

## **Malcolm Edey: The card payments review**

Speech by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the Cards & Payments Australia Conference, Melbourne, 12 May 2016.

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Thank you once again for the opportunity to address this event.

In some ways this is an awkward time to be giving a speech on card payments. As you know, the Reserve Bank Payments System Board has been conducting a comprehensive review of its regulation in this area. That review is now nearing completion. It is expected to be finalised at the Board's next meeting, which will take place next week.

Obviously I can't pre-empt any decisions that might come out of that meeting. Instead what I would like to do is offer a kind of curtain-raiser, by summarising the history of the review and the way it has unfolded to date. I plan to do that under three headings: the background, the issues and the process.

### **The background**

Let me begin with some brief background.

The current arrangements for payments system regulation date back to the Wallis reforms that were enacted in 1998. Those reforms:

- established a separate Payments System Board of the Reserve Bank with a majority of independent directors,
- gave the Board the power to designate payment systems, and to set regulatory standards for designated systems in relation to such matters as access and pricing,
- set the policy objectives of the Board as efficiency, competition and stability.

The Wallis Report recommended an initial focus on credit cards, and accordingly this was the first area of regulatory action taken by the new Board. The four-party credit card schemes were designated in 2001 and, after a period of consultation, a package of reforms was implemented from 2003 onwards.

The key elements of that package are well known and are still in place. They included:

- A weighted average cap on interchange fees of 50 basis points
- An access regime for credit card schemes, and
- Removal of no-surcharge rules imposed by the schemes.

Subsequently a package of reforms for debit cards was introduced in 2006.

The thinking behind these regulatory measures was heavily focused on the efficiency of price signals to consumers. Interchange fees and surcharging rules were at the heart of this, and it is not surprising that they remain central to the current review.

The Board's early work recognised that interchange fees play an important role in influencing the incentives to use particular payment instruments. In commercial terms, interchange fees serve the purpose of rebalancing incentives between issuers and acquirers and, to the extent that the fees are passed on to end users, between cardholders and merchants. In mature systems with wide coverage, merchants may have little power to decline cards, regardless of cost. If so, the main decision-making power over the choice of payment instrument rests with the consumer, who typically benefits from reward points funded by interchange revenues. The higher cost cards (from the point of view of the merchant) are also those that tend to offer the highest rewards to the cardholder. This configuration of incentives creates a

misalignment between the incidence of fees (mainly with the merchant) and the decision making power (which rests mainly with the cardholder). In formulating its early reforms, the Board took the view that this was inefficiently favouring the use of higher cost payment instruments and hence pushing up merchants' costs.

Closely related to this was the role of surcharging. In the Board's view, no-surcharge rules reinforced the problem of inefficient price signals by preventing relative costs from flowing through to the person making the decision of which payment method to use. Hence on both these issues the Board concluded that there was a case for regulatory intervention.

These core issues of pricing, access and surcharging rules have since been taken up by a number of other regulators around the world. And they have continued to be a focus of attention and debate domestically, both for policymakers and for a wide range of interested stakeholders.

It was always intended at the time of the initial reforms that they would be subject to periodic review. The Board conducted the first such review in 2007/08. That review concluded that the reforms had improved the efficiency of card payment systems in some important respects: they had improved access, increased transparency and led to more appropriate price signals to consumers. One important element of that was a significant reduction in average merchant service fees for card payments. In the five years following the initial credit card reforms, for example, average merchant service fees for the regulated card schemes fell by 60 basis points. Competitive pressures generated similar reductions for the unregulated three-party card systems.

As part of its review at that time, the Board considered some alternative regulatory approaches. For example, it gave serious consideration to reducing the credit card interchange benchmark from 50 to 30 basis points. It decided not to do so at that time, but left the option on the table for subsequent review. The Board also considered stepping back from formal regulation and relying instead on undertakings from industry, including an undertaking that average interchange fees would not rise in the absence of regulation. However, the industry was unable to arrive at suitable undertakings, and that approach was not adopted.

Another important part of the background to the current review was the Financial System Inquiry (the Murray Inquiry) announced by the government in November 2013 – the first major system-wide review since Wallis. The Murray Report, released in December 2014, endorsed the overall approach to reform undertaken by the Board since it was established. But it also recommended that the Board undertake a further review in some areas, particularly in relation to interchange fees, surcharging and competitive neutrality (including the competition between companion cards and the four party schemes). The Reserve Bank had itself flagged some of those issues in its submission to the Inquiry.

Following on from the Murray Report, the Bank launched its own review of card payments regulation in March 2015, with the publication of an issues paper and the commencement of public consultations. Preliminary conclusions were published in December 2015, and these have been the subject of a further round of consultations in the period since then. I will have more to say about the consultation process a bit later.

## **The issues**

With this background, the Bank's current review process has focused on three main areas of card payments, namely companion cards, interchange fees and surcharging. Let me elaborate on each of those.

