

REVIEW OF PAYMENT SYSTEM REFORMS

This coming 9 April will mark the 10th anniversary of the report of the *Wallis* inquiry into the Australian financial system. The Wallis report, among other things, re-focused official concern about the inefficiency endemic in Australia's retail payments system -- not least that flowing from the price-fixing entrenched in the credit-card cartel operated by Australia's banks and their associates.

The Reserve Bank of Australia – long the bland convener of the Australian Payments System Council – was accordingly given more formal regulatory powers, and a separate Payments System Board, to pursue the reform brief.

The need for resolute action could hardly have been clearer but it is not unfair to say that the RBA's pursuit of the brief over the past decade has been unnecessarily tortuous; without clear purpose and, frankly, quite unsatisfactory.

It was accordingly not surprising that the prospect of an independent review was raised (and deflected) for the setting of policy for the retail payments system. A decade on from the last independent stocktaking, an independent review is about due and unfolding events may see the RBA coordinating its work on the review with a wider ranging formal inquiry.

Whatever, the RBA is now planning to review the situation itself (including its own performance) and is proffering *a broad-ranging, open and transparent examination over some two-years aimed at improving the efficiency of the overall payments system.*

What follows is probably best seen as the latest in a set of submissions over some years now on payments system policy issues. The most recent summary of recurrent themes is my April 2006 submission to the parliamentary 'banking' committee (EFPA) along with the related transcript of the 'hearings' 16 May 2006.

Recent discussion of related issues is also in articles published in *CFO* magazine: *Retailers hold the aces*; *World war on cards* and *Trump card* were published in the March, July and October issues for 2006 (another story scheduled for the February 2007 issue will be circulated in due course).

LOOKING BACK

-- time has slipped away

Time, considerable time, has slipped away without the RBA making much apparent impression on its apparent preoccupation over the past decade with reforming the relative importance of alternative card payment systems.

The facts, however marginally confused by changes in the statistical collections, are overwhelmed by a four-fold increase in the number of credit-card transactions. A reasonable objective a decade ago, that debit-card transactions would well and truly dominate card transaction numbers, has not been met and credit card usage remains excessive on any reckoning of appropriate outcomes.

Any review of the development of payments system policy will hopefully account for this outcome, so contrary to what was reasonably expected in the wake of the Wallis report.

Accountability

There are a few of factors at play in a reviewer's assessment of accountability.

Presumably, for example, the latest round of reforms to VisaDebit scheme fees will reflect in a large volume of transactions previously attracting *ad-valorum* interchange fees, and counted as credit-card transactions, now being counted as debit-card transactions to which lower fixed-fees apply. Such a break in the series will need to be assessed carefully in terms of an abruptly different overall pattern of card transaction activity. To the credit of the RBA this 'event' marks important progress nonetheless, even if a decade or more overdue.

The intriguing and lingering conundrum is why, in mid 2002, the RBA reversed a decision, proposed in December 2001, to exclude from permissible interchange fees for credit card transactions, any (extraneous) costs associated with the voluntary provision by card issuers of free-credit in relation to some credit card purchases. The passage of time has done nothing to diminish the sense of dismay with this unexplained (inexplicable?) policy reversal.

Related to this conundrum (and a prospective task for the current review) is the explanation why the RBA has not yet seen fit to oversee a cost/benefit audit of a sample of overall personal banking relationships which include a credit-card account. A relatively simple audit process would have revealed if the 'cost' of so-called free-credit granted on credit card purchases (and 'recovered' in interchange fees), was practically matched in any meaningful way by a corresponding real benefit to customers usually holding deposit funds, in excess of their credit card debt, in accounts effectively not attracting interest.

In short, the RBA seems to have given credit card issuers – i.e. the banks -- the benefit of a Nelsonian ‘blind eye’ in choosing not to look for, and so not see, deceptive claims and attendant lucrative abuses of the community’s trust in the appropriate regulation of banks, not least their credit card operations.

Things ‘credit cards’ may finally be changing but accountability for policy decisions (and non decisions), would rank highly with any independent reviewer of card-payments policy developments over the past decade. Let’s not forget that this rot is of some considerable magnitude, a veritable ‘steal’ -- inappropriately excessive fees -- running to some \$1 billion or more per annum for most of a decade and still substantially ongoing.

Looking back, the community is entitled to an explanation.

LOOKING FORWARD

Can we have a properly functioning price system, please?

Any independent reviewer of the development of payments policy over the past decade could well take the long handle to the RBA for the blatant inconsistency of oft stating the importance of a properly functioning cost-related price system for self-regulating payments system efficiency and then ignoring the very obvious reality of the payment system operating without one. The retail payments system operates predictably inefficiently when the prices motivating customers have no semblance of a reasonable relationship with the costs of providing the payment services used by those customers.

