

Payments system

- 3.1 The Reserve Bank of Australia has important regulatory responsibilities for the payments system and plays a key role in its operations. These responsibilities include:
- regulatory responsibility for the payments system, controlling risk and promoting efficiency and competition;
 - providing facilities for final settlement of payments system obligation; and
 - participating in the system as banker for the Australian Government, some state governments and other customers.¹
- 3.2 In recent years greater attention has been given to the efficiency of the payments system; in particular, looking into the various means of payment and the associated costs of providing and using them. This is particularly important in the retail payments system as over 10 million non-cash payments are made every day.²
- 3.3 On the 24 February 2005, the PSB released draft standards for the EFTPOS and Visa Debit payments systems for public comment. The proposed standards seek to address the distortions in price and costs

1 Reserve Bank of Australia. About the Australian payments system. [www.rba.gov.au/Payments System/AustralianPaymentsSystem/about_the_australian_payments_system](http://www.rba.gov.au/Payments_System/AustralianPaymentsSystem/about_the_australian_payments_system), viewed 7 March 2005, p 2.

2 *Payments System Board Annual Report 2004*. 2004, RBA, Sydney, p 1.

of using the different types of payments.³ The draft standards propose to:

- reduce the EFTPOS interchange fees paid to the merchant's bank from around 20 cents per transaction to around five cents.⁴
- reduce the Visa Debit interchange fee paid to the cardholder's bank from an average of around 40 cents, to a maximum of around 15 cents;⁵ and
- remove the current requirement that merchant's accepting Visa credit cards also have to accept Visa Debit cards (it would also formally apply the no-surcharge standard to the Visa Debit scheme).⁶

3.4 The RBA also announced that it did not intend, at the current time, to regulate the American Express and Diners Club card payments system and in return, both American Express and Diners Club had agreed to:

- reword clauses in their merchant agreements that currently prohibit merchants from encouraging cardholders to use another card; and
- publish the average merchant service fee in Australia on a quarterly basis.⁷

3.5 Since the February hearing the committee has had a chance to consult a number of key stakeholders. With the exception of the initial reforms nearly two years ago (lowering of the Bankcard, MasterCard and Visa interchange fees from around 0.95 per cent to around 0.54 per cent of the amount spent which produced savings of around \$580 million)⁸, there is a difference of opinion, depending on who you talk to, about the draft 24 February 2005 proposals.

3.6 For some, the concern is based around the RBA's need to regulate rather than allow the normal competitive forces to establish appropriate fees and charges. Others are concerned about the staged reform process and the possible advantage this may give to certain stakeholders who will be operating outside of the "designated" areas

3 Payments System Reform, *RBA Media Release*, 24 February 2005, p 1.

4 Payments System Reform, *RBA Media Release*, 24 February 2005, p 1.

5 Payments System Reform, *RBA Media Release*, 24 February 2005, p 1.

6 Payments System Reform, *RBA Media Release*, 24 February 2005, p 2.

7 Payments System Reform, *RBA Media Release*, 24 February 2005, p 2.

8 *Transcript*, 12 August 2005, p 23, *RBA Bulletin*, August 2005, 67.

of the payments system. Another area of concern, real or perceived, is the possibility that banks will try and recover the reduced interchange fee revenue by other charges. Merchants, whether they are small or large operators, claim that they will be unable to pass on costs to consumers due to the very competitive nature of retailing. Finally, under the existing payments structure, the merchants have already invested a great deal of money in setting up their EFTPOS infrastructure which provides \$10 billion in cash out each year to their customers with little or no financial support from the banks. This situation, according to the merchants, will worsen, not improve, under the proposed reforms

