

Competition and Efficiency

As noted earlier, the choice between different payment methods is influenced most directly by their features and by the fees and charges for their use. The workings of the market place ought to determine which payment systems flourish, creating revenues for providers and benefits for users, and which do not. The Board has no view about the “right” mix of payment methods in Australia. Rather, its role is to promote efficiency and competition in the payments system to ensure that the market does provide users and providers of payment services with appropriate price signals on which to base their choices.

The strength of competition can, of course, be affected by the rules which govern the operation of individual payment systems, which are generally determined by the operators and participants in these systems. Co-operative arrangements between competitors are a feature of modern payment systems, with their complex linkages among financial institutions, and they can play an important role in underpinning the safe and orderly operation of these systems. However, self-interest may not coincide with the public interest where such arrangements restrict the interplay of competitive market forces. Inevitably, the rules and governance arrangements of individual payment systems have been a focus of attention for the Board. The main focus has been on card payment systems – credit cards, debit cards (EFTPOS) and ATM networks – where earlier analysis by the Reserve Bank, in conjunction with the Australian Competition and Consumer Commission (ACCC), showed that competition was not working as it should.

Credit card schemes

During 2002, the Board finalised its reform of credit card schemes in Australia.

The Board has, since its establishment, expressed concern about the structure of price incentives in the card payment market in Australia, which clearly favour the use of credit cards over debit cards. Credit card users are effectively “subsidised”, in the sense that they are charged less than the cost of the credit card

payment services they use (or are even offered rebates in the form of loyalty points). Banks and other deposit-taking institutions promote the credit card most actively because it is the payment service for which they receive the highest return, even though it is one of the most expensive for merchants to accept. The Board’s concern about this structure of price incentives is that it is not the result of normal competitive processes. Rather, it is the consequence of the restrictions imposed by the credit card schemes and their members and the fact that it is the same group of banks and other deposit-taking institutions that sets the fee structures for credit cards and the other main payment systems in Australia.

Credit card scheme restrictions involve the collective setting of wholesale (“interchange”) fees – fees paid to financial institutions which issue credit cards by financial institutions which provide services to merchants – restrictions on the freedom of merchants to pass through their credit card costs to cardholders and restrictions on entry to the schemes. The Board has concluded that these restrictions in credit card schemes in Australia are not in the public interest. The pricing of credit card services, in which interchange fees and restrictions on merchant pricing play an integral role, is sending consumers a quite misleading signal about the cost to the community of different payment methods, while barriers to entry are quarantining the credit card schemes from competitive pressures. Overall, the community is paying a higher cost for its retail payments system than is necessary.

Although extensive consultations and analysis preceded the step, the reform process began in a formal sense in April 2001, when the Reserve Bank designated the Bankcard, MasterCard and Visa credit card schemes in Australia as payment systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*. The Bank announced that it would proceed to establish, in the public interest, a standard for the setting of interchange fees and, if necessary, a standard for merchant pricing of credit card purchases, as well as a regime for access to these credit card schemes. The Bank did not designate the “three party” card

schemes in Australia, American Express and Diners Club, which do not have collectively determined interchange fees nor restrictions on access enforced by existing members. These latter schemes did, however, impose restrictions on the freedom of merchants to recover credit and charge card costs from their cardholders, and the Bank confirmed that any decisions it took in this area would apply to all card schemes in Australia.

Following designation, the Reserve Bank undertook a detailed evaluation of whether the main restrictions established by the credit card schemes were in the public interest. It gave high priority to the consultation process, receiving views on the operation of credit card schemes in Australia from over 30 separate organisations. A commissioned report by an international expert in network economics also helped the Bank assess the various submissions.

This consultation process culminated in the publication of a Consultation Document in December 2001, in which the Reserve Bank set out its proposed reforms to the designated credit card schemes in Australia and provided extensive discussion of the purpose and effect of these reforms. The reform measures involved:

- ♦ an objective, transparent and cost-based methodology for determining interchange fees;
- ♦ freedom for merchants to pass through to cardholders the costs of accepting credit cards; and
- ♦ a more liberal access regime that allowed for the entry of specialist credit card service providers, both issuers and acquirers, to be supervised by the Australian Prudential Regulation Authority (APRA).

A further extensive round of consultations, as required under the Act, was undertaken before the reform measures were finalised. The Reserve Bank received submissions from 28 organisations before the specified deadline of 15 March 2002, including from the designated and “three party” card schemes, financial institutions, other payments providers, merchants and consumer representatives, as well as submissions from a number of members of the public. Comments and other material were received after the submission

deadline, and the Reserve Bank considered these also. All organisations that made formal submissions were invited to discuss them with Reserve Bank staff. In all, 52 such meetings were held between mid March and August 2002, including 15 separate meetings with the designated credit card schemes.

