

Malcolm Edey: Competition and regulation in the card payments market

Speech by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the 15th annual conference "Cards & Payments Australasia 2010", Sydney, 15 March 2010.

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It's a pleasure to join you today for this 15th annual conference of Cards and Payments Australasia.

As a newcomer to this event, I want to take the opportunity to talk about the economics of the card payments industry, how it differs from other markets, and also about the Reserve Bank's approach to card payments regulation.

Card payments are an important part of the infrastructure of a modern economy. All of us here today, I'm sure, appreciate the convenience of being able to pay by plastic. More to the point, card payments account for a big slice of spending in the retail economy. There are currently roughly 40 million debit cards on issue in Australia, and around 20 million credit and charge cards. On those cards, nearly 10 million transactions are made every day, with a daily value of around one billion dollars. To put this in some sort of perspective, the value of spending on personal cards is about half the size of household consumption.

Card payments are a big proportion of the *number* of non-cash payments in the economy, but only a small proportion of their *value*. More card payments are made in Australia than the other main means of non-cash payments – that is, direct debits and credits, BPAY and cheques – combined. And yet, in terms of value, they make up less than three per cent of the total. This illustrates that, while card payments have few implications for the overall stability of the financial system, they have significant implications for its efficiency.

In this context, efficiency includes not just the efficiency of the processes by which payments are made, but also the way in which price signals function to allocate resources and guide decisions. The RBA has a mandate to use its regulatory powers, where needed, to promote that broader efficiency goal through its Payments System Board.

I'll talk more about the Board's activities in a moment. But let me start with some observations about the economics.

One of the first things I learned when I started to work on card payments is that the economics of this industry are not simple. In the simplest markets, we can think of supply and demand as being determined by a set of independent decisions made by producers and consumers. People will base their decisions on factors like price, quality and the cost of production. If it's a competitive market, we'd expect it to have certain characteristics, such as that: other things equal, a lower price means more demand; producers compete to offer the product at the lowest price they can; and the price mechanism promotes efficiency by guiding resources to their best use.

In practice, no market will meet those conditions perfectly. But the card-payments market has some particular qualities that make it very different from the stylised description I've just given.

First, the card payments market is subject to *network externalities*, which is another way of saying that the cost-benefit decisions made by the various players are highly interdependent. The value of the service I get from being part of a card network depends, in part, on the size of the network. Cardholders value having a particular card in their wallet because they know the card is widely accepted. And merchants value the capacity to accept a card because it's widely held. This aspect of the market adds a level of complexity to the pricing strategy, because the suppliers of card services will want to take those externalities into account. They have an incentive to adopt pricing strategies that promote the size of their networks.

The second difference is that card payments services are a *joint product*. The purchaser of the service, in any given transaction, is not the only one who benefits from it. When a card is used to make a payment, it delivers a service jointly to both the payer and the receiver of the funds.

Thirdly, the card payments market, particularly in the credit cards space, has evolved in such a way as to have a very unusual characteristic. That is, that the decision-maker in a transaction – the person who decides which payment method to use – is generally not the person who is on the receiving end of the price signal. To be specific, it is typically the purchaser who decides whether to use a card (and which card to use), but it's the merchant who, in the first instance, pays the fee associated with that decision.

So, in a world where cards are widely held and widely accepted, the effective demand for the service is determined mainly by the cardholders, while the price is charged to the merchants. This is where, in the four-party card schemes, interchange fees play a key role, because they are typically passed on to the merchant, and they therefore set the base for the merchant service fee.

It's this third characteristic that, to my mind, most clearly distinguishes card payments from other markets. We can think of examples of other markets with complex network effects, or of other markets where there are jointly-produced outputs. But I can't think of any example of a market where the separation of decision-making power from the price signal is such an integral part of the structure – the cardholder makes the decision, but the merchant pays the fee. And, in the pre-reform days, they were restricted from passing on that fee to the customer making the decision.

It remains true, of course, that merchants do have some decision-making power of their own. They can, for example, choose not to accept a card – that is, to stay outside a card network if they think it's too expensive. But this is where a fourth characteristic of the market comes into play. The card market is *highly concentrated*. In credit cards, for example, the two major schemes in Australia have a combined market share of more than 80 per cent of transactions. They have high levels of penetration of the potential cardholder market, and high rates of acceptance among merchants. These conditions can make it very unattractive for an individual merchant to stay outside a given card network, particularly in a world where the merchant doesn't know which cards a customer might be carrying. I don't say any of that as a criticism of the card schemes – it wouldn't be fair to blame them just for being successful – but it is an important feature of the market that has a bearing on competition and efficiency.

