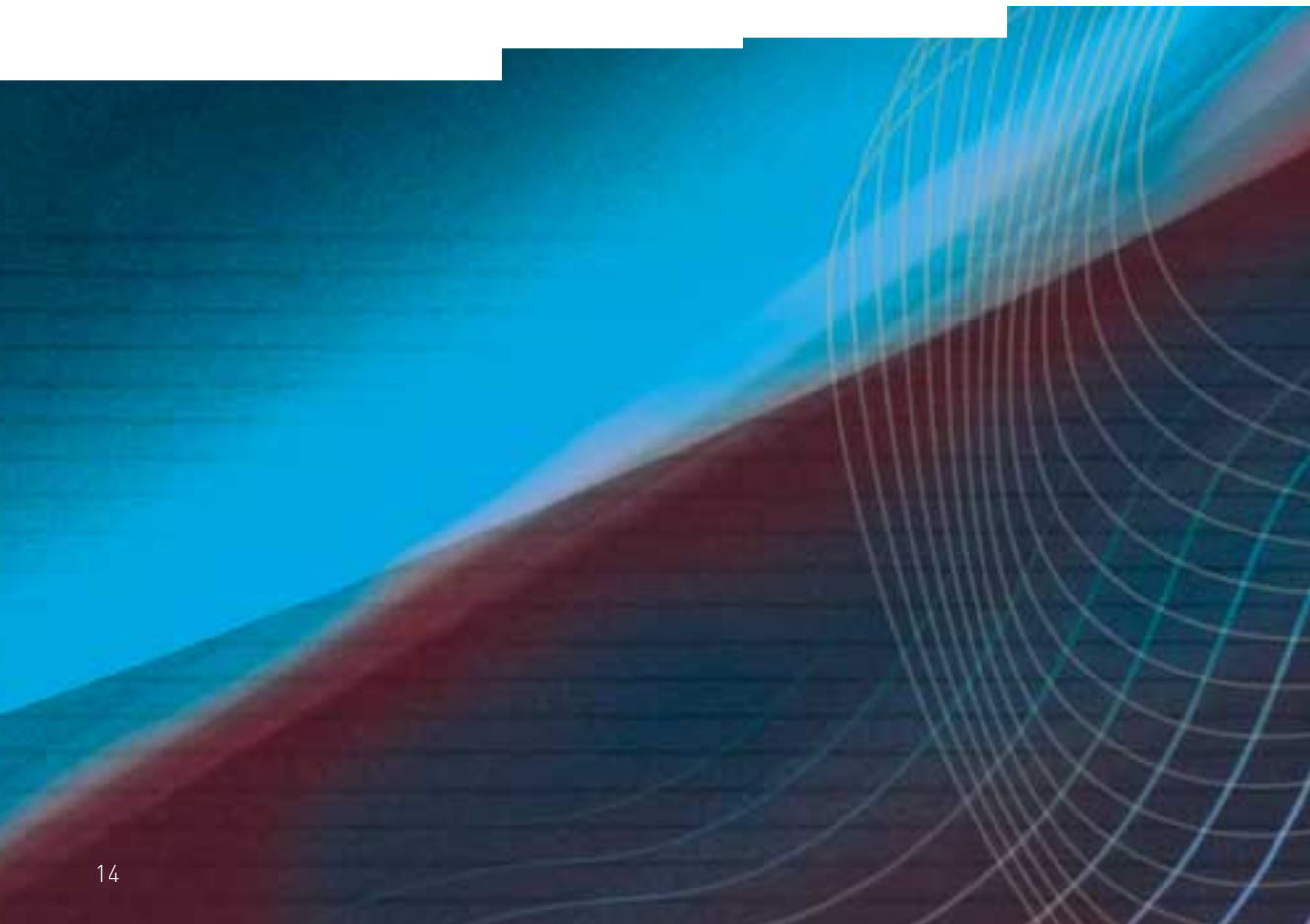
COMPETITION AND EFFICIENCY

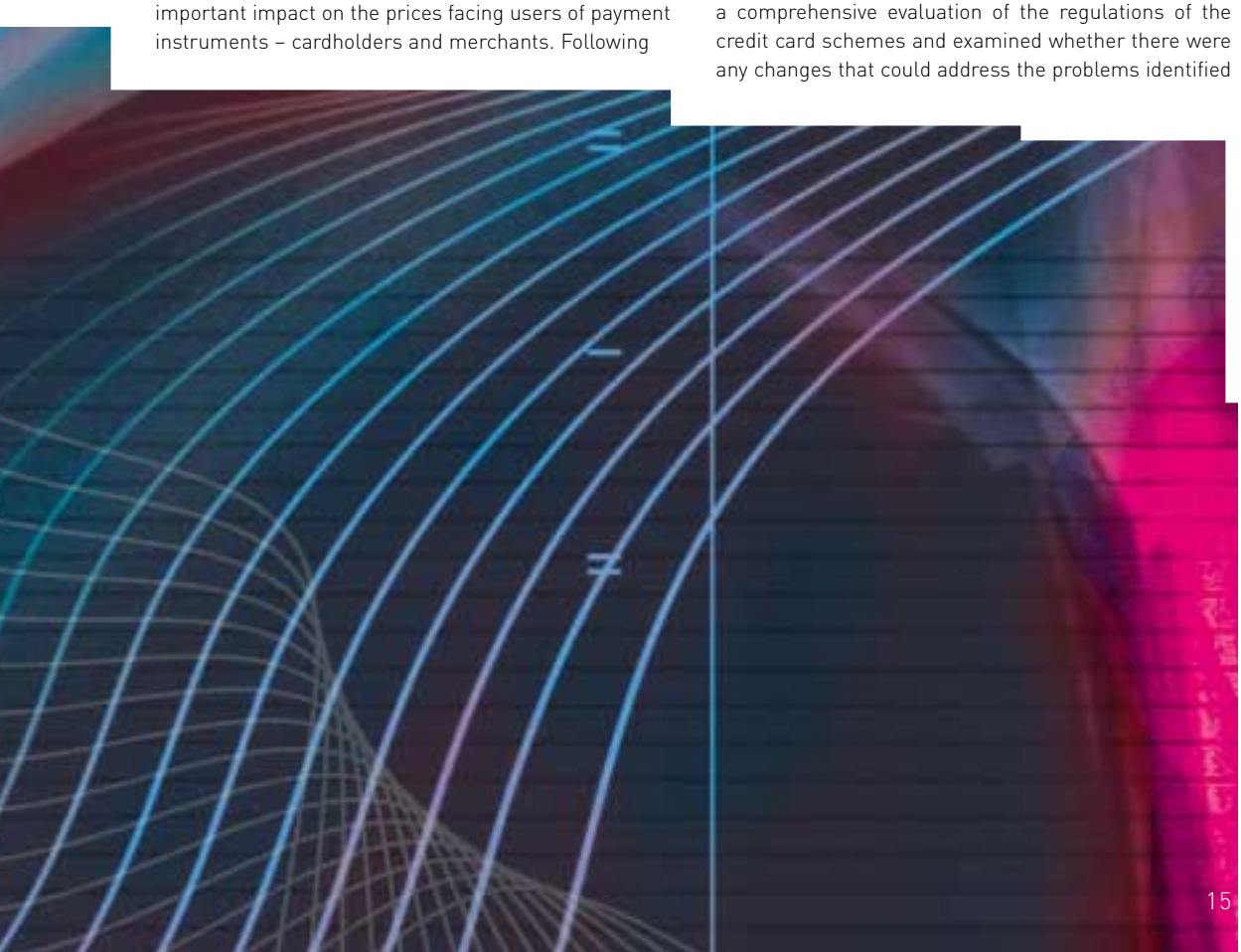


The Board's main focus over the past year continued to be card payment networks. It finalised regulatory reforms in the credit card market and encouraged industry efforts to address issues in the EFTPOS and ATM systems. In addition, the Board took steps to clarify and rationalise the regulatory framework under the *Payment Systems (Regulation) Act 1998* for purchased payment facilities and completed an important component of a project to collect and publish a broader and more detailed set of statistics on retail payment systems.

CREDIT CARD SCHEMES

The regulations of the credit card schemes have been a focus of the Board's work since 2000. The Board initially became interested in the credit card market in 1999. The Wallis Inquiry had recommended that the Board and the Australian Competition and Consumer Commission (ACCC) examine interchange arrangements in card payment networks. The Board recognised early on that interchange fees have an important impact on the prices facing users of payment instruments – cardholders and merchants. Following preliminary research, the Board endorsed a project, to be undertaken by the Reserve Bank and the ACCC, to find out more about these arrangements and to analyse their effects. The result was *Debit and credit card schemes in Australia: a study of interchange fees and access* (the Joint Study), published jointly by the Reserve Bank and ACCC in October 2000. The study concluded that a number of practices of the credit card schemes in Australia were distorting normal market mechanisms and hindering competition and efficiency in the payments system. It also concluded that interchange arrangements in Australia were resulting in a structure of price incentives that favoured credit cards over debit cards. However, it made no recommendations for action.

