

PAYMENTS SYSTEM REFORM: THE AUSTRALIAN EXPERIENCE

Remarks by Dr Philip Lowe, Assistant Governor (Financial System) and Mr Ian Macfarlane (Governor) prepared for the Federal Reserve Bank of Kansas City Conference on ‘Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?’, Santa Fe, 4–6 May 2005.

Thank you for the opportunity to participate in this excellent conference. It is fabulous to see so many people from academia and the public and private sectors so interested in the economics of interchange fees. When the Reserve Bank of Australia started looking at these fees in 1998 we found it hard to find people to exchange ideas with. Fortunately, this is no longer the case, and we would like to thank the Federal Reserve Bank of Kansas City for its role in helping bring this about.

Given the title of this session – Central Bank Perspectives and Options – these remarks touch on three topics. The first is to explain how the Reserve Bank of Australia (RBA) found itself as a regulator of the payments system. The second is to outline what we have done, and why we have done it. And the third is to make a couple of general observations about how things have gone.

The Reserve Bank as Regulator

Most central banks have some type of broad responsibility for oversight of the payments system. Often this responsibility is coupled with regulatory powers relating to high-value payments. In Australia, however, the responsibility runs much broader than this, encompassing the efficiency and competitiveness of the payments system as a whole, including retail payments.

This responsibility was given to the RBA following a wide-ranging inquiry into the structure of financial regulation in the mid 1990s – the so-called Wallis Inquiry. This Inquiry recommended that bank supervision be moved from the Reserve Bank to a stand-alone prudential regulator – today known as the Australian Prudential Regulation Authority (APRA) – but also recommended that the RBA be given responsibility for the overall efficiency of the payments system.

This recommendation reflected, in part, recognition of the fact that the RBA was already highly enmeshed in the payments system and had considerable expertise in what are often highly technical matters. It nevertheless came as a surprise to us. We had not been arguing for an extension of our powers and we had not been seeking responsibility for payments system efficiency.

In accepting the Committee's recommendations, the Government took the rather unusual step of establishing a second board within the Reserve Bank – the Payments System Board. This Board is chaired by the Governor and has up to eight members, six of whom come from outside the RBA. It is charged with controlling risk in the payments system and promoting efficiency and competition. The Board has the power to formally designate payment systems, and having done so, can then set standards, determine an access regime and give enforceable directions to participants in the system. The Government envisaged, however, that these powers would be used only if the RBA was not able to achieve voluntary reform by industry participants.

So that in a nutshell is what we can do. Now to what we have actually done and why we have done it.

Reforms to Credit and Debit Card Systems

Soon after being given its powers, the RBA, in conjunction with the competition regulator, undertook a major study of interchange fees and competition in card-based payment systems.¹ This followed longstanding concerns about the degree of transparency and competition in these systems. Out of that study we came to the view that the efficiency of the overall system would be improved by cardholders facing relative prices for various payments methods that more closely reflected relative costs than was then the case. We also formed the view that existing access arrangements and restrictions on merchants imposed by the card schemes were stifling competition.

Our main focus has been on the relative costs and prices for transactions on credit and debit cards. This reflects the fact that for many people there is a high degree of substitutability amongst payments through the credit card, PIN-based debit card and the signature-based debit card systems. Our original study showed that the PIN-based debit card system had significantly lower operating costs than these other two systems. Despite this, cardholders faced much higher prices for using this system. At the time of the study, it was not uncommon for transactions using a PIN-based debit card to attract a fee of around 40 to 50 cents. In contrast, transactions using the signature-based system were not charged, while many holders of credit cards were effectively paid each time they used their card as a result of the combination of interest-free credit and reward points. Not surprisingly, consumers responded to these price signals with spending on credit cards growing at rates of 20 to 30 per cent over the second half of the 1990s, while spending on PIN-based debit cards grew at an average rate of around 10 per cent.

When we looked at why the relative prices were so far out of line with relative resource costs it was clear that interchange fees played an important role. In the credit card and signature-based debit card systems the average interchange fee was around 0.95 per cent of the transaction value, paid to the issuer. In contrast, in the PIN-based debit card system we had the somewhat unusual situation in which the interchange fee flowed in the opposite direction – that is, from the issuer to the acquirer – and averaged around 20 cents per transaction.

¹ See *Australian Competition and Consumer Commission and Reserve Bank of Australia (2000). The RBA has subsequently published a large number of documents dealing with various aspects of the payments system (see References for details).*

Not surprisingly, these different arrangements for interchange fees were reflected in pricing to cardholders. In particular, the credit card interchange fees were helping subsidise the use of credit cards. As usual though, the subsidy has to be paid for by somebody. In the first instance it is the merchants that pay through their merchant service fees, but ultimately merchants need to cover their costs. One obvious way that they could do this would be to charge customers using a credit card a higher price than those using lower-cost forms of payment. But, of course, the credit card schemes' so-called *no-surcharge rule* prohibited them from doing this. The end result was that merchants had little option other than to charge higher prices to *all* their customers to pay for the relatively large subsidies to credit card users.