One of the consequences of the industry structure that I've just described is that competitive discipline on interchange fees has been weak. As I said before, in conventional markets, competition puts downward pressure on prices, because if you raise your price you will lose market share. But in card payments, there are significant pressures going the other way – a rise in the interchange fees charged to acquirers can allow issuers to increase their reward points to cardholders, thereby encouraging use of the card.¹ In other words, a rise in price can lead to an increase, rather than a decrease, in the effective demand for the service. Again, I can't think of any other significant market where that is the case.

This principle creates a natural tendency for average interchange fees to drift upwards over time. Within each scheme, there are multiple cards with differing interchange fees, and market share tends to shift towards those cards with the higher fees. It's an illustration of the

¹ The acquirer is the bank that services the merchant. The issuer is the bank that issued the credit card to the cardholder. In a typical credit card transaction, the acquiring bank pays an interchange fee to the issuer.

principle that, in these rather unique conditions, competition for market share tends to push the average price up rather than down.

What I've just set out is obviously not a complete description of the cards market. But I think it captures those features that are particularly distinctive, and which raise at least the potential for concerns about efficiency and the adequacy of competition.

With that background, I'll turn now to the RBA's involvement in card payments regulation.

The origin of that involvement was the decision by the Federal Government, in 1997, to implement the Wallis recommendations by giving regulatory oversight of the Australian payments system to the RBA. The Act set up a Payments System Board of the Reserve Bank, with responsibility for payments-system efficiency and stability. Among other things, the Act gives the Board the power to designate a payments system and, where a system has been designated, to set regulatory standards with respect to such things as fees and operating rules.

The Board's first major study in this area was conducted jointly with the ACCC, and was released in October 2000. That study raised a number of concerns about market practices in the industry, particularly the setting of scheme interchange fees and a range of other matters related to competition and the efficiency of price signals. Since industry attempts to address ACCC concerns about interchange fees had failed, and given that the Payments System Board had a clear mandate in this area, the Board then moved into a process of reform, starting with the credit card schemes.

After a period of consultation, the first package of credit card reforms was announced in August 2002. That package had three main elements, which were:

- A cost-based standard on interchange fees;
- Disallowance of no-surcharge rules; and
- Rules to expand access to the network.

But the Bank was always of the view that reform of the payments system needed to be holistic. So over the next few years, the reform process added a number of other elements, which covered both credit and debit cards. Some of the key ones were:

- A restriction on the honour-all-cards rule to allow merchants to make separate decisions for credit and debit cards;
- A cap on Visa debit interchange (which was also voluntarily adopted by MasterCard);
- A reduction in interchange fees for EFTPOS;
- Agreement by the three-party schemes to remove no-steering rules;
- Access regimes for a number of card-payment systems; and
- Increased transparency of interchange fees and merchant service fees.

Taken together, this expanded package of reforms was in place by the beginning of 2007.

These developments have been closely watched both by regulators and market participants around the world, because Australia was the first major country to begin reforms in this area. Subsequently, a number of other countries have taken steps of a similar nature, and some are considering the case to do so.

The sequence of reforms I've just outlined obviously has a lot of detailed elements to it. But, at a strategic level, it can be thought of as addressing the concerns about efficiency in two ways.

In the first place, the Board took the view that, left to itself, the market was delivering interchange fees that were too high. Hence they took direct action to regulate them lower. As a result, average credit card interchange fees have fallen from around 95 basis points before the reforms to around 50 basis points now. Merchant service fees associated with the large credit card schemes have correspondingly fallen (in fact by more than the reduction in interchange fees), and this in turn has put downward pressure on fees for the three-party schemes. Interchange fees for scheme debit and EFTPOS have also been reduced by direct regulation.

