REFORM OF AUSTRALIA'S PAYMENTS SYSTEM: THE 2007/08 REVIEW

Address by Philip Lowe, Assistant Governor (Financial System), to the 4th International Consumer Credit Card Summit, Sydney, 27 June 2007.

I would like to thank the organisers of the International Consumer Credit Card Summit for the invitation to be here this morning. From the Reserve Bank's perspective, the timing of the Summit is ideal. As you may be aware, a few weeks ago the Payments System Board released an Issues Paper, marking the beginning of the review into the reforms to Australia's payments system. This morning, I thought it would be useful to share with you the Board's plans for this review, and to highlight some of the issues that the Board will be thinking about over the months ahead.

My remarks will be in three parts.

Firstly, I would like to outline the broad objectives of the Payments System Board and to summarise the Board's main reforms and their rationale.

Secondly, I would like to talk about the genesis, scope and timing of the review. The main points I want to emphasise here are: that the review is wide-ranging; that the Board is committed to a very open process; and that the Board is keen to hear the views, analysis and evidence of all interested parties. We want to ensure that the review is forward-looking – not rehashing the debates of the past – and that it forms the basis for the continued development of an efficient and competitive payments system in Australia.

Thirdly, I would like to elaborate on three of the broad questions raised in the Issues Paper.

The first of these questions is what configuration of interchange fees across the various payment systems is most likely to promote efficiency, and how do we get there?

This question has been central to the whole reform process, but is one that sometimes gets a little lost in the debates about the appropriate level of interchange fees in the credit card system. As you are aware, the Payments System Board is responsible for promoting efficiency in the payments system *as a whole*, not just the efficiency of individual payment methods within the overall system. This means that any analysis of the efficiency implications of interchange fees in the credit card system cannot credibly ignore interchange fees in the other systems. A critical issue for the review, therefore, is what should the relativities amongst interchange fees in the various systems look like, and what arrangements are most likely to deliver outcomes that promote efficiency and soundly based competition?

The second question is to what extent can merchants influence the method of payment their customers use, and how do restrictions on merchants affect competition in the payments system?

This may seem a strange question to ask, but it too has been central to the reform process. I say this because an important effect of the reforms has been to give merchants more influence over how customers pay for goods and services. The Board is keen to hear views about the effects of this change, and whether it is practicable and/or desirable to go further in this direction.

The third question is what is the scope for self-regulatory solutions, rather than regulation by the Payments System Board?

As I hope you know, the Reserve Bank is a reluctant regulator, and views regulation as a last resort. We would much rather see public-policy concerns addressed by industry, rather than through formal regulation. So another important issue for the review is what are the roadblocks to self-regulatory solutions, and under what preconditions might self-regulation be made to work?

These are difficult questions, and if you read the Issues Paper you will see many others as well. But before I discuss these three questions in more detail, I would like to talk a little about what the Payments System Board has done and why it has done it, as well as say a few words about the review process itself.

The Reforms and their Rationale

As you are probably aware, the legislation under which the Board operates states that the powers of the Board are to be used to promote stability, efficiency and competition in the Australian payments system. While the Board's work has addressed all three of these issues, it is its work on promoting efficiency and competition that has attracted the most interest and debate.

This morning, I would like to draw your attention to three aspects of this work.

The first is the Board's efforts to promote more appropriate price signals to consumers. This work has had two aspects: a narrowing of the differences in interchange fees across the various card-based payment systems, and the removal of restrictions on merchants imposed by the card schemes.

The Board has been of the view that the structure of the Australian payments system and the schemes' rules meant that interchange fees were not subject to the normal forces of competition. It has also been of the view that the level of interchange fees across the various systems was not promoting an efficient payments system. In particular, many consumers were effectively charged significantly more for using the EFTPOS system than for using the credit card system, despite the EFTPOS system being cheaper to run. In the Board's view, these price signals were distorting payment patterns and contributing to significant cross-subsidies from users of EFTPOS and cash to users of credit cards.

Price signals were also being dulled or distorted by various restrictions imposed by card schemes on merchants – including the no-surcharge rule, the honour-all-cards rule and the no-steering rule. These restrictions meant that merchants had little ability to pass on the costs of accepting credit cards to the users of credit cards. They also limited merchants' ability to negotiate over the terms of acceptance of various types of cards.