With the exception of the designated credit card schemes, the overall tone of the submissions received was one of acceptance of the need for reform of credit card schemes in Australia, although views on the preferred details of such reforms varied considerably. The designated credit card schemes opposed each of the Reserve Bank’s proposed reforms, claiming them to be unnecessary and not in the public interest. Financial institutions and their respective industry associations broadly accepted that interchange fees in credit card schemes should be determined on the basis of an objective, transparent and cost-based methodology, but argued that the categories of costs that the Reserve Bank proposed were too narrow. In general, financial institutions did not object to the removal of scheme restrictions on merchant pricing or to the proposed more liberal access regime. Most merchants, and the consumer organisations which offered views, expressed strong support for the reforms.

After a comprehensive review of the views and issues raised in submissions and discussions, the Board endorsed a package of reforms to credit card schemes in Australia designed to promote transparency, competition and a more efficient allocation of resources in the Australian payments system. The Board was not persuaded by arguments that allowing normal market mechanisms to operate more effectively in the payments system is against the community’s interest. Although the purpose and likely effect of the reforms were unchanged from the proposals made in December 2001, a number of suggestions for simplifying the drafting and providing greater flexibility to the designated card schemes and their members were incorporated in the final measures. The Board acknowledges the constructive input of many parties during the consultation process.

The reform measures, which were announced on 27 August 2002, comprise:

- ♦ a *standard on interchange fees* that involves an objective, transparent and cost-based benchmark against which interchange fees in the designated credit card schemes can be assessed. The cost-based benchmark for each scheme will set a ceiling on average interchange fees in the scheme, and will be based on the costs incurred by card issuers in processing and authorising transactions, fraud and fraud prevention, and funding the interest-free period. Each scheme must recalculate the benchmark at least every three years. The standard becomes effective on 1 July 2003 and associated changes to interchange fees must be implemented by the end of October 2003. Regulations under the *Payment Systems (Regulation) Act 1998* are being finalised to ensure that participants in the designated credit card schemes complying with this standard will not be in breach of the *Trade Practices Act 1974* in doing so;
- ♦ a *standard on merchant pricing* that removes the restriction imposed by the international credit card schemes on the freedom of merchants to charge according to the means of payment. This standard came into effect on 1 January 2003; and
- ♦ an *access regime* that allows specialist credit card institutions authorised and supervised by APRA to apply to participate in the designated credit card schemes, and that removes any restrictions or financial penalties that disadvantage scheme participants seeking to specialise in acquiring. APRA is currently finalising the regulatory framework and prudential standards that will apply to the new class of specialist credit card institutions.

American Express and Diners Club each gave an undertaking to the Reserve Bank to remove their restrictions on merchant pricing when the standard on merchant pricing came into force.

The Reserve Bank's reforms are consistent with the broad objectives of the Government's competition policy and have received bipartisan support. They will

allow normal market mechanisms to work more effectively in the Australian payments system and reduce its overall costs to the community. This will be achieved through:

- ♦ lower merchant service fees as a direct consequence of reduced interchange fees, which will pass through to the community in the general level of prices. Average interchange fees are expected to fall by up to 40 per cent in 2003;
- ♦ greater market discipline on merchant service fees because of the freedom of merchants to pass through their credit card costs to cardholders;
- ♦ more efficient and transparent pricing of credit card services to cardholders and merchants; and
- ♦ greater competition in the provision of credit card services to cardholders and merchants from the entry of non-financial corporations of substance.

The Board will monitor the impact of the reform measures on an ongoing basis and report to Parliament, in the usual way, through its Annual Reports. The Board will also undertake a major review of credit and debit card schemes in Australia after five years and, on the basis of that review, will consider whether the reform measures remain appropriate.

In September 2002, MasterCard International and Visa International each filed an application in the Federal Court to have the reforms overturned. In developing the reforms, the Reserve Bank has acted consistently with its obligations and powers under the *Payment Systems (Regulation) Act 1998*, and at law, and it is vigorously defending the reforms. The hearing is expected to commence in mid 2003.