Secondly, the various other elements of the reform package can be thought of as working to improve the alignment between price signals and decision-making power – the issue that I spoke about earlier. One very important aspect of that is the disallowance of no-surcharge rules. It's important to be clear on the rationale for that. We're not saying that surcharging is an end in itself, or that it's going to be right for all circumstances. But rules against surcharging represent a restriction on the flow of price signals to the main decision-maker, and so the option to surcharge needs to be there. And where surcharging reflects the costs incurred in the provision of the payment service, it should contribute to efficient outcomes.

Another way of improving this alignment has been to remove restrictions on the ability of merchants to influence the choice of payment method at the point of sale. Examples of such measures were the regulation to allow separate acceptance choices on scheme debit and credit, and the dropping of no-steering rules. These things give the fee-payer greater scope to respond to the relative prices that are being charged.

Finally, moves to increase transparency have helped to provide more information to merchants and make them aware of the costs of accepting payment instruments. This transparency has supported the other elements of the reforms that have provided merchants with more competitive leverage.

I don't claim that perfection can be achieved on any of these fronts, but these were all areas where improvements needed to be made. The general principle is that, if you're paying a fee, there should be some commensurate degree of influence over the decision to incur that fee. Without that, price signals will be ineffective, and competitive pressure to keep fees down will be weak.

I've gone through that history in order to convey the overall sweep of card-payments regulation, and the general economic basis for it. Having done that, let me move on to look at the current position.

The immediate background at this point is the review of card-payments reforms that the Board undertook in 2007–2008. In thinking about the approach taken in that review, it's worth keeping in mind that the Reserve Bank has described itself as a reluctant regulator. Our general mandate with respect to the payments system is to promote efficiency and stability. For reasons that I've already described, that includes taking measures to stop fees from rising too far above efficient levels. But our preference is to do that, when we can, by promoting competition rather than by direct regulation of fees.

The results of the Board's review were presented in September 2008.

What did it find?

First of all, it found that the reforms to date had delivered clear benefits, in the form of lower costs to merchants and increased competition. In addition, it found that price signals had been strengthened, transparency enhanced, access improved, and that the competitive environment was more soundly based than it had been five years earlier. But the Board also concluded that more needed to be done. Specifically, it concluded that:

- at 50 basis points, credit card interchange fees were still too high;

- it also concluded that, even with the various reforms to date, competitive pressures were still not strong enough to put downward pressure on those fees if the regulation were removed.

Against that background, the Board set out two possible approaches for the next stage of its regulatory strategy.

The first possible approach would be to step back from interchange-fee regulation, if it could be reasonably satisfied that this was not going to result in the fees going back up again. Within that broad approach, the Board saw two ways that this objective might be met through action by the payments industry. Those were:

- by strengthening competition from alternative payment methods, particularly through development of industry-based EFTPOS and online payments schemes, coupled with further changes to honour-all-cards rules and increased transparency of scheme fees;
- and by voluntary undertakings from the credit card schemes that interchange fees would not rise.

The second possible approach put forward in the 2008 review was to maintain interchange regulation on credit card schemes, and to make a further reduction to 30 basis points. The Board indicated it would follow this path if progress on the first track was unsatisfactory.

As you know, the Board undertook to make an assessment of that in August 2009.

As you also know, the decision at that point was deferred. The Board took the view that good progress was being made by the industry, but that it wasn't yet enough to provide sufficient confidence that fees would be held down in the absence of direct regulation. So the decision was to allow some further time to assess developments. In the meantime, the Board did make one further change of a more limited nature, which was needed to put the new EFTPOS scheme on a comparable regulatory footing to scheme debit. That announcement was made in November.

I know that many of you involved in the industry would like me to give some predictions or clues about what the Board's next decision on these matters might be. I'm not in a position to make that kind of prediction today, but I hope I've conveyed some of the principles that are important. To reiterate:

- The Reserve Bank is a reluctant regulator. We'd prefer to see fees being held down by competition than by direct regulation.
- We believe there's been good progress in promoting competition over recent years. But it's not yet clear whether that will be sufficient.
- And hence, the Board's announcement in August last year explicitly left on the table both of the two broad approaches that I outlined earlier.

Let me conclude on a somewhat different note. I've talked mainly today about the Payments System Board's regulatory approach. But obviously there's more to the card payments industry than just interchange fees and regulation. This is an industry that's rapidly innovating, developing new ways to offer services, and also facing continuing challenges like fraud and security. I expect you'll be focusing mainly on those wider issues over the next few days and I wish you every success with the rest of the conference.