To a large extent, the Board's efforts in these two areas have been designed to promote a more soundly based competitive environment, rather than an environment in which competitive advantage is heavily influenced by the setting of interchange fees and/or by restrictions on merchants.

I have sometimes heard it said that the Reserve Bank regulated the credit card system because it wanted to control consumer debt. I have also heard it said that the Bank regulated the system because it wanted people to use the EFTPOS system since it involves fewer resource costs. Let me assure you that both of these claims are incorrect. The regulations have nothing to do with consumer debt. And we have no interest in promoting a payment system simply because it has lower costs. As we all know, the low cost-option is not always the best option!

It is worth pointing out that seven years ago, Australia was in the vanguard in expressing concerns about interchange fees and scheme rules – so much so, that I am sure that many of you have heard people refer to developments here as the 'Australian experiment'. But today we are no longer alone. Recently, there have been legal actions or investigations regarding either interchange fees or scheme rules by the authorities in the European Union, Israel, Mexico, New Zealand, Poland, Spain, Switzerland, the United Kingdom and the United States, and the list continues to grow.

The second aspect of the Board's work that I would like to draw your attention to is that designed to improve access. Over the years, the Bank has heard many complaints about how difficult it is for a new entrant to join parts of the Australian payments system. Given the importance of access in promoting competition, the reform process has led to more liberal access arrangements in both the credit and debit card systems. Encouragingly, in the case of the EFTPOS system, this progress was achieved by the Bank and the industry working together.

The third aspect of the Board's work that I would like to touch on is the efforts to improve the flow and quality of information about the Australian payments system. When the Board was established in 1998, there was very little information available. I think it is fair to say that this worked to the advantage of the card schemes and their members, but to the disadvantage of merchants and consumers. Since 1998 the Bank has worked to improve the transparency of the payments system, and today, there is a much wider array of information available that people can use to make decisions.

So in a nutshell, the reform process has been about establishing more appropriate price signals to cardholders, removing restrictions on merchants, improving access and enhancing transparency. The upcoming review provides an opportunity to assess the effects of the reforms in each of these areas and how both the Board and the industry can best work together to further promote competition and efficiency.

Genesis, Scope and Timing of the Review

As you may be aware, the review has its genesis in a commitment the Reserve Bank made in 2002 when it introduced the credit card reforms. At the time, we said that after five years we would undertake a major review of credit and debit card schemes in Australia, and consider whether the standards and access regimes applying to the credit card system remained appropriate.

Over the past year or so, there has been quite a lot of debate over whether the Reserve Bank – or somebody else – should conduct this review. The Board's view is that as part of good regulatory practice, it should periodically take stock of what has happened, and consider whether the regulatory arrangements remain appropriate. And this is exactly what it is now doing. Of course, it remains open to the government to commission its own review, if it thought that appropriate. However, last year the House of Representatives Standing Committee on Economics, Finance and Public Administration concluded, after extensive public hearings, that the Bank should conduct the review. We have the resources, the expertise, and the necessary understanding of the often diametrically opposite views amongst industry participants to conduct this review, and we are looking forward to doing so.

I cannot emphasise strongly enough though that the Payments System Board is committed to an extremely open process. It wants to hear from all interested parties and all submissions will be placed on the Bank's website. We are particularly keen to receive new analysis and evidence, and believe that the process will be best served by having that analysis and evidence in the public domain. While the Bank staff will have one-on-one discussions with those making submissions, it is also important that the issues are discussed in a public forum. So as part of the review, we plan to hold a conference – co-sponsored with the Melbourne Business School – in late November this year. This conference will draw together leading academics, industry participants, and policy-makers to discuss the reforms, and we see it as a central part of the review process.

As I mentioned a moment ago, in 2002 the Board said that it would review the regulatory arrangements for credit cards. This made sense at the time, as the only regulations that the Reserve Bank had introduced related to credit cards. The Board is, however, now planning a much broader review – including all the reforms, as well as a re-examination of the payment systems that, to date, have not been regulated.

At its heart, this broader focus reflects the fact that the Board has always seen the various reforms as part of a package. Through this whole process, the focus has been on the implications of each reform for the payments system as a whole. While the individual reforms have been implemented at different points in time, reflecting a variety of factors, it would be a pity if this disguised the fact that they are all closely related to one another.