In short, the operation of the retail payments system was not only denied the essential prerequisite of a proper price system but whatever prices were in place were often quite perverse – typically the most costly services are explicitly priced the most cheaply while the least costly services typically have excessive ‘hidden’ prices levied in ways which confuse and exploit retailers and their customers (and, apparently, the RBA).

The RBA should immediately make clear its determination to install a properly functioning price system in the payments system and so put an end to a situation fairly assessed as an absolute nonsense and plainly an affront to community trust in the integrity of the RBA’s regulatory processes.

‘Not an RBA responsibility’ – another failure of RBA independence?

It is no good claiming ‘independence’ for the RBA if it is unable to speak up clearly, and in a timely manner, when its particular policy responsibilities are being compromised by the decisions of other, more political, arms of government. Not to speak up as appropriate can be seen as a failure of character.

(i) an aside on housing

Australia is now embroiled in the unfortunate consequences of a dramatic blow out (and prospective blow down?) of housing prices largely driven by inappropriate personal tax-policy settings. In the late 1990s it was clearly a mistake, conducive to a boom in housing prices, to allow the offset of losses on residential property investments against other income while concurrently subsidizing house purchases and granting concessions on the taxation of capital gains. The RBA eventually blew the whistle on this monumental mistake of tax policy but alas too late, only when little could be done to redress the damage. Presumably claiming ‘not my responsibility’ for rapidly inflating housing prices was a clear failure of the independence of the RBA and a heavy price will long be paid for that forbearance.

Whatever excuses the RBA may tender for that oversight on the run in contentious circumstances it is surely a salutary lesson in the importance of being forthright in the assessment of policy issues.

(ii) a couple of ‘front-ons’ on payments policy

--- a minor ‘front on’

By way of illustration and to dispense with a somewhat minor matter, a simple and equitable reorientation of personal tax policy would deal effectively with the noisy nonsense surrounding the Amex and DinersClub charge-card schemes. These card schemes mainly servicing the so-called ‘travel and entertainment’ market typically convert high transaction-commissions on inflated business expenses into untaxed personal income payable to card users personally as ‘rewards’. That’s unfair and it distorts the payment system.

An ATO decision to tax these ‘rewards’ in the same way as it does other personal income and fringe benefits, would remove the advantage of an unfair privilege underwriting the existence of these schemes. The RBA should ring the changes on this blatant nonsense distorting the payments system and adding grist to the hot mill of pointless distracting debate.

-- a critically important ‘front on’

The single most important explanation for entrenched inefficiency in the retail payments system is the ‘blind eye’ turned to the practice of banks bartering under-priced ‘free transactions’ in exchange for largely ‘interest free’ personal deposits held in transaction accounts.

Banks use the earnings on the investment of funds held in these ‘current accounts not bearing interest (CANBIs)’ to subsidize the provision of free and under-priced transaction services, not least with all-you-can-eat pricing arrangements that leave the customers confused about their practical choices being concurrently rational and perverse.

It is well beyond time that the RBA asked for the ATO to be brought to account on this matter. If pension and social security benefits are docked for interest deemed to be received at a commercial rate on bank deposits and other 'non earning' assets, it is surely appropriate for depositors more generally to be deemed to receive taxable income on 'interest free' deposits exchanged for free transactions.

In short, if the RBA is looking to install a pricing system to the retail payments market and it has the independent authority to ask for unreasonable impediments to be removed, it should do so.

And, incidentally, how does the RBA account for decades of declining to do so while purporting to be actively and intelligently reforming the retail payment system so it could work efficiently? Pray tell.

As is, the parliament has given the RBA a responsibility for payments system efficiency while concurrently allowing a distortion that predictably frustrates efficiency in retail payments – the RBA should use its independence to demand that the government properly coordinates its policy objectives for payments system efficiency and an equitable personal tax system.

.... and there is no need to wait two years before doing so.

Another detailed study

While the proposed comprehensive and time consuming study of Australian payment system costs may lend some local credibility to related calls for action it would be surprising if the eventual conclusions do not basically mirror the results of similar studies in mainly European countries.

Preparing for action, including negotiations with the banks and payment industry bodies, should be commenced forthwith. It is a confident expectation that any local study will show continued over-reliance on cheques, credit cards and cash and the counterpart under-use of debit cards and internet payments.

More generally a revolution is in the offing with study after study revealing the considerable benefit likely to attend the development of electronic payments media akin to cash for use over the internet as and as a more efficient alternative to point of sale transactions for values up to say \$20.

Frankly, there is some sense of the proposed study being a make-work exercise more likely to buy time and delay the reform process than deliver added value to the reasoning and practical evidence for making needed reforms.

..... again, if the results of the study are already known, tantamount to certainty, it would be perverse to wait another two years before initiating clearly needed corrective policy reforms.