The Board's reform process for credit cards did not begin formally until 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 Reserve Bank then undertook a comprehensive evaluation of the regulations of the credit card schemes and examined whether there were any changes that could address the problems identified



in the Joint Study and thus improve competition and efficiency and further the public interest. The Board finalised its reforms on 27 August 2002 after extensive consultation and consideration of a large number of submissions from interested parties, including the designated card schemes. The reform measures, introduced under the *Payment Systems (Regulation) Act 1998*, are set out in *Reform of credit card schemes in Australia: final reforms and regulation impact statement* and involve standards on merchant pricing and interchange fees, and an access regime.

The first reform measure to take effect, the *Standard on merchant pricing*, came into force on 1 January 2003. It removed the restrictions imposed by the international credit card schemes on the freedom of merchants in Australia to charge according to the means of payment. The standard provides that neither the rules of a designated credit card scheme nor any participant in the scheme may prohibit a merchant from charging a credit cardholder any fee or surcharge for use of a credit card in a transaction. Although not captured by the Reserve Bank's regulatory measures, American Express and Diners Club (known as "three party" schemes) gave undertakings to remove their restrictions on merchant pricing at the same time as the standard came into force.

To date the incidence of surcharging by merchants has been limited. This response was expected by the Board and is in line with experience in other countries where the rule has been banned. This is because an important aim of the reform is to provide merchants additional leverage in negotiating lower merchant service fees for credit and charge cards (including those issued by "three party" schemes), even if they ultimately choose not to surcharge. Where they are able to negotiate an acceptable outcome, there is no incentive to surcharge. However, a small but growing number of merchants are exercising their new pricing freedom. One major national corporation began surcharging on 1 July 2003. There are also reports of some clubs and associations imposing surcharges on members electing to pay by credit or charge card.

Throughout this process the Reserve Bank has worked closely with the Australian Securities and Investments Commission (ASIC), which has responsibility for ensuring that merchants planning to impose surcharges properly disclose the relevant information to customers, and with the ACCC, which has responsibility for ensuring that merchants do not agree on surcharges in contravention of the *Trade Practices Act 1974*. Concerns by the credit card schemes that this freedom would be abused by merchants have not proven justified.

One issue that the Board is clarifying is the effect of restrictions similar to "no surcharge" rules applied to purchasing cards. These cards are typically issued by a company for use in locations bearing its brand. They operate in a number of ways, but there have been concerns that in some cases the rules imposed on outlets accepting these cards can prevent independent operators (such as franchisees) from imposing a surcharge on cardholders to cover their associated fees. Although cards issued outside the designated schemes are not subject to the Bank's standard, the Bank has consulted with issuers of these cards to clarify the operation of such rules. The Board believes some such policies have the potential to undermine the reforms and is working towards their liberalisation where appropriate.

The Bank's *Standard on interchange fees* came into effect on 1 July 2003. Under the standard, a cost-based benchmark for each scheme will set a ceiling on average interchange fees in the scheme. A benchmark is calculated for each scheme based on "eligible costs" incurred by card issuers in processing and authorising transactions, fraud and fraud prevention, and funding any interest-free period on their credit cards. For the first set of calculations, cost data for January to June 2003 will be used to set the benchmark for interchange fees beginning at the end of October 2003 and for the next three years. On the basis of data supplied by the largest card issuers in 2002, the Bank estimated that this would result in a reduction in average credit card interchange fees in Australia from around 0.95 per cent of the value of each credit card transaction to around 0.55-0.6 per cent – a reduction of around 40 per cent. This amounts to around $400 million a year.

The Board and the Reserve Bank have been closely monitoring the implementation of the interchange

standard. Each scheme is required under the standard to appoint an independent expert to compile the cost data provided by issuing members of the scheme in accordance with the data collection requirements of the standard. Earlier this year, the Bank agreed to the appointment of independent experts for each of the designated credit card schemes. In June 2003 the Government enacted a regulation under the *Payment Systems (Regulation) Act 1998* to ensure that, in setting interchange fees collectively in compliance with the interchange standard, participants in the designated credit card schemes are not in breach of the *Trade Practices Act 1974*.

