

## Malcolm Edey: The current agenda in retail payments regulation

Address by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, to the Cards & Payments Australasia 2012 Conference, Sydney, 20 March 2012.

\* \* \*

Once again I thank the organisers of Cards and Payments Australasia for the invitation to speak here today, my third time at this event. Looking at the conference agenda for these two days, what stands out to me is the intense focus on innovation. This is an industry where there is a great deal of work going on in areas like online payments, mobile payments, new card-payment products, and improvements in security. All of these are signs of a vibrant industry.

My subject for today is the current agenda in retail payments regulation.

The Reserve Bank has had a direct role in payments regulation since 1998. Following the report of the Wallis Committee, the Payment Systems (Regulation) Act in that year established the basic governing structure that we have today. It set up the Payments System Board within the Reserve Bank with a mandate to promote efficiency and stability. And the Act gave the Bank significant powers to that end. They include the power to designate a payment system and to set standards in areas like network pricing and various aspects of a payment system's internal rules.

One of the first areas of focus for the Board was on credit card schemes. But the remit of the Payments System Board extends much more broadly than just card payments, or even retail payments more generally. The Board also has oversight responsibilities in the high-value system as well as for clearing and settlement facilities in Australia, and it has been increasingly devoting attention to the second of those areas. I expect that trend will continue, given the rapid changes that are taking place internationally.

Today, though, I want to focus on our work on retail payments.

Public consultation is an important part of that work. In some matters we have a formal obligation to consult, but that is not the only reason for doing it. The issues involved in payments regulation are often complex and we see it as very important to engage with industry, and other stakeholders, to make sure we have all the relevant facts when we make our decisions.

Currently there are four areas of retail payments regulation where we are in various stages of public consultation. I want to take the opportunity to review those briefly today.

The first is the **surcharging standard** for card payments.

The question here is a simple one: should card schemes be allowed to place limits on merchant surcharging for card payments, and if so, in what form? That question was first examined by the Payments System Board during its initial round of credit card reforms, which were announced in 2002. The Board's decision, as you know, was to require the removal of rules against surcharging. That was part of a wider reform package that also included a standard for interchange fees.

A newcomer to this debate might ask the question, why did we take action against no-surcharge rules when the effect would be to make some cardholders pay more for their transactions?

It's worth briefly re-capping the answer to that.

One of the distinctive features of card payment systems, historically, has been a lack of alignment between pricing and decision-making power. In a typical credit card transaction, the person who makes the choice of payment instrument is usually the cardholder, but the

transaction fee is incurred by the merchant. In simple terms, the cardholder makes the decision but the merchant pays the fee.

The interchange arrangements that underpin this fee structure have tended to be configured in a way that rewards issuance and usage of cards while adding to merchant costs. We have observed in this structure that competition tends to push fees up rather than down because, the higher the fee, the greater the capacity to reward cardholders for using a given card. Scheme rules prohibiting surcharging have had the effect of reinforcing that pattern, because they prevent price signals from flowing to the person who chooses the payment instrument. This was the basic logic for the decision to prevent schemes from making rules against surcharging.

A decade later, what can we say about the effects of that decision?

I can best answer that by describing the results of the reform package as a whole, because the different elements of it were closely inter-related. The clearest impact has been a reduction in card payment costs. In the case of the four-party credit card schemes, the average merchant service fee has fallen by about 60 basis points. Although the three-party schemes are not regulated in this way, they have voluntarily accepted the surcharging standard and have been subject to some of the same competitive pressures. As a result, merchant service fees for the three-party schemes have fallen by a similar amount.

Since the adoption of the reforms, the prevalence of surcharging has significantly increased. According to data from East & Partners, around one-third of Australian merchants now impose a surcharge on at least one of the credit cards they accept. The figure is higher for the largest merchants<sup>1</sup>, where the proportion surcharging is slightly over half. It also seems likely that surcharging will become more widespread in the future – only 12 per cent of merchants say they are not at least considering applying a surcharge.

In the early stage of the reform process the Payments System Board considered, but did not proceed with, an alternative approach that would have allowed schemes to limit surcharging to an amount linked to the cost of acceptance<sup>2</sup>. The Board's view, on balance, was that giving merchants the right to surcharge was important in realigning incentives and in giving merchants more bargaining power in the determination of fees. The Board also took the view that market forces could be expected to work as a discipline against excessive surcharging.