3.7 At the August hearing, the Governor, Ian Macfarlane gave a very robust defence of the RBA's reform agenda.⁹

3.8 In summary, the Reserve Bank's case for reform is outlined below:

- The consumers have benefited from the \$580 million savings in interchange fees although you cannot prove directly that prices have fallen. This amount represents between 0.1 and 0.2 per cent of consumer expenditure and with the CPI running at 2.5 per cent per annum it is not possible to identify something that is between one-twenty fifth and one-twelfth and a half.¹⁰
- The net savings is estimated to be around \$400 million after you deduct around \$180 million for increased bank charges.¹¹ The cut back in reward benefits cannot be as easily quantified but the Bank estimates that they are considerably less than \$180 million. By way of comparison, QANTAS reward points are now worth 0.6 per cent of the value of each transaction compared to 0.8 per cent prior to the reforms.¹²
- In a competitive retailing industry, costs and prices are strongly related, therefore it is inconceivable that a reduction in costs did not have an effect on prices.¹³
- The whole point of the reform process was to make the users of the payments system better off, because the Bank believed that

9 *Transcript*, 12 August 2005, p 23-25.

10 *Transcript*, 12 August 2005, p 23.

11 *Transcript*, 12 August 2005, p 26.

12 *Transcript*, 12 August 2005, p 26-27.

13 *Transcript*, 12 August 2005, p 24.

the providers of payment services were charging too high a price.¹⁴

- The Reserve Bank says that it is a mistake to assume the consumers are simply cardholders. Consumers include all types of payment forms; including the two types of cardholders - transactors and those who actually borrow against their cards. Consumers also include all the merchants. In aggregate, this group of people are better off to the tune of \$580 million.¹⁵
- The Bank acknowledges that cardholders are not as well off under the reforms because they have suffered a reduction in the subsidy they were receiving. These people were using someone else's credit and not paying for it. The Bank makes no apology for this because they are making the totality better off.¹⁶
- According to the Bank, one objective of the reform process is to reduce or eliminate the cross-subsidies and ensure the costs incurred by the various payment methods are actually reflected in the price or charge for that particular service.¹⁷ If this results in higher card fee charges and less rewards/inducements then this is the price people will have to pay in order to achieve a more equitable and open payments system.¹⁸
- The Reserve Bank maintain that some of the allegations about lost market share between those bound by the four-party scheme and those that come under the three-party scheme will only be tested once data is published about the respective market shares.¹⁹ This has now occurred and the Bank in its August 2005 Bulletin published aggregated market shares between the two schemes.²⁰ The data reveals for the first time that,

...that around 83 per cent of the value of purchases on credit and charge cards are currently undertaken with a Bankcard, MasterCard or Visa. These schemes account for a slightly higher share of the number of purchases, reflecting the fact

14 *Transcript*, 12 August 2005, p 24.

15 *Transcript*, 12 August 2005, p 24.

16 *Transcript*, 12 August 2005, p 24.

17 *Transcript*, 12 August 2005, p 24, 27.

18 *Transcript*, 12 August 2005, p 24.

19 *Transcript*, 12 August 2005, p 24-25,

20 *RBA Bulletin*, 12 August 2005, p 69, Table C2, p S28

that the average purchase made through these schemes is lower than the average purchase made through the American Express and Diners Club schemes.²¹

- According to the RBA in its August 2005 Bulletin, most of the recent increase in market share (by value) by the charge cards from 14.6 per cent in June 2003 to 16.5 per cent in July 2004 was largely concentrated in the second quarter of 2004 which coincided with the introduction of the Westpac and National Australia Bank issued American Express cards and market share has not changed significantly since that release.²²
- These types of “joint/hybrid” cards are not a result of the reform process. They are common through out the world .
- Putting this into perspective, the Bank estimates that the two percentage point increase in share by American Express and Diners would have increased merchant services fees by \$44 million but this has already been factored into the cost saving to merchants of \$580 million over the same period.²³

3.9 The committee believes that it is too early to conclude that the increase in market share is just a one-off as a result of the introduction of the bank-issued AMEX cards and/or the co-branded Diners card. It will depend very much on whether merchants are prepared to surcharge or steer customers to less costly cards and this will, in the longer term, determine the extent to which particular cards can continue to offer and pay for the higher rewards schemes.