The Board expects that the reduction in interchange fees as a result of the implementation of the standard will be passed through to merchant service fees and ultimately, through a reduction in merchants' costs, to the community as a whole in the form of lower prices. To assist the Board's monitoring of the effects, the Reserve Bank has initiated a survey of merchant service fee income.

The third plank of the Bank's reform of credit card schemes, the *access regime,* will liberalise current barriers to entry to the designated credit card schemes for non-financial institutions. The new regime involves the creation of a special class of authorised deposit-taking institutions (ADIs), known as specialist credit card institutions, that will be authorised by the Australian Prudential Regulation Authority (APRA) to conduct only credit card activities. In July 2003 the Government enacted a regulation under the *Banking Act 1959*, which defined credit card issuing and acquiring activities as "banking business", thus giving APRA authority to supervise specialist credit card institutions. APRA's authorisation guidelines and prudential standards for specialist credit card institutions came into force on 1 August 2003. In light of release by APRA of its final prudential requirements for specialist credit card institutions, the Reserve Bank released a revised proposed access regime. The Bank provided the opportunity for interested parties to make further submissions on the revised access regime and will take them into account, as well as previous submissions, before the access regime is finalised.

Under the proposed access regime, specialist credit card institutions authorised by APRA will be able to apply to the designated card schemes for participation. Schemes will still be able to impose their own business and operational criteria in assessing applications but must not discriminate against these specialists as a class, as opposed to other ADIs such as banks, credit unions and building societies. Potential specialist credit card institutions will need to demonstrate to APRA that they have the skills, staffing, risk management and operational capacity to conduct the credit card activities proposed without compromising the safety of the schemes. Given the sole-purpose nature of these specialist institutions, non-financial corporations that conduct other commercial business and wish to establish a specialist credit card institution will generally need to establish a subsidiary, which will then be subject to APRA's requirements relevant to their credit card business. Accordingly, APRA has indicated that it may exempt specialist credit card institutions from consolidated supervision at the parent company level where the specialist subsidiary is the only ADI in a non-financial or commercial group, recognising that it does not engage in deposit-taking in the normal course of its operations.

APRA has also indicated that specialist credit card institutions will be required to maintain a higher minimum capital ratio than a traditional ADI, reflecting their concentration of risk in one business line. This requirement would primarily affect a specialist that proposed to conduct a card issuing and lending business; specialists that conduct mainly transaction acquiring would not generally hold assets such as loans and other financial assets which are the primary determinant of risk-based capital requirements. APRA has also issued prudential guidance on risk management of credit card activities. This guidance highlights the particular risks of the various aspects of credit card activities and applies to all ADIs conducting credit card activities, and not just to specialist credit card institutions. The Board believes this new structure appropriately balances risks and more open entry of non-financial organisations into the credit card market.

Over time, the Board expects that this package of reforms will allow normal market mechanisms to work more effectively in the Australian payments system and reduce its overall costs to the community. 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, it will consider whether the standards and access regime of the designated credit card schemes remain appropriate.

In September 2002, MasterCard International and Visa International each filed an application in the Federal Court to have the Bank's reforms overturned. The cases were heard together over a six-week period beginning 19 May 2003. The judge has reserved his decision.

More recently, the Board has devoted some attention to the issue of credit card fraud in Australia. The Board supports moves by the industry to reduce fraud but is still gathering information and seeking views on how this should be achieved. Consistent with its approach in other areas, the Board is of the view that incentives have an important role to play in encouraging investment in fraud-reducing technology by card issuers, acquirers and merchants that own their own terminals. In particular, the Board's view is that the schemes and their members need to face the costs of fraud and should not just pass them to their customers, particularly merchants.

DEBIT CARD PAYMENT NETWORK

The Board has also actively encouraged reforms in the Australian debit card network. The network structure and the direction of debit card interchange fee flows in Australia is unique. In most other countries, the interchange fees are either paid to the card issuer, or there are no interchange fees at all. In Australia, interchange fees for proprietary PIN-based debit card transactions (known as EFTPOS) are negotiated bilaterally and are paid by the card issuer to the card acquirer.

The Joint Study concluded that there was no convincing rationale for interchange fees (in either direction) in Australia's EFTPOS system. As with other means available for making payments at the point of sale, such as cheques and cash, financial institutions acquiring debit card transactions could seek to recover their costs directly from their own customers, as could merchants who in some cases own parts of the EFTPOS infrastructure.

