Malcolm Edey: Card payments regulation – from Wallis to Murray

Speech by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the Cards & Payments Conference, Melbourne, 21 May 2015.

* * *

Thank you for the invitation to speak here today.

I have been asked to talk about the outlook for payments regulation. This is a subject that is very much front of mind at present, given that the Murray Inquiry only recently presented its findings in that area and the Reserve Bank Payments System Board (the PSB) is conducting its own review following on from the Murray recommendations.

I'll say a bit more about that later, but I have to begin by saying that the PSB's review process is still underway, and I am not going to pre-empt any conclusions that might come from that. Instead, I want to address the topic in a more indirect way, by giving an overview of the PSB's general approach to retail payments since it first entered the field. In doing so, I hope to bring out some key principles that have been consistently applied and which remain part of the ongoing policy framework.

The Reserve Bank's role as a regulator of retail payments systems was established following the report of the Wallis Inquiry in 1997. Like Murray, the Wallis Inquiry was about more than just payments. It was about the financial system as a whole, and Wallis took a holistic approach to understanding the role of payments within the wider system.

I suggest there were four key observations that determined the overall shape of the Wallis recommendations.

First, Wallis observed that the business model of traditional banking was fundamentally changing. In simplified terms, banks could be thought of as suppliers of a portfolio of products, the three main ones being deposits, loans and transaction services. In the earlier highly regulated world, these were bound together in full-service banking institutions. Credit was heavily rationed and potential borrowers needed to demonstrate loyalty to a bank in order to qualify for loans. This environment tended to produce outcomes where net interest margins were high, customers were immobile and banks cross-subsidised payment services effectively as a utility.

This model broke down over time because of the combined effects of deregulation and financial innovation. These forces enabled new players to compete separately for the most profitable business lines. Examples were cash management trusts on the deposit side, which enabled depositors to gain access to wholesale interest rates, and mortgage securitisers on the lending side, which competed separately for lending business at lower margins. This was the phenomenon of "unbundling". It meant that cross subsidies were competed away and the different components of banking services had to be separately priced, including payments. One of the manifestations of this, noted by Wallis, was the increased incidence of highly unpopular transaction fees for bank accounts. But of course the implications were much broader than that and are still being seen across the financial system today.

Second, Wallis noted the importance of technology and innovation. Today, at a conference like this, it is impossible not to be struck by the pace of change in payments technology. Of course, the specifics of that couldn't have been foreseen 18 years ago when Wallis presented his report. What the report did foresee was the general tendency for the system to innovate and the associated trends towards electronic and card-based payments, away from traditional instruments like cash and cheques. Again, this is a process that is continuing today.

Third, and related to the first two points, Wallis foresaw the growth of payment systems as a business, in contrast to the utility-based model that I described earlier. If commercial realities were leading to the unbundling of payments from other financial services, then it was to be expected that this business would open up to innovative and specialist providers. It also meant that existing players would need to put their own payments services on a more commercial footing.

And lastly, Wallis looked at the regulatory implications of these developments. Payments systems are networks which link service providers and their customers. That means that they need to have ways of ensuring adequate coordination among network members who would normally be competitors. This in turn raises a whole suite of questions as to whether particular network arrangements are generating efficient outcomes: for example, is there appropriate access to networks for new players, are network pricing arrangements efficient and are there effective coordination mechanisms to promote network innovation?

Wallis concluded that there was a need for regulatory oversight of payment systems, and the recommendations that flowed from that formed the basis for the arrangements we have today.

To summarise the main elements, Wallis recommended that:

- the Reserve Bank be given powers as payments regulator;
- those powers should be vested in a separate board with a majority of independent directors (the Payments System Board);
- the mandate of that board should be to promote efficiency, stability and competition in payments systems; and
- as a starting point, the PSB should look at credit card schemes, with particular focus on access arrangements, pricing and scheme rules.

Wallis also recommended that the PSB maintain a more general watching brief on the efficiency of the system as a whole.

Looking back on the work of the PSB since that time, it has very much followed the original Wallis outline and philosophy. Early work of the PSB focused on credit card systems, leading to a package of reforms in 2003. This was followed by reforms to debit card systems in 2006 and to the ATM network in 2009.

