

SUBMISSION TO RBA: PETER MAIR / PAYMENTS SYSTEM REFORM /

2007/08 REVIEW OF CARD PAYMENTS REFORMS

PART A: A SORRY PASS

It is a sorry pass indeed when the sheriff is in the box canyon and the outlaws are on the high ground.

When most were expecting the RBA to step further forward and again confront a banking industry notorious for disregarding national competition policy in setting credit card transaction fees, the RBA is, apparently unable to pursue the issues – and the cardsharps – any further:

.....the Board.....is prepared to step back from the regulation of these fees on the condition that industry takes further steps to improve the competitive environment¹.

The Australian community is painfully well aware of banks' preferences when it comes to managing the competitive environment: banks couple noisy complaints -- four pillars bad, two pillars good – with predatory pricing practices while otherwise waiting for misfortune, such as the sub prime crisis, to set the scene for forced consolidation of retail intermediation.

For the pillars, 2007/08 was a vintage year as first mortgage brokers and then the next biggest bank were taken out of the game and some retail insurers were on the ropes, before the RBA conceded defeat on the regulation of card payment systems operating as a de-facto cartel. A well established pattern of events, similarly favouring banks, has long been aided and abetted by the RBA as a compliant regulator seemingly unable to understand how the game works: other regulators charged to protect the public interest also seem to have been gelded when it comes to dealing with the retail financial sector.

One explanation along these lines stresses regulatory failure: a decade of the RBA dilly dallying with interminable studies and inquiries – and pulled punches -- allowing the cardsharps to restructure beyond its reach.

Perhaps the RBA has discreetly withheld the full story along the way, whistling for credibility as its card game was collapsing about its ears.

¹2007/08 Review, summary of the main conclusions (page 39)

It was unsettling to see the unrelieved insouciance of the cardsharps over recent years when interchange fees were supposedly under threat in many countries. On reflection, the cardsharps had an ace up their sleeve, presumably as far back as 2002 when the RBA first reneged on a promise to reduce interchange fees close to zero and no explanation was given for the retreat.

A global sense of ‘was my face red’ regulators being mocked and put on the back foot will probably become clearer as a similar standoff develops in other countries where other regulators also substituted bluff and bluster for effective action.

Looming embarrassments include Europe where MasterCard is now unable to levy interchange fees on cross-border transactions while Visa still may. In the UK the OFT seems to have gone quietly to ground after a decade of threatening to outlaw interchange fees for credit card and on-line debit card transactions.

In the US, where strong regulatory intervention is most needed, there is no sign at all of a responsible regulator: a private members’ bill before Congress that would require the cardsharps to negotiate lower card transaction fees will meet strong resistance from a banking lobby wanting to underwrite the status quo as part of a rescue strategy for a floundering industry.

We can only guess what has stayed the hand of putative regulators of retail payments systems for the past decade – it now seems that the cardsharps warned regulators that they would restructure their business, substituting ‘scheme fees’ levied directly on retailers for the interchange fees under threat of regulation. That guess may explain both the insouciance and the surrender: I am open to other explanations.

Back on the home front we will wait to see the detail of banks’ promised improvements in the competitive environment to be put to an RBA unable to regulate interchange-fees and apparently grasping for anything that imitates regulatory credibility. Presumably the banks will play the RBA’s game and promise ‘improvements’ but, with interchange fees no longer pivotal, they will not be inclined to offer anything of substance.

The form guide for bank promises is littered with disappointments.

The banking industry has grown used to doing as it likes with casual disregard for the public interest: any suggestion that local banks will now rollover and restore an appropriately competitive environment to the card transaction arena seems fancifully disturbing in its naivety.

Moreover, banks offering concessions in Australia may prejudice the cardsharps’ profitability internationally, derogating their newly acquired responsibilities to shareholders that are not member financial institutions.

..... and a layer of fairy dust

Allowing the RBA to review its own previous reform initiatives risked a loss of objectivity and, predictably, the RBA has put an unwarranted gloss on the success claimed for the outcome of its policies.

.....the reforms have met their main objectives -- improving price signals; increasing transparency; improving access and creating a more soundly based competitive environment.....improved competition and efficiency in the payments system.....and substantial welfare gains to the community².

Words like 'improving' have very limited content without hard numbers that measure the extent of any claimed improvement. The persuasive hard numbers are about the relative importance of 'credit card' and 'debit card' transactions. The RBA collects and publishes these very numbers and, assessed against that critical benchmark, there has been no progress of real consequence over the past decade.