The growth of surcharging has, however, brought to light practices that look inconsistent with the efficiency objective. While comprehensive data are not available, there is significant anecdotal evidence of some surcharging that is not reasonably related to the cost of acceptance. One example is the practice of blended surcharging, where a merchant might be recovering costs on an average basis without distinguishing between high- and low-cost card payments. Another would be where a surcharge simply exceeds any reasonable estimate of the cost of acceptance. Although these practices do not appear to be widespread, they are of concern from a payments efficiency point of view because they can distort consumer choices about the payment methods that they use. They go against the principle I stated earlier of allowing the efficient flow of price signals to the economic decision maker. It is for these reasons that the Bank reopened consideration of the surcharging standard last year

A draft revision to the standard was released in December, and is now in the final stage of consultation. If adopted, the revised standard will allow schemes to limit surcharging to a reasonable cost of acceptance, but schemes will not be able to prohibit surcharging altogether or prevent merchants from recovering their costs. For this purpose, the cost of acceptance will be defined as including, but not being necessarily limited to, the merchant service fee.

---

<sup>1</sup> Currently, those with annual turnover greater than \$530 million.

<sup>2</sup> The existing Standard does allow the merchant and the acquirer to agree to do so.

I want to stress that we should not view this change as a panacea that will do away with every consumer complaint. It is also important to make clear that the Reserve Bank is not setting itself up as a regulator of merchant behaviour. What the proposed standard does is to empower the schemes to take action where surcharging is clearly excessive. It will be in their own interests to make use of this power. At the same time, the proposal preserves the original goal of giving merchants the right to recover their costs. In that way I think it strikes a reasonable balance and it should strengthen the incentive for schemes to compete in lowering their fees to merchants. The less a scheme costs to merchants, the lower will be the permissible surcharge.

The second policy area I want to talk about is the Reserve Bank's ***strategic review of payments innovation***.

This was the subject of my talk here a year ago and so I can be much briefer in my remarks today.

When we talk about innovation, we need always to keep in mind the distinction between what is *proprietary* and what is *systemic*. The proprietary sphere covers any area where a service provider can act independently and use an innovation to gain a competitive edge. The payments industry is very good at innovating in that way, and we see the evidence of it in many of the things that are being talked about in today's conference. Systemic innovation is much harder to achieve because it requires co-operation in the collective interest, even when there may be no strong proprietary benefits at the level of the individual service provider

It's this second area that is the focus of the current review. We are asking the question, are there any gaps in the system that can only be addressed collectively, and if so, how do we make that happen?

Submissions to the review have been helpful in identifying a number of gaps of that nature. Here are the main ones:

- ***Transmission of data with payments.*** This has been a long-time concern of businesses, who often find the 18 character limit under the Direct Entry system too restrictive. Often this drives businesses to use cheques so that paper-based information, like an invoice, can accompany the payment. Alternatively they might separate the payment and the remittance information, and then rely on a separate process to reconcile them at a later stage. This is likely to be expensive and error prone.
- ***Use of international standards.*** I won't dwell on this one, but in some ways it is related to the previous point, because the international framework for messaging standards provides for transmission of a significant amount of additional data. I think there is widespread acknowledgement within the payments industry that international standards should be adopted wherever possible.
- ***Timeliness of Payments.*** As communications technology advances, there is little doubt that people are expecting greater immediacy in many areas, and payments are no exception. It is currently not possible for me to make a payment to someone who banks with another bank and for them to be able to use those funds within a short space of time. In some circumstances this lack of capacity can be a significant problem – for instance when someone is waiting on an emergency government payment. This seems like an area we could improve on and it is increasingly becoming a focus overseas. Likewise, the fact that payments cannot occur between banks out of normal business hours seems out of line with the 'always on' world we now live in.
- ***Addressing Payments.*** Cheques are always a good reminder of the things that are missing in our electronic payments. I can pay someone with a cheque when all I know about them is their name. But if I want to make an electronic payment, I

typically need to know a 6-digit BSB number and a 9-digit account number, things the receiver probably cannot readily provide. People are finding partial workarounds that make use of mobile phone numbers or email addresses, but we are yet to have a truly seamless system.

All of these are areas where any progress will have to be made co-operatively, because they are characteristics of the network, not just of the individual players. But that also means that a decision to move ahead in any of these areas needs to take into account the costs and benefits across the system as a whole, both for service providers and end-users.