Debit card payment networks

In Australia, the structure of interchange fees for proprietary debit card (EFTPOS) payments is virtually unique: interchange fees are paid by the card issuer to the acquirer and are negotiated bilaterally rather than set at a system level. In other countries the flow is to the card issuer or there are no interchange fees at all, as is the case in the two most heavily used debit card

payment systems – Canada and the Netherlands. The fee structure in Australia may have been relevant in the establishment phase of the EFTPOS network in the early 1990s, as an incentive for merchants and their banks to invest in the infrastructure needed to accept transactions and switch them to issuers. On the basis of data provided by participants, however, the Reserve Bank/ACCC study of debit and credit card schemes, released in October 2000, concluded that there was no convincing case for an interchange fee in Australia's debit card payment system, in either direction. The bilateral interchange fees, which have hardly changed since they were introduced, are a major determinant of fees charged by issuers to their cardholders. The interchange arrangements also appear to be a barrier to new entrants, who must negotiate a multitude of interchange fee contracts with other participants before they can compete effectively.

Initially, industry participants showed little willingness to review these arrangements. Over the course of 2002, however, as the momentum for credit card reform built, there was growing acceptance of the sense in reforming debit card interchange fees at the same time as those for credit cards, so that consumers and merchants can face more efficient prices for both means of payment.

Early in 2002, the Reserve Bank convened a series of meetings of industry participants to explore options for debit card reform. The industry group consisted of the largest direct participants in the EFTPOS network, including one large merchant. Industry views on reform are quite diverse and strongly held; for this reason, the Reserve Bank encouraged the industry group to seek public input into the reform process. In July 2002, the industry group released a paper, prepared with Reserve Bank assistance, which outlined three basic options for reform: retention of the current arrangements (with small modifications); adoption of collectively determined interchange fees calculated on a cost-based approach; or abolition of interchange fees altogether.

Following publication of the paper, the industry group met with interested parties to discuss the options. At the group's request, the Reserve Bank stepped back from its direct role in facilitating reform efforts; this

is fully consistent with a "co-regulatory" approach under which industry participants have an opportunity to progress reform. In the end, significant differences in commercial interests have remained, both within the industry group and among other interested parties. Banks, building societies and credit unions have recently applied to the ACCC for authorisation of a proposal to reduce debit card interchange fees to zero. The Board strongly supports this proposal, and expects the reduction in interchange fees, if authorised, to be passed immediately and fully to debit card users through lower transaction fees.

The Board believes that reform also needs to address the issue of access to the EFTPOS network (and similar considerations apply to ATM networks). Potential new entrants claim that it is extremely difficult to overcome the operational and commercial hurdles to establishing the required bilateral links with all of the major banks. Unlike the APCA clearing streams for cheques, for example, where each institution is obligated to pay any valid cheque drawn on it that is presented by another institution, APCA members are not obligated to exchange EFTPOS payments with all other members. Instead, individual interchange agreements must be negotiated before one institution will accept EFTPOS transactions from another. One bank alone can effectively "hold up" access for any new participant by delaying the technical connections and the signing of interchange agreements, even when the new participant has clearly met APCA's technical requirements. The Board believes that these *ad hoc* bilateral arrangements are not beneficial to the Australian payments system and can be a significant barrier to new entrants. Since merchants usually prefer to have one financial institution provide both credit card and debit card acquiring services, the bilateral arrangements also mean that the Bank's opening-up of access to credit card schemes might be less effective than otherwise.

A concern of the Board that is yet to be resolved is the interchange fee arrangements in one particular debit card product – the Visa-branded debit card. Depending on the selection made by the cardholder, issuers of this card can earn the same interchange fee

rate as that for credit cards for what are essentially debit card transactions. Although the product has some features that are typically associated with scheme credit cards, such as “money back guarantees” for cardholders and the ability to use the cards for card-not-present transactions, the Board sees no case for simply applying credit card interchange fee rates to Visa debit card transactions. In last year’s Report, the Board set out two steps which, in its view, are necessary to deal with this issue. On the technical level, Visa debit card transactions need to be identified separately from Visa credit card transactions at point-of-sale, as they are in some other countries. On the pricing level, card issuers will need to demonstrate that a case can be made for a collectively determined interchange fee for Visa debit card transactions that would meet the appropriate public interest test. The Board understands that the Visa debit card product is under review and it is not yet able to assess whether any proposed changes will meet its public interest concerns.