In implementing the Wallis recommendations, the government's intention was that the policy approach should be *co-regulatory*. The explanatory memorandum to the law which set up the PSB's powers in 1998 stated that:

> The philosophy of the Bill … is co-regulatory. Industry will continue to operate by self-regulation in so far as such regulation promotes an efficient, competitive and stable payments system. Where the RBA considers it in the public interest to intervene, the Bill empowers it to designate a payment system and develop access regimes and standards in close consultation with industry and other interested parties.[1]

The approach taken by the PSB since its inception has been consistent with that intent. The PSB directly regulates only five payment systems (namely ATMs, eftpos, MasterCard and Visa credit, and Visa Debit) and only in limited areas – that is, the level of interchange fees, restrictions on merchants, transparency and access. In contrast to the more interventionist approach of some other jurisdictions, the Australian framework leaves many aspects of the payments system unregulated.

This philosophical approach has also very much guided the PSB's work on payments innovation.

[1] Payments Systems (Regulation) Bill 1998, Explanatory Memorandum, p 12.

I have already mentioned the industry's enormous capacity to innovate. In talking about this subject, however, it is important to distinguish between *proprietary* innovations, which are carried out at the level of particular payment businesses, and *network* innovation, which occurs at the level of the system as a whole. As you would expect, the industry is very good at innovation in the proprietary space. Among the many examples of this are cardless ATM withdrawals, new authentication techniques such as fingerprint, mobile banking and payment apps and now digital wallets. These are areas where the incentives to innovate are clearly effective.

But it is well recognised that efficient innovations can be more difficult to achieve at the level of the system as a whole, because the available incentives do not necessarily support coordinated action. Consistent with the Wallis vision, the PSB has been active in promoting coordinated industry solutions where that was in the public interest. An early example was in encouraging faster cheque clearing – an obvious improvement in system efficiency but one that couldn't have been achieved without effective coordination.

On a larger scale, the PSB more recently undertook its Strategic Review of Innovation in the Payments System, the results of which were published in 2012.[2] That review was conducted over a two year period and involved extensive consultations with both the payments industry and with users of payments services. It found a number of areas where there was scope for system improvements that could be achieved through coordinated action.

The key areas were:

- same-day settlement of direct entry transactions;
- faster payments and out-of-hours payments to be made generally available;
- capacity for richer information with payments; and
- an easy addressing solution for electronic payments.

The first one of these was delivered at the end of 2013 and essentially involved an acceleration of existing direct entry processes. The remaining three form a more ambitious agenda and are together being taken up as part of the industry's New Payments Platform (the NPP project).

The NPP is a successful example of what can be done through collaboration between the industry and its regulator. It is also a good example of the catalyst role for the PSB in promoting system innovation that was envisaged by Wallis. While it is an industry-led project, it is strongly supported by the PSB, and the Board continues to encourage commitment to the project and to its timely completion.

The project was launched in early 2013 and is now well advanced. On current scheduling the NPP will deliver a fast payments service with rich information and addressing capabilities in the second half of 2017. It will be linked to a fast settlement service provided by the Reserve Bank, which will allow transactions to be cleared and settled 24/7 in close to real time. All of this will amount to a world-class payments infrastructure.

It will also be a platform for further innovation. One of the key decisions made at an early stage of the project was to separate the basic clearing and settlement infrastructure from the commercially based overlay services that would use it. The industry is committed to an initial overlay that is intended to provide an attractive service and drive early volume growth. But it is important to note that access to the overlay space has always been intended to be open and competitive. Over time, this structure will allow new and specialist providers to make use of the rich capabilities provided by the core infrastructure.

[2] RBA (2012), Strategic Review of Innovation in the Payments System: Conclusions, June.

Before moving on to some more detailed regulatory matters, I will mention one more initiative to have come out the 2012 Strategic Review, and that is the establishment of new industry coordination and consultation arrangements. In line with a recommendation from the 2012 Review, a new industry coordination body, the Australian Payments Council, was launched last year. The Council is a high-level body representing a diverse range of industry participants including banks, payment schemes and other service providers. It will have the capacity to give strategic direction to the industry as well as engaging in dialogue with the PSB. At the same time, it is important that the policy process engages with users and not just suppliers of payment services. To facilitate that, the Reserve Bank has also set up a Payments User Consultation Group which began meeting late last year.

In summary then, the policy work of the PSB has been very much consistent with the philosophy and objectives of the original Wallis reforms. A good deal of that work has been what might be termed "co-regulatory" in nature, in the sense that it involved promoting industry-led solutions rather than using formal regulatory powers.

But of course the PSB does have a regulatory mandate, and it has used its powers to regulate a number of aspects of card payments where it judged that there was a public interest case to do so. Probably the aspects of this regulation that have attracted the most attention have been those related to *interchange* and *surcharging,* and I would like to make some general comments about each of these.