The review therefore provides an opportunity to again look at the payments system as a whole and to ask where we should be heading and how we should be getting there. Reflecting this broad scope, the review will address three interrelated questions:

(i) what have been the effects of the reforms to date?

(ii) what is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach? and

(iii) if the current regulatory approach is retained, what changes, if any, should be made to the standards and access regimes?

The Board is seeking submissions by 31 August this year. It then anticipates releasing its preliminary conclusions for consultation by April next year. If at the end of that consultation, it were to propose making specific changes to the standards or access regimes, the draft changes would be released for public comment. It is anticipated that any new arrangements would be finalised by the end of 2008.

As inputs to the review, the Bank is conducting two related pieces of research with the co-operation of industry.

The first is a comprehensive study of the resource costs of different means of payments.

You might recall that in 2000, the Reserve Bank and the ACCC published the Joint Study, which for the first time provided comprehensive data on costs that financial institutions incurred in the credit card, EFTPOS and ATM systems. Since the publication of that study, there have been numerous calls for the work to be extended and updated. We think that now – as part of this review – is the right time to do this. The updated study will include a broader range of payment instruments and will collect data from merchants as well as financial institutions. It will also include comprehensive information on the costs of cash payments.

The second study is of how consumers actually use various methods of payment. As part of this work we have commissioned Roy Morgan Research to conduct a survey in which around 600 people are filling out a diary recording all payments – and how they make them – over a two-week period. We have also sought information from a wide range of businesses about how their customers actually pay for goods and services. A number of banks have also provided us with information about the use of various payment methods.

Both these studies are major pieces of work and are requiring significant assistance from merchants and financial institutions. But they are worth the effort. Once the results are in and published, we will have as good a picture as any country in the world as to the costs of payment systems and the patterns of payment use. This information will be useful not only to the Reserve Bank, but to all those involved in the payments industry.

I would now like to turn to the three questions I raised at the outset.

The Configuration of Interchange Fees

The first of these questions is what configuration of interchange fees across the various payment systems is most likely to promote efficiency, and how do we get there? This question is particularly important given the central role that interchange fees can play in influencing how consumers pay for goods and services.

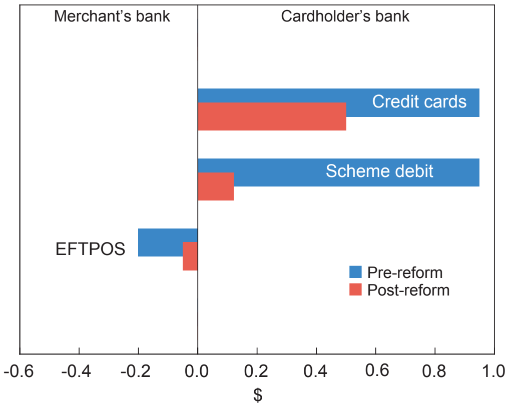
To date, much of the analysis of interchange fees – both by industry and by academics – has focused on the merits of these fees in a *single* electronic payment system (typically credit cards) competing with cash. But as you all know, the world we live in is much more complicated than this. In terms of electronic payments, we all have many choices, including credit cards, EFTPOS, scheme debit and prepaid cards. Each of these different payment methods has its own features and each has interchange fees paid between acquirers and issuers.

If we wind the clock back a few years, you might remember that prior to the reforms if you made a $100 payment with a credit card, the institution that issued the card would,

Graph 1

Interchange Fees on a $100 Payment

Exclusive of GST



Source: RBA

on average, have received an interchange fee of around 95 cents. If you had made that same payment with your EFTPOS card, your institution would have had to pay around 20 cents (Graph 1). Receive 95 cents or pay 20 cents. For many institutions the choice was clear: promote credit cards over EFTPOS. The result was an explosion of new credit card products, and enticing reward programs. This meant that many consumers faced an effective price for using a credit card that was considerably lower than the effective price for using EFTPOS. This was despite the EFTPOS system having lower running costs. Not surprisingly, many Australians embraced this new world and credit card payments grew rapidly.

