resumption capabilities.

Graph 7



* For total settlements, CLS records both sides of each trade settled. The sale of A\$10 million for US\$7.5 million, for example, is counted as a settlement with a value of US\$15 million.
Source: CLS Bank

Graph 8



* For settlements in individual currencies, CLS counts only the relevant side of each trade settled. The sale of A\$10 million for US\$7.5 million, for example, would be measured as an A\$ settlement with a value of A\$10 million.
Source: CLS Bank

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Payments System Board



Chairman: Ian Macfarlane AC
Chairman since 1 July 1998
Governor of Reserve Bank of
Australia
Present term expires
17 September 2006



Deputy Chairman: Philip Lowe
Deputy Chairman since
8 March 2004
Assistant Governor (Financial
System)
Reserve Bank of Australia



John Laker
Chairman
Australian Prudential
Regulation Authority
Member since 24 July 1998



Joe Gersh
Managing Director
Gersh Investment Partners
Ltd
Member since 15 July 1998
Present term expires
14 July 2008



Sue McCarthy
Director
Member since 15 July 1998
Present term expires
14 July 2007



John Poynton AM
Executive Chairman
Azure Capital Pty Ltd
Member since 26 May 2000
Present term expires
24 May 2010



John Thom
Chairman
Centre for Money, Banking
and Finance
Macquarie University
Member since 15 July 1998
Present term expires
14 July 2006

RESERVE BANK *of* AUSTRALIA