ATM networks

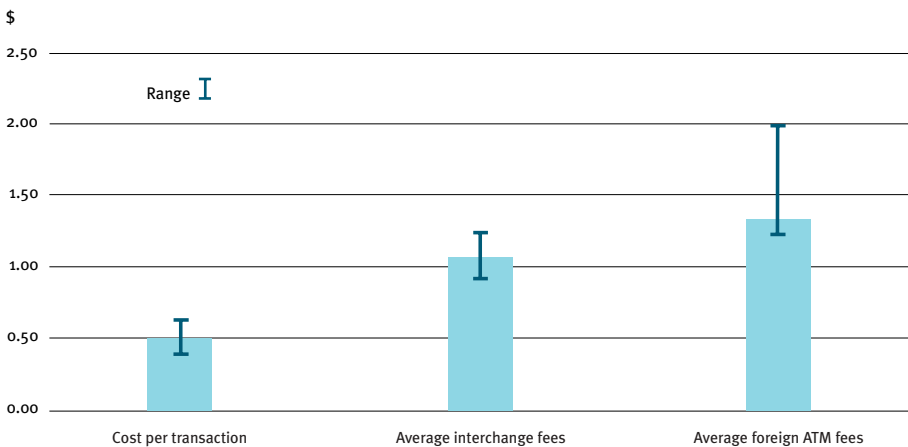
An overhaul of ATM interchange fee arrangements is the third plank in the Board’s reform agenda for card payment networks.

ATM interchange fees in Australia arise whenever cardholders of one financial institution use an ATM owned by another financial institution (so-called “foreign” ATM transactions). The fees are paid by the card issuer to the ATM owner, which incurs costs in providing a cash dispensing service to the issuer’s customers. The fees are determined by bilateral negotiation.

The Reserve Bank/ACCC study found that cardholders using another institution’s ATM pay “foreign ATM fees” that are considerably more than the cost of providing the service, and that competitive forces are not working to bring interchange fees and “foreign” ATM fees more into line with costs. The interchange fee arrangements effectively prevent ATM owners from

ATM COSTS AND FEES

Cash withdrawals



Source: CANNEX Australia & Reserve Bank of Australia

competing on the basis of price or services provided, since they do not receive any more or less revenue from users for changes in the quality of service or the cost of providing it. The study considered an alternative pricing regime – that of “direct charging” – that would encourage competition and greater transparency in the pricing of ATM services. Under this regime, there would be a direct relationship between the ATM owner and cardholders wishing to withdraw cash. The ATM owner would charge customers of other financial institutions a transaction fee which would be clearly posted at each ATM. That fee would be debited to the cardholder’s account along with the cash withdrawal, and the resulting amounts settled between card issuers and ATM owners as at present.

The industry’s response to these issues has followed much the same pattern as debit card reform – the convening of a meeting of industry participants by the Reserve Bank, detailed discussions within the industry group of different regimes for charging for “foreign” ATM transactions and, more recently, a stepping-back by the Reserve Bank from its role as facilitator to enable an industry-led solution to be reached. However, the process has been more protracted than that for debit card reform. Industry participants have now released for public consultation a proposal that ATM interchange fees be replaced by a regime under which each ATM owner would be free to levy charges – disclosed at the point of transaction – directly on customers. Card issuers would also be free to charge their customers directly for “foreign” ATM transactions.

The Board strongly supports this proposal. In its view, a direct charging regime will result in lower and more transparent fees on “foreign” ATM transactions and, over time, an expansion in the quality and range of ATM services available to consumers. Given the long period of review and discussions which has already passed, the Board sees no compelling reason why the industry could not finalise the proposed reform in 2003.

Direct debits

The Board has supported industry initiatives to promote greater use of direct debits as a very efficient means of paying regular bills or recurring obligations, and it welcomes signs that Australian consumers are more ready to adopt this payment method.

The major initiative has been the introduction of safeguards that give consumers greater confidence that they will be able to stop any incorrect payments under direct debit arrangements. These safeguards are enshrined in the Charter for Direct Debit Customers, first published in 2000, which guarantees service levels for retail customers. The Charter confirms that customers will be given adequate notice of debits to be made to their accounts and will be able to stop the debit if they believe that they have been incorrectly billed, provided they give the required notice. Recently, APCA has introduced more streamlined procedures that allow customers to cancel direct debit authorities directly through their bank, building society or credit union. Customers can now quickly cancel direct debit authorisations and stop individual payments through either their financial institution or the biller; financial institutions cannot deflect requests back to the biller.

Useful though they are, these consumer safeguards do not provide any guarantee of a refund if the bill is disputed after payment. In the United Kingdom, where direct debiting has much wider acceptance, “direct debit guarantee” arrangements provide that if a customer claims a mistake was made in having a direct debit made to their account, their financial institution will refund them immediately, and the refund is not limited by amount or time. Although refunds are initially paid by the financial institution, they are borne by the billers under an indemnity. A review of the Code of Banking Practice (the Viney report), conducted for the Australian Bankers’ Association (ABA), recommended that the Code include a requirement that banks seek to amend APCA’s rules to provide for a guaranteed refund along UK lines, as a way of

ensuring greater protection to consumers, and that this be done by no later than 1 July 2002. The ABA endorsed the Viney recommendation and, in last year's Report, the Board encouraged APCA to bring it to fruition as soon as possible.