3.10 In response to concerns that the charge cards operate outside of the designated four-party scheme, the Governor made it very clear that American Express and Diners Club have had to agree to three changes:

- publication of their merchant services fees;
- abolition of the no-surcharge rule (ie. merchants can charge customers extra if a more expensive card is used); and
- abolition of the no-steering provisions (ie. merchants can ask customers to use a less expensive card).²⁴

21 RBA *Bulletin*, August 2005, p 69.

22 RBA *Bulletin*, August 2005 p 69.

23 RBA *Bulletin*, August 2005, p 70.

24 *Transcript*, 12 August 2005, p 26.

- 3.11 The recent publication of merchant fees shows that the combined average Bankcard, MasterCard and Visa has fallen from around 1.46 per cent of purchase value in September 2003 to around 0.97 per cent in June 2005. Over the same period, American Express has dropped from 2.60 to 2.38 and Diners Club has dropped from 2.35 to 2.31.²⁵
- 3.12 Since the commencement of the reforms, many new entrants have entered the credit card market and are now offering cards at far lower interest rates to consumers who actually borrow on a credit card.²⁶ These cards are giving the credit users a cheaper alternative as apposed to the transactors who pay off their credit balance monthly. The two-thirds of credit card holders who actually borrow are benefiting from the lower monthly interest charges of around 10 per cent as apposed to the more traditional 16-18 per cent and in the process the new entrants are still making money.²⁷ This has now prompted two of the banks to offer similar low cost cards presumably to retain existing cardholders who do rely on credit and to compete against the new entrants.²⁸
- 3.13 Mr Macfarlane was emphatic that no matter what type of card customers choose to suit his or her needs, it should not be done on the basis of cross-subsidies which ultimately distort the payments system.²⁹
- 3.14 In response to concerns that many retailers are not in a position to surcharge let alone negotiate a lower merchant service fee with their bank, Mr Macfarlane stated that around five per cent are already surcharging and 45 per cent are considering surcharging.³⁰ The Governor also believed that merchants as a whole have underestimated the power they have at their disposal due in part to over 30 years of restrictions that have been placed on them. They are now in a position where they can start to exert some power.³¹
- 3.15 Notwithstanding the fact that small retailers possibly have less power to negotiate individually with each credit card provider, many

25 RBA *Bulletin*, August 2005, Table C.3, p S29.

26 *Transcript*, 12 August 2005, p 27.

27 *Transcript*, 12 August 2005, p 31-32.

28 *Transcript*, 12 August 2005, p 32.

29 *Transcript*, 12 August 2005, p 27.

30 *Transcript*, 12 August 2005, p 28.

31 *Transcript*, 12 August 2005, p 28.

already do not accept American Express and Diners because of the higher fees.³²

- 3.16 In the US where MasterCard and Visa compete in a deregulated market, the interchange fees went up, not down, simply because of the peculiarity and structure of the payments system (surcharging and steering are not allowed). One would raise their fees and in return offer more rewards and the other would compete by doing the same and both would then go to the merchants and raise their fees on the premise that so many people use their cards that they could not afford to opt out of the scheme.³³ The Reserve Bank Governor said that this system defied the normal competition policy theory not because of lack of transparency but because of the unique structure and agreement setting processes. The interchange fee rose from 1.3 per cent in 1994 to 1.65 per cent in 2004 while over the same period the merchant services fee rose from just under 2.0 per cent to slightly over 2.2 per cent.³⁴
- 3.17 If the payments system, and in particular the inter change fee, had been left unregulated in Australia, the Reserve Bank Governor claimed that fees would continue to rise as had occurred in the US where there had been no regulation of the payments system. Mr Macfarlane stated that as difficult as regulation may be, it is the only way to bring about some parity between the cost incurred and prices charged for each payment type within a reasonable period of time.³⁵
- 3.18 Some committee members questioned whether the US experience was rather a consequence of a failure to ensure merchants were allowed to surcharge on particular cards and/or encourage customers to use one card rather than another. In the US (as was until recently the case in Australia) the card companies require that merchants do not surcharge or steer customers away from a particular card. The Reserve Bank Governor, by way of a partial concession, agreed that the big difference between Australia and the US was the inability for US merchants to surcharge or steer customers to less expensive cards.³⁶ The question which arises therefore is whether the reform objectives could have been achieved in Australia without regulating

32 *Transcript*, 12 August 2005, p 29-30.