Unlike the credit card system, however, for which voluntary reform was not forthcoming, participants in the EFTPOS system have themselves pursued a reform agenda. Under the co-regulatory arrangements embodied in the Board's mandate, the Board and the Bank have encouraged co-ordination on appropriate reform measures by the industry and to date have not found it necessary to use the Bank's formal powers to achieve reform.

In February 2003, after a public consultation process, a group of banks, building societies and credit unions submitted an application to the ACCC requesting authorisation to reduce interchange fees for EFTPOS transactions to zero. The application also recommended that the Australian Payments Clearing Association (APCA) consider measures to improve access as part of the renewal of the current authorisation of its Consumer Electronic Clearing System regulations and procedures due by early September 2003. The Board, through the Bank, supported this application.

In early August, after taking submissions, the ACCC issued a draft determination on the EFTPOS authorisation application. It was not satisfied that the proposal would, in itself, provide a net public benefit without corresponding liberalisation of access to the network. As a result, the ACCC proposed to deny the application. It suggested, however, that if the industry were to return with a suitable proposal for addressing access within a concrete timeframe, a net public benefit may result such that the ACCC could approve the interchange fee arrangements.

The logical place to address access is APCA's rules for the Consumer Electronic Clearing System. In the Board's view, APCA and its members need to develop a framework within these rules to provide fair and open access to new and existing network participants, based on appropriate technical, financial and operational conditions. The current EFTPOS network is complex, and there are difficult technical and business issues to confront, but there are a number of steps that could be

taken to address these access issues. These could include a set of business rules that would provide access rights to all firms that had been admitted to membership of the Consumer Electronic Clearing System. This would replace the need for prospective participants to negotiate separate commercial arrangements with all existing members. The rules would also provide rights to direct interchange links between members, subject to appropriate efficiency-based criteria; APCA would take responsibility for ensuring that links were established in a timely manner, with costs allocated on a fair and transparent basis. The Reserve Bank has put these views over recent months both as a member of APCA and to the ACCC.

In the longer term, the Board believes that the current technical structure of the network is likely to need to be reassessed in the light of developments in technology and in payment systems both in Australia and abroad. This would provide an opportunity to address more fully the issue of fair and open access with a view to promoting competition and efficiency in the EFTPOS system.

Although they have not yet come to the fore, similar issues arise in Australia's ATM network, where realisation of the potential benefits of moving to a direct charging regime depend on ensuring that competitive pressures are maximised by an access policy that does not place unnecessary barriers in the way of potential entrants, especially deployers of ATMs.

A longstanding concern of the Board remains the interchange fee arrangements of one particular debit card product – the Visa-branded debit card. Visa debit cards are linked to deposit accounts, typically at smaller financial institutions, and do not require PINs to be entered at the point of sale. However, issuers of these cards currently earn the same interchange fee rates as for credit cards, even though features of the product and costs of providing it are quite different.

The Bank has recently held discussions with Visa and financial institutions that issue Visa-branded debit cards. Visa and its members are considering a number of changes to the product. The Board is encouraged that some of the proposals under discussion are attempting to meet its concerns about interchange fees for this product. The Board is hopeful that appropriate changes can therefore be achieved over the coming months.

A related issue is the so-called "honour-all-cards" rule of Visa and MasterCard which effectively ties acceptance of other cards within the brand to acceptance of that brand's credit card. This rule effectively requires merchants accepting, for example, Visa credit cards also to accept Visa debit cards (and vice versa). While the Board has not previously examined the operation of this rule in Australia, the recent settlement in a major court case in the United States brought by large merchants against the card schemes has resulted in an agreement to eliminate the rule in that country. The effect of this settlement is that merchants can make separate decisions about whether to accept credit cards and debit cards offered by a scheme. This development has raised the issue of the applicability of this tying rule in Australia. The Reserve Bank has asked Visa whether it intends to maintain this rule in Australia and, if so, to identify the public benefits of doing so. As MasterCard does not currently have a debit card product in Australia, the issue has not arisen with MasterCard.

ATM NETWORKS

In previous Annual Reports, the Board has also expressed concern over interchange fees paid in the ATM network for so-called "foreign" ATM transactions. These bilaterally determined interchange fees are paid by the card issuer to the financial institution which owns the ATM, and generally set a floor on fees paid by cardholders for using another institution's ATM. The Joint Study found that foreign ATM fees charged to cardholders are considerably more than the cost of providing the service. Furthermore, there was no evidence that competitive forces would bring these fees more closely into line with costs.