From the community perspective it is appropriate, frankly, to regard the continuing prominence of credit card transactions as evidence of the capacity and determination of the card cartel to exploit the community. As noted in a current CFO story³:

Ideally, card payments would be plain debits to customer transaction accounts. The transactions would be processed using an electronic network linking all banks, all retailers and all customers -- locally and internationally, and over the counter, phone and internet. Within that ideal framework, retailers and customers would pay appropriate fees for transactions. Eligible customers could access a line of credit, paying interest on any net debt.

The RBA's reform initiatives were superficially consistent with fostering this ideal – an ideal, incidentally, characteristic of card payment arrangements prevailing in some European countries where credit cards have a very minor role at best.

On the face of it, Australian retailers were given defensive options -- scope to surcharge to recover excessive fees paid to banks for credit card transactions and to elect to accept only some cards (rather than 'honour all cards'). The practical reality, however, is that most local retailers, already captive to the cardsharps, have little capacity to use these discretions: the use of credit cards is now so entrenched as to be 'coin of the realm' and for many transactions credit cards are contrived to be the only 'legal tender'. At best the impact of the reforms on credit card activity has so far been very marginal (and it is always a flight of imagination in Australia to suggest 'more competition' or 'new entrants' in the retail payments system).

² summary and conclusions (page 38)

³ *House of cards* :June 2008 issue of CFO magazine

The only sensible public reaction to this preliminary report is renewed calls for an independent review: the likely upshot of any independent review would see the primary responsibility for regulating the retail payments system (and the structure of the retail banking industry more generally) reallocated to a specially constituted financial services regulator, perhaps a separate division of the ACCC as competition regulator.

One would like the RBA itself to clearly acknowledge this: after some two ‘lost’ decades as the regulator, but having made little if any effective progress to reform the retail payments system, it is well beyond time for a different policy regime.

.....an emerging sense of failure

It has been fairly evident for some time, and in a few countries, that one possible basis of the ideal -- a dominant local EFTPOS debit-card system – has been lost. Late calls by the RBA in Australia, and its counterparts in Europe and elsewhere, to save or newly develop linked national EFTPOS schemes seem destined to fail.

Frankly, if the schemes now operated globally by the terrible twins were pulled into line with domestic (and international) criteria of fair play, there would be no need to ‘rescue’ local, domestic systems: the come-lately realization that it would be a good idea to have (linked) national EFTPOS operations competing with the terrible twins is itself an abject admission of prior regulatory failure now beyond redemption.

Equally relevant, with the same banks being the key participants in all card schemes operating nationally, it could be expected that the pricing policies of all schemes would be coordinated in due course to achieve much the same mirror-image outcome evident with the twins’ international schemes now.

Why would local banks, participating in the roort of the community as associates of the terrible twins, now repent and agree to favour a fairer local system that was less profitable to themselves – please, give us a break?

The demise of *Bankcard* is a relevant precedent for Australia’s EFTPOS system: the banks will do whatever is most profitable for themselves.

Apart from the redundant bilateral architecture and the contrary fee structure of EFTPOS – features intended to advantage the four pillars over small banks and others – this system seems set for terminal decline with local EFTPOS cards supplanted by scheme debit cards issued by the internationals.

More importantly, if regulators have lost control of card fees for all cards, it will not be long before different fee structures (scheme fees and interchange fees) emerge for transactions on international cards, credit and scheme-debit, which will make redundant any required limits on interchange fees alone.

The report has a pervasive sense of the RBA, as the regulator, having lost the battle after being outpointed and outgunned by the cardsharps.

Tell tale signs in a dissembling report include: *.....participants will inevitably find ways around the regulations* (page 12); *...the Bank does not see interchange fees as... compensating for specific costs* (page 7); *surcharging is not yet sufficiently widespread...to be effective* (page 12) and, ultimately, *scheme fees could be used (like) interchange fees to raise revenue from retailers to pay card issuers and cardholders* (page 14).

Implicit in this line of thinking is the long sensible conclusion that the only difference between credit cards and debit cards is the way in which the credit card product is contrived to be essential and then (over)priced by a cartel to exploit the community: so called free-credit and reward schemes were always and remain marketing tricks akin to a smoke-and-mirrors illusion.

As the card game newly embraces ‘scheme fees’ substituting for interchange fees, it is predictable that costs imposed on retailers and cardholders will increase while the advertised benefits to cardholders – free credit and fly-by points -- will be eroded with little reaction from a cardholder base already knowing they were practically worthless.