### ***Companion cards***

I will start with companion cards.

It has been just over a decade since the Bank first considered the case for regulating interchange-like payments made by American Express to its partner banks under companion card arrangements.

Since then, issuance of companion cards has grown faster than that for the four-party schemes, and the combined share of credit and charge card transactions accounted for by Diners Club and American Express has noticeably increased. The change largely occurred in two steps coinciding with the introduction of companion cards by the major banks. At the same time, evidence cited in our consultation paper points to a steady increase in the importance of companion cards within the overall American Express card business in Australia. Some merchants have indicated that an increased cardholder base as a result of companion card arrangements has increased the pressure for them to accept American Express cards.

For reasons that I have already outlined, differentials in interchange-like payments can have an important influence on the incentives to use particular payment methods, and these developments in companion card usage suggest that the different regulatory treatments for the two arrangements may have been a factor in shaping the development of the market. In the Bank's view, an efficient payments system is promoted where the relative prices of different payment methods consistently reflect their relative resource costs.

In reviewing this area, the Bank has indicated that three options have been under consideration. Those options are to retain the current arrangements, to remove regulation of the four-party schemes, and to regulate interchange-like payments for companion cards so that they would be subject to the same cap as the four-party schemes. In its consultation paper released in December last year, the Bank indicated that it favoured the third of those options, and this has formed the basis for further consultation in the period since then.

### ***Interchange fees***

The second main area under review relates to a range of issues around interchange standards.

The interchange benchmarks set by the Board are the primary instrument for the Bank to anchor credit and debit card interchange fees at a desired level. The current benchmarks of 50 basis points for credit cards and 12 cents for debit have been in place since 2006. As I mentioned earlier, reductions in those benchmarks were considered, but not adopted, at the time of the 2007/08 review.

In the period since then, the Board has remained concerned that interchange benchmarks may still be higher in Australia than is desirable for payments system efficiency. Another concern has been the proliferation of interchange categories over time and the widening dispersion of interchange fees. Often these work to the disadvantage of smaller merchants who do not benefit from preferential strategic rates. As at September last year, the average credit card interchange rate faced by non-preferred merchants was 55 basis points higher than the rate faced by preferred merchants; for debit cards the difference was around 13 cents. At the individual merchant level, these differences can be much bigger.

In its December consultation paper the Bank set out a series of regulatory options in this area. They included retaining the status quo, reducing the weighted average benchmarks, and supplementing those benchmarks with hard caps on individual transactions. A fourth option of removing interchange regulations, while strengthening transparency of these fees to merchants, was also included. The Board's preliminary assessment was in favour of a mix of the second and third options I just described. This would involve retaining the existing weighted average of 50 basis points for credit cards, supplementing it with a hard cap of 80 basis points on individual transactions, and reducing the debit benchmark to 8 cents. Once again, this was not a final decision but was announced as a basis for the subsequent phase of consultation that is now being completed.

As well as looking at the overall level of interchange fees, the Review is also considering a number of related issues concerning **coverage** and **compliance**.

On **coverage**, the issues discussed in the December paper concern commercial cards, foreign-issued cards and pre-paid cards. Currently commercial cards are included within the scope of the Bank's interchange standards and hence form part of the calculation for the purposes of compliance with the weighted average benchmark. A number of interested parties have argued that these cards should be exempted, especially in the event that interchange caps were lowered. They argue, for example, that commercial cards typically provide a higher value of associated services than other card types, with fewer non-interchange revenue streams, and that these features could justify higher fees. On the other hand, consultations also suggest that these cards provide significant benefits to both sides of the market, and hence it is not clear that higher interchange fees are needed to promote their use. The Bank has also noted that, since commercial cards typically carry higher interchange fees than consumer cards, their exemption would amount to a de facto loosening of the weighted average cap.

Foreign-issued cards are currently excluded from the benchmark calculations, and the question is whether these should be brought within the scope of domestic regulation for transactions acquired in Australia. Here a key consideration is the possibility of circumvention. Foreign-issued cards used in Australia typically carry a much higher interchange fee than the domestic benchmark, and under current arrangements could be used to circumvent the domestic cap. At this stage, however, the market share of foreign issued cards in Australian card transactions is still relatively small – around 3 per cent. In response to the December consultation document, Mastercard and Visa (among others) have made a number of arguments for retaining the existing treatment of foreign-issued cards, and these are being carefully considered.

For domestic pre-paid cards, the Board is similarly considering whether these should be brought within the scope of the existing standard.

The issue concerning the **compliance mechanism** can be stated fairly simply. The current mechanism operates on a three-year compliance cycle, such that the weighted average benchmark has to be met in November of every third year. Since the mix of card transactions within any system tends to shift towards the higher cost cards over time, average interchange fees have tended to rise during each three-year period. This in turn has had the paradoxical effect that the actual weighted averages for the Visa and Mastercard schemes have been almost always above the cap. The Board's intent, however, is that average fees should be below the cap, not above it. That is what a cap means. The review process is consulting on options to tighten the compliance mechanism in keeping with that intent.