In thinking about appropriate regulatory responses to these distorted price signals the RBA considered simply requiring that the no-surcharge rule be removed, thus allowing merchants to charge customers using a credit card a higher price. To the extent that merchants did so, the subsidy that credit card users received from their bank could, in principle, have been unwound, at least in part, through a higher price at the point of sale.

We saw considerable merit in this approach, and have in fact required that the no-surcharge rule be removed from merchant contracts. However, our view has been that removing this rule was not enough, by itself, to establish more appropriate price signals to cardholders. This largely reflects the considerable customer resistance to charging for credit cards. This resistance is hardly surprising given the long history over which cardholders have not had to pay higher prices for using a credit card. Many merchants fear that the imposition of even a small charge would put them at a significant competitive disadvantage. Having removed the rule in Australia, we have seen a number of businesses charge for credit cards, including some in very competitive industries, but the vast majority of merchants have so far chosen not to do so. Over time we expect to see more charging as attitudes change, but it is unlikely to happen quickly.

Given this assessment, we felt it necessary to also address interchange fees. These fees are not subject to the normal forces of competition and in the RBA's view were distorting the use of payment methods in Australia.

Where interchange fees are set by the card schemes – as is the case with credit cards – competition between schemes can perversely push interchange fees up, not down. The higher is the interchange fee set by the scheme, the higher is the subsidy that issuers are able to offer the cardholders to use the scheme's cards. Merchants are forced to pay for these subsidies as most are unwilling, except in extreme circumstances, to refuse acceptance of credit cards. As the US experience demonstrates, the result can be a series of competitive increases in fees, with the higher-cost system tending to drive out the lower-cost system.² Where fees are set bilaterally, as in the Australian PIN-based debit card system, normal competitive forces also appear to be weak, with fees in this system typically having remained unchanged for many years despite significant changes in costs and revenues on both the issuing and acquiring sides of the market.

In pursuing reform of interchange fees we initially sought a voluntary reduction in these fees in both the credit and debit card systems. It quickly became apparent though that MasterCard and Visa would not agree to do so, nor would they remove the no-surcharge rule or liberalise

² For further details see Macfarlane (2005).

access arrangements. This led us to first designate the credit card systems and then set two standards: one that abolished the no-surcharge rule and one that set a standard for the calculation of interchange fees.³ The interchange standard has had the effect of reducing the average credit card interchange fee from about 0.95 per cent of the transaction value to around 0.55 per cent. Our understanding is that this is one of the lowest interchange fees for these schemes in the world, although given the secrecy still surrounding these fees in many countries, it is difficult to be sure!

The standard requires Visa and MasterCard to calculate a benchmark fee, with the weighted average of the fees in each scheme to be below the respective benchmarks. These benchmarks are based on eligible issuers' costs as set out in the standard. We adopted this cost-based approach not because we believed it had particular theoretical merit, but rather because it was a pragmatic and transparent way of moving to a regime with less distortionary interchange fees. The alternative was simply to specify a specific per cent cap on interchange fees. We elected not to do this partly because, while we have strong powers, there is some doubt as to whether these powers extend to fixing a price – in this case an interchange fee.

The lower interchange fees came into effect on 1 November 2003, and almost immediately merchant service fees fell by a similar amount as acquirers passed on their lower costs; the average merchant service fee on credit cards in Australia is now almost exactly 1 per cent. We are confident that these lower costs will flow through into lower prices for goods and services, with our calculations suggesting that the Consumer Price Index will be 0.1 to 0.2 of a percentage point lower than would otherwise have been the case.

For the domestic PIN-based debit card system the reform process has been more protracted. Following discussions with the RBA, the banks took a proposal to the competition authority to abolish interchange fees. At the time, we saw this industry-led approach as preferable to one in which the RBA used its regulatory powers to impose an outcome. The competition authority eventually approved the proposal, but it was then successfully challenged in a review tribunal by a group of merchants, arguing that there were no net benefits from what was ostensibly an illegal collective price fix (that is, a fix at zero). Following the review tribunal's decision we came to the view that if progress was to be made then it would need to be done by the RBA using its regulatory powers. As a result, we designated the system in September 2004 and have recently released proposals, which if implemented would likely see the average interchange fee fall from around 20 cents to around 5 cents. The fee would remain payable by issuers to acquirers.

We have also recently released for consultation proposals to reduce the interchange fee in the smaller signature-based debit card system operated by Visa. If implemented these proposals would see the interchange fee in that system fall from a percentage-based fee averaging around 40 cents currently to a flat fee of around 15 cents. We have also proposed requiring that Visa remove the rule that requires a merchant to accept Visa debit cards as a condition of accepting Visa credit cards. Similar arrangements would apply to other scheme-based debit cards introduced into Australia.