That raises the broader question of whether there needs to be a change in governance arrangements in the industry, so as to make them more conducive to innovation in general. There are a number of reasons why co-operative innovation can be hard to achieve. Industry participants have differing commercial interests, and even factors like the timing of their investment cycles can make coordinated actions difficult. A change in messaging standards or timeliness of payments might benefit the public, yet remain hard to achieve because there is no proprietary benefit to the individual service providers. The challenge is to find a way of determining when innovations of that nature are in the public interest and, if so, to ensure they go ahead. Industry-level decision making may be only part of the answer.

Along with these questions of governance, the critical decisions of the review are likely to relate to the architecture of the payments system. By that I mean in particular the question of whether there is a place for additional centralised architecture in the Australian payments system. A possible argument for that proposition is that centralised systems may be better able to innovate than bilateral systems. They may also be structurally more efficient when a network has a large number of participants, and better suited to providing open access to new players. The possible need for a centralised architecture is also relevant to the question of faster (or real-time) payments at the retail level.

The consultation process has brought out a range of views on this subject. Some argued that the existing architecture provided a sufficient level of centralisation, or pointed to the potential cost of moving existing systems onto a hub. Others focused on the potential for some form of hub to provide real-time retail transfers and went as far as proposing a governance framework for such a system. We should be in a position to announce some conclusion on that in the near future, along with the other matters I've outlined today.

Let me turn briefly to the third and fourth areas of current policy work.

Issue number three is the ***regulatory framework for the eftpos system***.

One of the very significant developments in recent times has been the establishment of ePAL as a national scheme for eftpos payments. The Reserve Bank has welcomed that development because we see it as strengthening competition among card payment schemes in the domestic market.

As a consequence of the establishment of ePAL, the eftpos system now works largely as a multilateral network. But much of the existing framework – the Access Regime and interchange fee standards – was designed in reference to the earlier bilaterally-based system. As a result, the relevance and applicability of the existing framework will need to be reviewed.

One change that has already been made was the decision in November 2009 to bring multilateral eftpos fees under the same interchange fee standard as applies to scheme debit cards. But further changes to all elements of the regulatory framework for the eftpos system will need to be considered. Some of the reasons for that are purely technical, because the regulations as they stand do not reflect the system's current structure. But there are also some more substantive questions as to whether we need to maintain the currently existing arrangements and, if so, in what form. We expect to complete the consultation on those questions and reach conclusions later in the year.

The fourth issue on which we are currently consulting is ***retail payments system resilience***.

Much of the work of the Payments System Board over the years has been in regulation and oversight of what we might call self-contained systems: things like a credit card network, or a clearing and settlement facility. But the Board's remit extends more broadly to the efficiency and stability of the payments system as a whole. On any common sense reading, the payments system encompasses the capacity of person A to make a payment to person B when they bank with different banks. The ability of the system as a whole to deliver that basic service, dependably and efficiently, clearly comes under the Payments System Board's overall policy mandate.

That is why it is appropriate for the Board to be conducting the innovation review that I've just outlined. It relates to the efficiency of the system as a whole. It is also why it is appropriate for the Board to take an interest in the operational resilience of individual payments service providers.

In recent years there have been a number of high-profile outages affecting the availability of services to significant numbers of customers. Obviously individual banks have a strong incentive to minimise the risk of these sorts of incidents. It affects their own reputation when something goes wrong and it impairs their ability to meet the needs of their customers.

But there is also a system-wide dimension to these problems. All participants in the system, and all users of payments services, have an interest in high standards being maintained across the system as a whole, not just their own component of it. When Bank A's systems go down, customers of all the other banks are affected, because their capacity to exchange payments with customers of that bank is impaired.

For some time the Reserve Bank has been monitoring significant retail payment outages, and following up with the relevant banks as to diagnosis and appropriate remedial actions. So in a sense, a role for the RBA in this area is not new. What we are now proposing is to formalise that role in two ways. First, we have announced that we will be putting in place a more systematic reporting regime for retail outages. And second, we have begun a consultation process with the banks as to whether further measures are needed to improve operational resilience across the system.

## **Conclusion**

Those then are the four areas in retail payments regulation where the Reserve Bank is currently conducting consultations with industry, and with other interested parties. What ties all of these things together is the focus on efficiency and competition. In many ways competition is working well to deliver benefits to end users. But in an industry of complex network interactions like this one, there is an important role for regulation in promoting efficient outcomes.

As I said earlier, in carrying out that role the Payments System Board takes very seriously the need to consult, both with industry and end-users. Many of you here today will have participated in that process, and I take the opportunity to thank you for your co-operation.