A related question on compliance concerns the possible regulation of scheme payments to issuers. These marketing and incentive payments are bilaterally negotiated and can be quite material in value, and the flexibility of such payments means that they can be structured in ways to circumvent interchange regulation. Internationally, regulators have moved to limit these types of payments. Under European regulation, for example, they are treated as if they were interchange payments. As part of its Review, the Board is considering whether a similar treatment should be adopted here. The preliminary position announced in December was in favour of that option.

### **Surcharging**

The third main area under review by the Board is surcharging.

As I have already mentioned, the Board has long held the view that the ability to surcharge for more expensive payment methods is part of an efficient payment system. The ability to surcharge expands the options available to merchants beyond a binary decision to accept or reject a card, and it allows price signals to pass through to the consumer who decides which payment method to use.

Nonetheless, efficient surcharging should reflect the cost to the merchant. When the Board's initial surcharging reforms were put in place in 2003 it was expected that market forces would provide a sufficient discipline on surcharging behaviour. Since then, however, evidence of excessive surcharging in some industries has accumulated.

The Board revised its regulation in 2013 to give schemes greater power to prevent excessive surcharging, but those arrangements proved difficult to enforce. This has prompted a further review by the Board as part of its current process. As well as consulting with the full range of interested stakeholders, the Bank has had discussions with the ACCC and Treasury about possible policy approaches. The Board's proposed response builds on the recent Government measures to strengthen ACCC enforcement powers in this area.

The main elements of the coordinated approach were set out in the December consultation paper. These are, that:

- Government legislation bans excessive surcharging, defined as surcharging in excess of the Reserve Bank standard
- The Bank's standard is based on a simple and verifiable measure of the cost of acceptance, with appropriate transparency of costs to merchants
- The ACCC has enforcement powers in cases of excessive surcharging by merchants, and
- The Bank's standard continues to stipulate that schemes may not have no-surcharge rules.

Under the Bank's preferred approach, acquirers would be required to provide merchants with regular statements of the cost of acceptance for each payment method. The cost of acceptance would have to be expressed in percentage terms unless the acquirer fees for that payment method were fixed across all transaction values. As a result, surcharging would normally also have to be percentage based. Among other things, this would rule out the current system of fixed-dollar surcharges in the airline industry, which would appear to result in significant over-recovery of payment costs on low-value fares.

Again I stress that this is still a preliminary assessment, and decisions will be finalised next week in light of the consultations that have taken place in the interim.

I have had to skate over a lot of detail today. But, taking all these elements together, the current review can be seen as a continuation of the approach adopted by the Board since its inception and endorsed by the Murray Report. It maintains a focus on efficiency of price signals and competitive neutrality, which have been core principles in the reform strategy from the start.

## **The process**

So far I have described the background to the card payments review and the main issues that are being covered. I would like to conclude now with some comments about the process.

Under the *Payment Systems (REGULATION) Act 1998*, any standards or access regimes that the Bank might propose to apply cannot be implemented without appropriate public consultation. In the case of the current review, the process of consultation and debate has been particularly extensive. This has been partly because of the comprehensive nature of the review itself, and also because of the complementary role played by the Murray Inquiry in examining many of the same issues.

The Bank first publicly indicated its intention to hold a review of this nature in its March 2014 submission to the Murray Inquiry. That Inquiry, conducted through the course of 2014, itself undertook extensive consultations and made a number of recommendations to be followed up by the Payments System Board and the Australian Government.

The Board launched its review with an issues paper in March 2015. In response to that, the Bank received more than 40 written submissions from interested parties, conducted meetings with 28 parties (some more than once) and hosted a roundtable with participants from 33 organisations. These included card schemes, banks, other financial service providers, consumer groups and government agencies. The Board's preliminary assessment, taking all of that into account, was presented in a second consultation paper that was published in December, including a set of draft standards for further comment. The Bank received over 40 substantive submissions in this second round and held more than 50 further stakeholder meetings, all of which will be considered in the Board's final assessment. As I said at the outset, I expect the Board will decide on a final set of standards at its meeting next week, with an announcement to follow soon afterwards.

All up, it will have taken a bit over two years from the time when the Bank first signalled its intent to undertake this review until its completion. I sometimes hear comments to the effect that an even longer time should have been allowed for stakeholders to present their views, but the more common concern that I have heard has been from those who would prefer a faster process – consumers who would like to see faster action on excessive surcharging, or businesses who want greater regulatory certainty. I can only say in response that the Bank is bound to follow due processes and takes its responsibility to consult very seriously. But for those keen to see the final result, there is not long to wait.

Once again, I thank all those who have taken part in the consultation process and I thank you for the opportunity to talk to you today.