--- a hollow threat is not a strategy

It is almost beyond comprehension that the RBA is now reduced to making a hollow-threat in appearing to protect the public interest in retail payments policy.

Against the backdrop of its apparent surrender, the RBA says it wants ‘*the EFTPOS system ‘to be saved’ (and all that that implies); remnants of the ‘honour all cards’ rule removed and greater transparency around scheme fees and average interchange fees*’: where is the credible operational content in that request?

The RBA goes onto say:

.....if these steps are not made, or ‘promised’ to be made, ‘*interchange regulation would continue with a required narrowing in the spread of interchange fees, between credit cards and debit cards, from some 60 cents to 25 cents*’: again, where is the substance in such a threat when the dominant schemes care little anymore about interchange fees per se (or credit cards per se) as they shift the emphasis to scheme fees

(and scheme-debit cards) which are essentially the same thing? Never forget that reduced to its essentials a credit card is just a debit card with an overdraft line of credit – any remaining practical differences are wholly contrived to exploit the pricing power of the card-scheme cartel.

In the racing industry such a challenge is known as ‘a walk through hurdle’: just wait for the banks’ Swiss-cheese plan to save the local EFTPOS system.

Does anyone at the RBA – or anywhere else – truly believe that banks will voluntarily ‘improve the competitive environment’? Does anyone at the RBA – or anywhere else -- truly doubt that the banks won’t spin and weave a persuasive smoke-and-mirrors story enabling the RBA to save face as it steps back from a humiliating defeat in a protracted regulatory battle fought without any sense of conviction or heart?

The only one-word conclusion to this charade is ‘ ’.

PART B: A WAY FORWARD

Ben Franklin probably said ‘a job not done remains to be done’ – or something similar.

Australia is ever more oppressed by banks become a law unto themselves, ever more powerful and ever more disdainful of a community left unprotected by its banking and competition regulators.

Day after day the community is regaled with politicians and regulators promising to outlaw abuses of market power associated with ‘cartels’; ‘predatory pricing’ and ‘tax lurks’.

Many consider the Australian banks to be past masters in perpetrating such offences with the many, nonetheless, not properly comprehending why such misconduct is not only allowed but actually aided and abetted by the very regulators – primarily the RBA – which the community believes was appointed to proscribe such malpractices and protect the public interest.

It was, accordingly, beyond the bounds of reasonable credibility to hear the new Treasurer vocally promoting the ideal of a competitive banking system while seemingly oblivious to the oxymoronic character of any expectation of such a practical outcome in Australia without a regulatory revolution.

Over recent years I have set out – including in submissions to the RBA – what I see as the mechanics of fundamental flaws in public policy settings conducive to abuses of market power by the banks.

I won't labour the points again but again ask the RBA to reconsider their possible relevance to its loss of regulatory authority for the retail payments system -- and the converse, initiatives to restore regulatory authority.

-- two key points

Two key points, in summary, are:

The RBA should negotiate with the Australian Tax Office (ATO) to require banks to account for, and distribute to account holders as taxable income, the 'deemed' income inherent in banks bartering 'free transactions for interest free deposits' and giving 'interest-free credit and flyer-point rewards' on credit card purchases.

It is beyond comprehension that any regulatory authority would expect the retail banking and payments system to function effectively while ever the four pillars are effectively subsidized extensively but unfairly – \$ billions per annum -- from the public purse. These hidden subsidies encourage banks to exploit their conduct of the retail banking and payments system in ways totally inimical to the public interest in its efficiency and fairness. The pressing need for reform on this front is a 'no brainer': banks will only start to pay attention to an appropriately 'competitive' alignment of costs and prices once their opportunity to exploit these tax-avoiding deals is curtailed.

The RBA, meantime, should cooperate with the ACCC to promote amendments to the Trade Practices Act to ensure the de-facto cartel arrangements underpinning joint-venture payment networks are tested against criteria of 'maximum benefit' to the community, not 'net benefit'. A recommendation to this effect was made in 2002 in the Dawson Report reviewing the trade practices law. As things stand it is entirely inappropriate to allow the four pillars to operate cartels -- credit cards, debit cards, EFTPOS and BPay -- in ways which the RBA itself considers contrary to the public interest. The RBA (and ACCC) should similarly seek to join with counterpart trade practice authorities internationally to ensure network payment schemes operate in the public interest – the sense of this reform is underscored as the 'terrible twins' prepare to supplant conventional cash globally (and misappropriate seigniorage revenue) using conventional transaction cards ahead of introducing more sophisticated electronic-money alternatives.