As an alternative to the current interchange fee arrangements, the Joint Study suggested that a "direct charging" regime might improve transparency and promote competition in the pricing of ATM services. Under this pricing model, ATM owners could charge customers of other financial institutions a transaction fee which would be clearly displayed to customers at the

ATM. That fee would be debited to the cardholder's account along with the cash withdrawal, and the resulting amount settled between card issuers and ATM owners.

In March 2003, an industry working group of ATM owners including banks, building societies and credit unions released a discussion paper on a proposal to remove bilateral ATM interchange fees and move to a system of direct charging. Under this proposal, an ATM owner would be free to recoup its costs through a direct charge on cardholders using its ATM, rather than through an interchange fee paid by the card issuer. The Board supports this proposal to eliminate hidden fees and believes that it would lead to greater competition in the ATM market.

In response to concerns about the proposal expressed by a consumer organisation, the industry group is studying direct charging experience overseas and surveying potential consumer reaction in Australia toward such a regime. The Board's own work in this area suggests that a direct charging regime is likely to result in much greater availability of ATMs, particularly in locations where there were previously none. Some of these ATMs are likely to charge a higher fee than banks currently charge on their machines. Nevertheless, many ATMs are likely to continue to charge less than the "convenience" ATMs, providing consumers with choice.

The Board strongly encourages the industry to finalise the proposed reform by the end of 2003.

PURCHASED PAYMENT FACILITIES

As foreshadowed in last year's Annual Report, the Board has been working to rationalise the regulatory framework for purchased payment facilities in Australia. The current framework is the result of a recommendation by the Wallis Inquiry, which took the view that new electronic money payment facilities had the potential to become an important element in the Australian payments system. The Inquiry did not want providers of such facilities to be restricted to traditional financial institutions but it concluded that providers of such facilities may need to be subject to prudential regulation. The Reserve Bank was given very broad and wide-ranging powers under the *Payment Systems (Regulation) Act 1998* for the regulation of purchased payment facilities (that were not supervised by APRA). More recently, as a result of reforms to financial services licensing, ASIC has also been given responsibilities in this area.

The distribution of responsibilities for purchased payment facilities among APRA, ASIC and the Reserve Bank has generated some overlap and uncertainty among potential participants. At the same time, market developments have not supported the need for the extensive regulatory structure envisaged by the Wallis Inquiry. As a result, the Board is seeking comments on general exemptions from regulation, consistent with the *Payment Systems (Regulation) Act 1998*, that will reduce the potential for regulatory uncertainty and burden on smaller, low-risk purchased payment facilities. In order to avoid regulatory duplication for other facilities not falling under these exemptions, the Reserve Bank also intends to rely, to the extent practical, on ASIC's financial services licensing regime, which also requires licensing of purchased payment facilities under the *Corporations Act 2001*. Subject to comments on its proposals, the Board aims to have the new arrangements in place by end 2003.

RETAIL PAYMENTS STATISTICS COLLECTION

In 2003, a major component of a long-running project to improve the data on retail payments was completed. When the Board was formed in 1998, data on the retail payments system were sparse and of low quality. The Reserve Bank had been collecting and publishing data on credit and debit card transactions monthly since 1994. The data were collected from domestic banks and a few foreign banks that issued cards in Australia. Data on other payment instruments such as cheques and direct entry transactions were collected annually by APCA. These data were collected over a one-month period during the year and were not timely.

Accordingly, in 1999, the Bank started a project to design a collection of a more comprehensive and timely set of data on retail payment systems. The project involved determining which data would be desirable to collect, liaising with institutions on their data needs and on the practicalities of collection, introducing new forms, guiding participants through the new process and working with them to ensure a consistent and accurate series. The project came to fruition in July 2003 when the Reserve Bank began publishing the

first data from the new collection. Further series will be published over coming years.

The new collection increases the number of direct reporting institutions from 14 under the old transaction cards reporting, to more than 50. New participants include larger building societies and credit unions and their industry service providers and some non-deposit taking institutions (including, for example, the Reserve Bank itself and charge card issuers) that are significant providers of payment services. Data for a number of other smaller institutions, primarily credit unions, are obtained indirectly through the institutions that act as their agents. The new collection redefines a number of series and adds considerable detail in a number of areas. Details of the collection can be found in "The changing Australian retail payments landscape", published in the Reserve Bank *Bulletin* in July 2003. Key series from the new data collection are published monthly in the *Bulletin*; additional data can be found on the Reserve Bank's website at *www.rba.gov.au.*