The outcome is a disappointment. The recommendation relating to a guaranteed refund was omitted from the revised Code of Banking Practice launched in August 2002, and no amendments have been made to APCA's rules to facilitate the introduction of a guarantee. The Board regrets that the industry has failed to grasp an important opportunity to further the use of a very efficient payment mechanism.

Purchased payment facilities

In the mid 1990s, the birth of Internet commerce and the commercialisation of smart cards were widely perceived to be leading towards an electronic payments revolution. High-profile trials of products such as the Mondex "electronic purse" (a smart-card-based payment system) and Internet-based "e-cash" caught the attention of media commentators and regulators. The Financial System Inquiry, reporting at the height of public interest in electronic money systems, took the view that these new payment facilities had the potential to become an important element in the Australian payments system. The Inquiry wanted to ensure that participants other than banks could compete in these new technologies but, in the interests of protecting consumers, recommended to the Government that providers of such facilities be subject to prudential regulation. As a result, the Reserve Bank was given wide-ranging powers for the regulation of "purchased payment facilities" under the *Payment Systems (Regulation) Act 1998*. Section 4 of the Act requires that the "holder of stored value" backing such a facility – that is, the entity receiving the proceeds from the sale of the facility – either be prudentially regulated by the Reserve Bank, exempted by the Bank from regulation or be an authorised deposit-taking institution (ADI) supervised by APRA.

Since that time, electronic money systems have

generally been commercial failures or, at best, have underperformed expectations. Many of these systems were designed by technical specialists who developed impressive technology to interface with users but may not have fully appreciated the importance of back-office clearing and settlement and the associated costs and complexity. Other products that were designed as substitutes for cash at point-of-sale ran up against the reality that cash is very efficient and effective for high-volume, low-value transactions. Only a few countries (including Singapore, Hong Kong, Belgium and Sweden) have achieved relatively wide usage of general-purpose stored-value cards.

In Australia, like most other countries, the bulk of electronic money products in operation are card-based means of payment not available for general-purpose payments. They are used in "closed" environments, such as universities, or for purchases of specific goods or services only. Closed-system cards include cards provided by State and Territory governments for use in transport, libraries, parking and other community services. Several tertiary institutions have developed student cards that consolidate identification and purchases of campus services. Some new payment methods have developed out of the need to improve the efficiency of payment in specific markets. Such systems are typically established by the organisation providing the goods or services and include prepaid transport cards, disposable phone cards and electronic gift certificates that allow pre-payment for purchases at a specific merchant or group of merchants. Health benefit member cards with a stored-value function have also been trialled, but usage has been low.

Some rationalisation of the regulatory framework for purchased payment facilities in Australia has taken place, and further rationalisation might be needed. The *Payment Systems (Regulation) Act 1998* created the potential for duplication of resources and regulatory burden between the Reserve Bank's role in overseeing the safety and efficiency of payment systems and APRA's responsibilities to supervise specific institutions which, in many cases, also provide

payment services. To address this concern, in June 2000 a regulation was enacted under the *Banking Act 1959* to allow APRA to supervise purchased payment facilities which have deposit-like characteristics. The criteria for supervision by APRA are that the product is available on a “wide basis” as a means of payment and the stored value is redeemable by the user on demand.

Although it is yet to authorise any facilities under this regulation, APRA is expected to become the supervisor of purchased payment facilities that achieve material size, since any successful payment product will probably need to be redeemable on demand in order to ensure consumer confidence. Purchased payment facilities with narrow applications or limited usage will, however, remain outside APRA’s purview. Many of these systems were operating before the Financial System Inquiry and the value of funds held by providers of these facilities is small; hence, they are unlikely to raise concerns on financial stability or payments system integrity grounds. The Board sees no need for the

Reserve Bank to regulate the holders of stored value in these cases. Accordingly, an exemption from regulation will be issued for small and limited-purpose purchased payment facilities (up to a threshold in stored value outstanding), or facilities that are guaranteed by an ADI or government.

It is possible that a small number of purchased payment facilities may emerge – primarily those in a start-up phase or with usage restrictions of some sort – that fall outside APRA’s supervision and the class exemption. The Reserve Bank is discussing the appropriate regulatory framework for such facilities with the Australian Securities and Investments Commission (ASIC), which has assumed a consumer protection role under the *Financial Services Reform Act 2001* that is particularly relevant for smaller purchased payment facilities. The objective of the discussions is agreement on a division of responsibilities between APRA, ASIC and the Reserve Bank that is consistent with the respective roles of the three agencies in the financial system.