³ The RBA also established an access regime under which the card schemes are not permitted to discriminate against potential new entrants based on whether or not they are a traditional deposit-taking institution or whether or not they will be only an issuer (or acquirer) of credit cards.

In proposing these reforms to the two debit card systems we have been mindful not only of the substitution possibilities between credit and debit cards as well as other means of payment, but also between different debit card systems. One concern has been that if the current interchange fees were to remain in place then, over time, issuers of debit cards would find it more attractive to issue and promote the signature-based system – in which they receive an average interchange fee of 40 cents – at the expense of the lower-cost PIN-based system – in which they have to pay an interchange fee of 20 cents.

A central issue right through the reform process has been the fact that, by its very nature, a credit card offers many cardholders a subsidised method of payment. If the balance is paid off by the due date, the cardholder receives a per-transaction subsidy equal to the value of the interest-free period, to say nothing of reward schemes. The issuers' costs of offering this subsidy are paid for by a combination of annual fees on cardholders, interchange fees, and the interest margin on those who do not pay their balance off by the due date. While ever the credit card product exists as it currently does, this subsidy will remain for a large group of cardholders.

At issue is how competing payment methods should be priced in an efficient system given the existence of this subsidy. Resolving this issue is far from straightforward. Given the complexities involved, our approach has been to move interchange fees in what we see as the right direction, rather than to seek the perfect solution, whatever that might be, in one step. This gradualist approach, however, has meant that if the current proposals are implemented we will have three different interchange standards, each based on different eligible costs. We have indicated that, to the extent possible, we would like to move to a more consistent approach to the setting of these fees over time and will undertake another major review in 2007.

A Couple of General Observations

Finally, a couple of observations about the reform process and the involvement of the central bank.

The first observation is that the process has been more difficult and more protracted than we initially thought. In a number of cases, achieving voluntary reform has proved to be all but impossible. Perhaps this is not surprising because there are strong commercial interests at stake and those who see themselves as losers from any particular reform typically strenuously oppose that reform.

The reform process has also been subject to legal challenges. In the case of the credit card reforms, both MasterCard and Visa took the RBA to court, arguing that it had overreached its powers. After a six-week hearing, preceded by more than eight months of intensive preparation, the challenges were comprehensively rejected and MasterCard and Visa were ordered to pay the RBA's costs. The real winners from the case were undoubtedly the lawyers and consultants.

Now again we are due in court in three weeks time to defend another challenge. This time it is by a group of merchants. While these merchants strongly supported the credit card reforms they are opposed to the proposed reforms of the PIN-based debit system, given that these reforms are likely to lead to higher merchant fees on transactions using this system. We have argued that their objections are short-sighted, for as mentioned earlier, if the current arrangements remain in place, use of the PIN-based debit system is likely to decline in relative terms, with its place

being taken by signature-based debit and credit cards, both of which are more expensive for the merchants to accept.

The reform process has also been made more difficult by the relatively underdeveloped nature of economic theory in the area of interchange fees. In particular, there is little guidance as to what constitutes an optimal set of fees in a world where there are multiple competing payments systems each with different costs at the issuing and acquiring ends and where, in at least one payment system, there is an inherent subsidy to cardholders. In addition, at the empirical level, there is a dearth of comprehensive studies on the degree of substitutability between various payment methods. This has meant that we have had to proceed carefully, collecting evidence where it exists and making informed judgements where the evidence is incomplete.

The second general observation relates to the role of a central bank in all of this. It is fair to say that having specific payment system legislation with responsibility assigned to the central bank has led to greater scrutiny than might otherwise have been the case. Given our experience and the difficulties of unravelling and understanding the details of the payments system there would appear to be merit in having an institution with ongoing responsibility for efficiency, with that institution being able to act proactively, rather than just reactively in response to breaches of competition law.

Another positive aspect of our arrangements has been the Board process. Not only do the external members bring considerable expertise, but the fact that decisions are taken by a Board gives those decisions some extra credibility in the eyes of the public. The formal processes associated with the Board have also provided a useful internal discipline.

One concern sometimes expressed about central bank involvement in reform of retail payments systems is that controversy surrounding the process has the potential to damage the bank's reputation, harming its ability to successfully pursue its other responsibilities. This has not been an issue in Australia, although there certainly has been plenty of controversy!

None of this though means that the case for giving the central bank, rather than another institution, responsibility for the efficiency of the payments system is compelling one way or the other. What is compelling is that someone has this responsibility and that it be taken seriously.

Thank you. ✎

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* All references are available on the Reserve Bank of Australia's website (www.rba.gov.au).