33 *Transcript*, 12 August 2005, p 29.

34 Speech by I. J. Macfarlane, Governor of the RBA, *Gresham's law of Payments*, talk to AIBF Industry Forum 2005, Sydney 23 march 2005, p 2-3.

35 *Transcript*, 12 August 2005, p 29-30.

36 *Transcript*, 12 August 2005, p 30.

the interchange fees, but simply by ensuring greater transparency and in particular an ability on the part of merchants to surcharge and steer customers to less expensive cards. Fundamental to this proposition, of course, is the ability and willingness of merchants to exploit their newly gained freedom.

- 3.19 The reform agenda will enable merchants to improve their bargaining position. The big retailers are in a far better position to negotiate lower merchant services fees. Mr Macfarlane hopes that the smaller retailers will start talking to one another and also improve their bargaining position. After 30 years, merchants are now in a position to adopt the user-pays principle and not feel powerless against the banks and credit card companies.³⁷
- 3.20 The issuers of Visa Debit Cards have also been critical of the reforms because of the reduced revenue they will receive as a result of any lowering of interchange fees. Mr Macfarlane was quick to point out that the Visa Debit card is debit masquerading as a credit card. Card holders are using their own money every time they make a debit transaction but merchants have to pay a fee as though it was the more expensive credit card transaction.³⁸ According to the Governor, this is a basic case of misrepresentation and should be stopped.³⁹
- 3.21 What is happening to the debit card/EFTPOS industry is central to the payments system reform agenda. Mr Macfarlane said,
- The more fundamental issue is the whole future of the debit card industry or the EFTPOS industry. In Australia at the moment we have this peculiar situation—we are the only country in the world that has it—whereby, if I am a bank and issue you with an EFTPOS card, every time you use it I have actually got to pay money out. But if I issued you with a credit card, every time you use it I receive money in. In the long run what do you think the banks are going to do? In the long run it is in their interest whilst this continues to allow the whole EFTPOS system to dwindle and move everyone into credit cards. Our starting point to this deregulation was very difficult. That is an absurdity which we have in Australia for historical reasons that no-one fully understands

37 *Transcript*, 12 August 2005, p 30.

38 *Transcript*, 12 August 2005, p 31.

39 *Transcript*, 12 August 2005, p 31-32.

and no-one else in the world has. We have a starting point that is very difficult to deregulate from.⁴⁰

- 3.22 Interestingly, the Governor told the committee that industry is now asking the RBA to step in and reform the ATM system so it cannot be said that the Bank is hell bent on regulation.⁴¹ The Bank has held back to see if the industry could come up with a workable model but that process seems to have stalled and the Payments System Board will have to decide at its next meeting what the next step will be with regard to issues of transparency of ATM owner charges customers and the transparency of the price that the customer's bank charges.⁴²
- 3.23 Once the reform agenda is firmly established, the Reserve Bank expects that consumers will select the payment system that best meets their specific needs. Hopefully consumers will be able to do this based on the best available information taking into account all the costs, fees and charges that are incurred through the entire transaction chain and not simply on the level of rewards that may be offered.
- 3.24 The committee will follow carefully the legal challenges to certain aspects of the proposed reforms and will be interested to see how the Payments System Board deals with the ATM system.
- 3.25 The committee will look at this issue again next year with a view to holding a public inquiry into the reform of the payments system which would involve all stakeholders, including consumers (card users).

The Hon Bruce Baird MP

Committee Chairman

8 September 2005

40 *Transcript*, 12 August 2005, p 31.

41 *Transcript*, 12 August 2005, p 32.

42 *Transcript*, 12 August 2005, p 32-33.