Now of course strong growth in credit card spending is not, of itself, a sign of inefficiency; indeed, in many situations the use of a credit card offers consumers considerable advantages. Rather, the central issue has been whether the price signals facing consumers were encouraging the efficient use of the various payment instruments. For the reasons I mentioned a moment ago, the Payments System Board concluded that they were not. Given this assessment, the Board has sought a narrowing of the differences in the interchange fees across the various systems in an effort to promote more appropriate price signals to consumers.

As a result of the reforms, on average, a $100 payment on a credit card now earns the institution that issued the card around 50 cents, not 95 cents, while an EFTPOS transaction costs the issuing institution around 5 cents, not 20 cents. Similarly, the difference in interchange fees between the EFTPOS and scheme debit systems has also been narrowed significantly.

As part of the review the Board is seeking views on the appropriate configuration of interchange fees across the various payment systems. An obvious question is whether the same interchange fee should apply in the credit and debit card systems. If the fee should be the same, what level should it be set at? If the fees are to be regulated, how should they be regulated, and should a common methodology be used? If the interchange fees in the various systems should be different, what is it in the economics of the systems that means that this is so?

Not surprisingly, a question that the Board has asked itself is whether it is a long-term solution for the issuer to receive 50 cents on a $100 credit card payment, 12 cents on a scheme debit payment, and have to pay 5 cents on an EFTPOS payment. Are the network effects so different in these various systems that one can conclude that these differences in fees are promoting efficiency in the system as a whole? Are there different externalities that justify these fees, or are there some other explanations?

A related question is whether any case for interchange fees in a particular system depends upon the maturity of that system. It is sometimes said that interchange fees can be very important in getting a payment system established because of the chicken and egg problem. But once the system is established, and is widely used, does the case for interchange fees weaken?

And finally, what arrangements are most likely to promote a configuration of interchange fees across the various systems that promotes efficiency and competition in the long run? Is the nature of payment systems such that some form of regulation is inevitably required? Or can changes to scheme and payment system rules introduce competitive pressures on interchange fees, and/or lessen any distortionary impact of these fees on payment patterns? And if more competitive pressures can be brought to bear on interchange fees, could this allow the Reserve Bank to step back from regulation of these fees?

Merchants' Ability to Influence Choice of Payment

This brings me to the second question that I raised at the start: that is, to what extent can merchants influence the method of payment their customers use, and how do restrictions on merchants affect competition in the payments system?

As I said, this might seem a strange question to ask, but merchants' acceptance decisions and their ability to influence how payments are made by their customers can potentially play an important role in influencing the competitive dynamics in the payment systems.

Historically, it is fair to say that once a merchant had decided to accept particular methods of payment – say cash, credit cards and EFTPOS – it had little ability to influence which of these methods its customers used. The no-surcharge rule in the credit card system limited merchants' ability to use the price mechanism to influence choice and to put downward pressure on interchange fees. Similarly, the anti-steering rule in the American Express system limited merchants' ability to use persuasion, or other non-price methods, to influence choice. And the honour-all-cards rule in the credit card system made it impossible for merchants to accept credit cards without also accepting scheme debit cards and other cards a scheme might promote. Given these restrictions, it is not surprising that many merchants saw things being stacked against them when it came to the payments system.

Nor is it surprising that payment schemes have often sought to skew the pricing incentives towards cardholders and away from merchants. After all, if in most situations it is the cardholder who determines how the payment is made, there is a natural incentive for payment schemes to make it attractive for the cardholder to use their payment method. And one way of doing this is to load the payment costs onto the merchant, rather than the consumer. The proliferation of reward schemes in the late 1990s can be seen as an example of this. While there is a limit to this process – because if you skew the incentives too far, merchants will stop accepting the payment method – many merchants appear reluctant to refuse acceptance of widely used methods of payment, at least up to some point. Not unreasonably, they fear if they do not accept a particular payment method, they will lose sales to other merchants.

Now one of the consequences of the reform process has been to give merchants more influence over what payment methods are ultimately used. The removal of the no-surcharge rule has allowed merchants to more easily use the price mechanism. The removal of the no-steering rule has allowed them to encourage the use of lower-cost methods of payment. And the watering down of the honour-all-cards rule has allowed them to accept a scheme's credit card, but not its debit card, and vice versa.