Just what is it that the RBA feels it does not know or understand about what's wrong and what must be done to fix it?

Electronic cash --played off a break again?

Whatever credit the RBA may now be conceded for the hopefully emerging prospect of ending the rackets long associated with the VisaDebit scheme and credit card schemes more generally, and eventually displacing credit cards, the 'success' was not without costs.

In particular allowing VisaDebit to become entrenched over the past decade before recently being both shortened up and given a fixed interchange-fee lifeline, seems to herald the demise of Australia's independent EFTPOS payment system: like *Bankcard* before it, local EFTPOS cards will almost certainly be replaced by scheme-debit card systems operated by the international ringmasters, Visa and MasterCard.

Spilt-milk anyway and an inevitable outcome perhaps, though possibly not on the most favorable terms for Australia and the rest of the world now also facing the prospect of most debit-card payments attracting an interchange fee after decades of getting by without them.

Whatever, this history is fair warning about the next major play in the development of retail payments schemes globally – Visa and MasterCard operations allowing small payments in some fast, tap'n'go mode using conventional credit cards and scheme debit cards, transactions that will require 'no-signature' and 'no-PIN' to be authorized.

It would be a travesty if these innovative 'playing the percentages' developments with credit cards and scheme debit cards were to become established with loss-leader pricing initially and then left in place with subsequently ramped-up prices exploiting new payment habits among customers.

Visa and MasterCard and especially their participating card-issuer banks should be put on notice by payments system regulators globally, that no new cartel-style rorts will be accommodated.

Ultimately the development of these fast-payment arrangements will be the basis of some more sophisticated e-money, chip-card function embodied in scheme debit cards to allow both stored-value 'cash' transactions at point of sale and presumably also over the internet, including so-called micro payments.

The importance of these prospective developments cannot be understated if dot.com money will be a critical catalyst for realizing the dreams of the dot.com economy.

Similarly important will be ensuring that these developments occur on fair terms for the community and that they come to fruition quite quickly. Moreover given the prospect of any successful e-money initiative being global in scope, close international cooperation particularly with European regulators would seem to be prerequisite.

Appropriate trade practices: credit cards out, e-money in

I would expect any further study of the costs (and rewards) of operating credit card schemes to be enlightened by the wisdom of policy shortcomings over the past decade in Australia, and the emerging determination in Europe to ensure that exploitative credit card schemes go to the rubbish tip. Scheme debit cards with lines of credit, please, and interchange fees if we must, but conventional credit cards no longer, thanks.

The past decade has revealed some intriguing tensions between the RBA and the ACCC in the administration of trade practices policy to the banking industry. If it is now finally conceded that the RBA is the arbiter of banking trade practices then one would like to see some proper sense of balance imposed on the use of interchange fees for credit card transactions.

Not to lead the witness but a few steps to this end seem sensible. Chips on cards will both eliminate fraud and presumably the eligibility of a cost allowance for it in permitted interchange fees. More importantly the eligibility of the real or imaginary, but always extraneous, costs of 'free credit' for credit card purchases should be outlawed, again perhaps as a united front with sympathetic European regulators.

These two steps taken, the permitted interchange fee for credit card transactions would be more akin to the small fixed fee for scheme debit transactions – and the likely further implications for credit cards are obvious enough.

Again, lessons so painfully learned with credit cards have future application – not least to ensure that any cash-substitution schemes are, from the outset, priced fairly to the community and participating retailers rather than monopolized and cartelized by the banks and their coordinating front organizations.

In short whatever uniform price fixing may be considered appropriate to the establishment and operation of e-money schemes should be done in open consultation with both the Australian and other international communities.

END PIECE

The story of the development of retail payments systems over the past 30 years in Australia, and the world more generally, is sad story. It is a case study of the heavy price the community pays when powerful commercial interests – the banks – are first permitted to monopolize critical public infrastructure and then not only to extract excessive rents, but to protect their commercial power by withholding the benefits of technological change.

Sure there have been changes in the operation of the retail payments system, and cumulatively dramatic changes at that, but the pace of change has been slowed to protect the commercial position of dominant national banks.

Not only has the community paid the heavy deadweight costs of progress slowed and denied in the retail payments arena but, in important respects, the essential viability of banks has been sapped as they became over reliant on the soft and featherbedded revenue flows associated first with the tax-free barter of free transactions for interest-free balances and more latterly with the rent-extraction schemes associated with the credit-card cartels.

The concept of competition driving efficiency in retail banking is a long redundant figment of imagination.

There will be a wash up for this nonsense: globally some retail banks, heavily dependent on captured regulators protecting their credit card franchises, will almost surely have a traumatic future.

..... and there are obvious implications in all this for the appropriate sense of urgency and clear purpose that should colour the RBA review now underway.

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