First, interchange. The commercial function of interchange fees is a very interesting one. They serve as a device for shifting the benefit-cost balance between issuers and acquirers in a four-party scheme and therefore, indirectly, between cardholders and merchants. Payment schemes argue that this can be an important competitive device that can promote innovation, for example by being structured to encourage network growth or the take-up of new products. Typically, interchange flows from the acquirer to the issuer, and hence the fee structure tends to encourage issuance and use of a card, but may discourage acceptance by merchants if the fee is too high. For mature schemes, however, the capacity of merchants to refuse acceptance may be quite limited. As a result, it has been frequently observed that competition between schemes can have the effect of pushing fees up rather than down, in order to maximise incentives to issuers and cardholders.

The reason that this kind of outcome is possible is that there is a misalignment between the incidence of these fees and the structure of decision-making power in a typical transaction. In a nutshell, the cardholder chooses the payment instrument but the merchant pays the fee.

In designing its card payment reforms, both for credit and debit, the PSB concluded that competition of this nature was distorting price signals in a way that inefficiently encouraged the use of high cost cards and added to merchant costs. Hence, it judged that there was a case for interchange fees to be capped by regulation. A number of other jurisdictions have since taken a similar view.

The second aspect that I want to talk about is surcharging. The PSB has consistently taken the view that merchants should not be prevented from surcharging for higher-cost payment methods. Scheme rules that prohibited surcharging had the effect of reinforcing the distortive effects of interchange fees by preventing costs from being passed on to cardholders. They also reduced the flexibility of merchants in deciding how to respond to high-cost payment instruments. The ability to surcharge improves merchants' bargaining position by allowing them a greater range of responses, rather than just being faced with a binary decision to accept or reject a particular card.

Efficient surcharging should of course reflect the underlying payment cost. The PSB's initial reforms to credit and debit gave merchants the right to surcharge, while effectively relying on competition to ensure that surcharging would not be excessive. This regulation was revised in 2013 in response to concerns about practices that had developed since the initial reforms, particularly about surcharging that appeared excessive or unrelated to costs. The amended regulation still prevents schemes from imposing no-surcharge rules, but it allows them to limit surcharging to the reasonable cost of acceptance. In doing so it strikes a balance, at least in principle, between the rights of merchants and schemes. Merchants cannot be prevented from recovering reasonable acceptance costs, but they can be prevented by scheme rules from going beyond that. More on that in a moment.

The PSB's reforms to surcharging and interchange have formed part of a broader package that also included rules relating to access and transparency. I don't have time to cover all of that today. But taken together, the effects have been beneficial. The system has continued to innovate, and merchants' card payment costs have fallen.[3] It is also notable that these costs are significantly lower in Australia than in a jurisdiction like the United States, where reforms to card systems have been much more limited.[4]

The Murray Report last year broadly endorsed the PSB's reform approach while flagging a number of areas for further consideration, particularly in relation to surcharging and interchange. These have now been taken up as part of the PSB's card payments review.

The issue of surcharging remains contentious. Instances of apparently excessive surcharging have persisted. While they acknowledge arguments for what might be called a "no excessive surcharge" regime, the schemes have argued that the current formulation is too complicated and difficult for them to enforce.

The card payments review is looking at several possible mechanisms for addressing this. One option proposed by Murray is a tiered approach that would allow tougher surcharging constraints to be placed on low-cost cards. A number of other options are available to strengthen enforcement and disclosure practices, for example allowing schemes to cap surcharges that are not percentage based at some low fixed amount.

On interchange fee regulation there are a number of issues to consider. These include the overall level of the interchange cap, the complexity and proliferation of interchange categories, the phenomenon of interchange "drift" with the three-year compliance cycle, and the wide disparity between interchange rates for preferred merchants and those applying to others.

While it broadly endorsed the PSB's regulatory approach to date, the Murray Report recommended that consideration be given to tightening existing interchange regulations in some significant respects. These included lowering the overall interchange cap, and broadening its coverage to include other incentive payments that serve a similar function. It argued that this would help to prevent circumvention and, in the case of companion card arrangements, would improve competitive neutrality.

All of these things are now being carefully considered. As I said at the outset, the review process is still underway and I won't pre-empt any possible conclusions. Reserve Bank staff have already consulted extensively with interested parties, and I expect there will be more of that to come in response to the submissions received. I take the opportunity to thank industry participants for your constructive engagement, not just in this review but in the wider agenda of promoting a more efficient and innovative payments industry.

---

3 Combining transactions across all card systems, average merchant service fees in Australia have fallen by 37 basis points from their level prior to the Bank's reforms. See RBA (2014), Submission to the Financial System Inquiry, Sydney, p 213.

4 Merchant service fees are around 75 basis points lower than in the United States. See RBA (2014), Submission to the Financial System Inquiry, March, p 213.