An important issue for the review therefore is whether the current balance between cardholders and merchants is where it should be. In particular, the Board is seeking views on whether there remain aspects of the scheme rules, or the structure of the payments system itself, that inappropriately limit merchant influence over how payments are made. For example, some commentators have expressed concern that the honour-all-cards rule still overly constrains merchant choice. In particular, the current rule requires a merchant to accept all credit cards of a particular brand if it accepts any credit cards of that brand. This means that merchants are not permitted to refuse acceptance of premium cards even if they view the cost of accepting these cards as too high.

One suggestion is that the honour-all-cards rule be further watered down by allowing merchants to make independent decisions about accepting each class of card to which a separate interchange fee applies. Such a change would leave intact the honour-all-issuers aspect of the rule, but would allow merchants to make independent acceptance decisions regarding, say, premium and standard cards. Similarly, independent acceptance decisions could be made for debit and prepaid cards.

A related issue is to what extent an increase in the ability of merchants to influence payment patterns affects the case for regulation of interchange fees. This is relevant given that some commentators have concluded that the lack of normal competitive forces on interchange fees is, in part, rooted in the various rules and practices that have effectively limited merchants' ability to influence the type of payment method that is used. Others have suggested that merchants will inevitably be reluctant to take full advantage of any new freedoms, and thus removing restrictions will have little impact on the competitive dynamics. Given these different perspectives, the Board is seeking views on the extent to which an increase in merchants' influence over how payments are processed alters the competitive forces in the payments system, and thus potentially affects the case for regulation of interchange fees.

Self-regulation

This brings me to the third question I raised at the outset: that is, what is the scope for self-regulatory solutions, rather than regulation by the Payments System Board?

Again, to repeat a point I made earlier: the Reserve Bank is a reluctant regulator and we would much rather see an industry, than a regulatory, response to public-policy concerns. Despite this, in a number of areas an industry response to the Board's concerns was not forthcoming, and the Board eventually judged that if adequate progress was to be made in a timely fashion, regulation was required. Without getting into debates about history, I think it was fair to say that this outcome was not inevitable. The Bank's public-policy concerns could have been addressed by industry, and indeed, in some cases, they have been.

Looking forward, one of the issues that the review will be exploring is what are the practical alternatives to the current regulatory approach? I think it is reasonably widely accepted that there are aspects of payment systems that are unusual and that do raise issues for public policy.

The question is how best to deal with these issues. The Board is looking for people's views as to whether self-regulatory solutions are now feasible in a number of areas where, to date, regulation has been required. It would also like to hear from industry as to any roadblocks to industry-based solutions, and how any such roadblocks might be addressed.

Given the structure of the industry, it would be naive to suggest that there will not be a need for continuing close public-sector oversight. Indeed, you can view much of what the Payments System Board has done as removing private-sector regulations or restrictions which inhibited the efficiency of the payments system as a whole. But again, looking forward, the Board is interested in the scope for the private sector to develop arrangements that address public-policy concerns about competition and efficiency.

A related question is under what conditions might the current regulations – particularly those surrounding interchange fees – be removed or relaxed. As I discussed a few minutes ago, one possibility might be a further increase in the ability of merchants to influence payment choices. Another might be a continuing rise in the number of merchants that are prepared to impose surcharges for relatively expensive payment instruments. Such changes might either put greater competitive pressure on interchange fees or lessen the impact of interchange fees on payment patterns. There may also be other changes to the way that things operate, that could work in the same direction. We look forward to hearing your views over coming months.

Concluding Remarks

This brings me to the end of my three broad questions – the configuration of interchange fees, the relative power of merchants and cardholders and the possibility of self-regulation. Of course, there are many other questions that the review will address, including the competitive impact of the regulations on different schemes, the overall impact of the reforms on consumers, and the existing incentives to invest in upgrading the payments system. These, and a considerable number of other questions, are discussed in the Issues Paper and no doubt we will have opportunities to talk about them in the months ahead.

I would like to conclude by repeating the Payments System Board's commitment to a wide-ranging and open review. We look forward to hearing your views and your analysis of what are difficult, but important issues. Both the Board and industry have a common interest in promoting an efficient and competitive payments system that serves all Australians well. The review provides an ideal opportunity to again look at how best to do this.

Thank you for your time this morning.