Submission to the Payments System Board

Response to the Preliminary Conclusions of the 2007/08 Review

Submission prepared on behalf of American Express Australia Limited

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ACIL Tasman

Economics Policy Strategy

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1 Introduction

This submission has been prepared in response to the paper by the Payments System Board (PSB) entitled *Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review* (preliminary conclusions paper). This submission has been commissioned by American Express Australia Limited, however, all views and opinions expressed in this submission are those of ACIL Tasman. The submission focuses on the following:

- The competitive forces acting on interchange fees
- The effect on welfare from the regulation of the payments system
- Competitive position of the three-party schemes
- The no-surcharge standard
- Options regarding interchange fees.

2 The competitive forces acting on interchange fees

In subsection 5.1 of the preliminary conclusions paper, the PSB comments that:

> Following a careful consideration of this issue, the Board remains of the view that, in the absence of regulatory oversight, there is a significant risk that interchange fees in some systems will be set at levels that are too high from the point of view of the efficiency of the system. (Payments System Board, 2008, p. 15)

ACIL Tasman is concerned that the PSB still believes that it is possible to determine a socially optimal interchange fee in a two-sided market context.

Externalities occur when participants to an economic transaction do not necessarily bear all of the costs or reap all of the benefits from the transaction. The 1991 Nobel Laureate for economics, Ronald Coase, made the observation that when trade in an externality is possible and there are no transaction costs, bargaining will lead to an efficient outcome regardless of the initial allocation of property rights (Coase, 1960), a result that was labelled as the Coase Theorem. However, market failure can occur when parties cannot resolve externalities privately due to transaction costs.

Prominent industrial organisation economists Jean-Charles Rochet and Jean Tirole have defined a two-sided market on the basis of two criteria (Rochet & Tirole, 2004). First, that transaction costs are sufficiently high to prevent the elimination of a network externality between individual agents. Second, that a per unit fee imposed on one side of the market is not neutral; had the same fee been imposed on the other side of the market, it would result in a different outcome. Credit cards have commonly been cited as an example of a two-sided market.

David Evans, an academic and consultant who has contributed extensively to the literature on payments cards, has commented that in a two-sided market context it is extremely difficult for regulators to arrive at a social-welfare maximising price as one needs to consider prices and marginal costs on all sides jointly along with demand characteristics (Evans, 2003, p. 345). According to David Evans a regulator faces an onerous information problem in attempting to set a social-welfare maximising price in a two sided market context (Evans, 2003, p. 345). Eric Emch from the US Department of Justice and economic consultant T. Scott Thompson have observed that:

> There does not appear to be consensus among economists on how to define a competitive level for interchange rates. (Emch and Thompson, 2006, p. 53)

If the PSB has been able to overcome the inherent difficulties of determining a social welfare maximising interchange fee then it would be helpful for academic commentators to be able to review and consider this. Conversely, without such a solution, then ACIL Tasman suggests that a more circumspect and qualified approach to the challenge of achieving an efficient level of pricing for an interchange fee would be appropriate.

2.1 Merchant coordination problems

In addition, ACIL Tasman has some misgivings in regard to the analysis conducted in subsection 5.1 of the preliminary conclusions paper. This analysis appears to extend the work of the RBA's commissioned expert Professor Michael Katz (Katz, 2001). In response to claims that the existence of a cross subsidy alleged by the Reserve Bank of Australia (RBA) and the Australian Competition and Consumer Commission (ACCC) in the joint study (2000) did not necessarily meet the standard definition of a cross subsidy because demand effects were not taken into account, Professor Katz argued that demand considerations would only be relevant if it could be shown that credit card usage leads to a permanent increase in sales from the perspective of the economy as a whole. Professor Katz essentially rejected the notion that credit card usage leads to a permanent increase in sales across the economy on the basis that the loss of sales by merchants who don't accept credit card payments would be made up from increased sales by merchants who did accept credit cards.

The PSB has now extended the work of Professor Katz by comparing the situation of merchants considering credit card acceptance to a game akin to the 'prisoner's dilemma'. The PSB contends that merchants would be better off collectively if they could agree on the terms of credit card acceptance, paying no more than their collective benefit, but due to a coordination problem they act individually instead, potentially resulting in merchants paying more for credit card acceptance than the benefit they receive.

While there may be numerous obstacles to the effective coordination of merchants in regard to credit card acceptance, one obstacle in particular is the competitive conduct provisions of Part IV of the *Trade Practices Act 1974* (TPA), especially the *per se* prohibition on primary boycotts in section 45 of the TPA. ACIL Tasman is concerned the PSB may be advocating collective action in regard to credit card acceptance by merchants that raises issues under Australia's competition laws. Given recent comments by the RBA Assistant Governor for the Financial System (Lowe, 2008), it would appear that the RBA/PSB is aware of the implications under competition law of allowing merchants to collectively negotiate on credit card acceptance.

In the preliminary conclusions paper the PSB opines that it does not accept the idea that in the long run credit card acceptance by merchants significantly increases the aggregate value of spending although it concedes that it is likely to bring forward some spending.

The provision of interest-free credit by merchants to their customers is not a late 20th century phenomenon linked to the development of credit cards. The late William F. Baxter, who served from 1981 to 1983 as Assistant Attorney General in charge of the Antitrust Division of the US Department of Justice commented:

> The precursors of the bank credit card were the retail merchant's open book account and later the travel and entertainment card.
>
> For centuries merchants have extended short-term, interest-free credit to customers whose patronage is highly valued…
>
> There is a strong although not perfect correlation between customers with high time costs, high incomes, and high wealth positions, so the default risk of extending credit to such customers is also relatively low. For all these reasons merchants have long used the selective extension of open book credit as a competitive tool by which to attract and retain the patronage of such customers. (Baxter, 1983, p. 572)

The provision of interest free credit by merchants predates the worldwide development of competition laws (that commenced with the US Sherman Act of 1890) which would have enabled merchants to coordinate their behaviour free from any legal prohibition and the prospect of any legal sanction. Presumably some merchants have been offering the facility to provide interest free credit, both before and after the advent of credit cards, because they perceive they receive a benefit from its provision that outweighs the cost of provision.

The presumption that the aggregate value of spending does not increase in the long run through credit card acceptance is probably based on the premise that the economy is in a steady state. However, economies in the real world are rarely, if ever, in a steady state.

3 The effect on welfare

ACIL Tasman has reviewed the welfare analysis conducted in subsection 5.2.2 of the preliminary conclusions paper. Although the PSB has not explicitly outlined what standard of welfare it is using to assess the impact of regulating the payments system, implicitly it appears to have adopted the Kaldor-Hicks criterion. A commonly used standard in welfare economics is the Pareto criterion in which it is not possible to make anybody better off without making someone worse off. An action can be described as Pareto-superior when it leaves one party better off while leaving no one worse off. Given that parties have not been compensated for any losses incurred as a result of the imposition of regulation of the payments system, it is not unreasonable to conclude that the PSB is not using the Pareto criterion as its standard of welfare. An alternative approach to the Pareto criterion is the Kaldor-Hicks criterion which requires that net benefits are generated as a result of the regulation. In the case of the Kaldor-Hicks criterion, it should in theory be possible for the beneficiaries to fully compensate the losers without sacrificing all of their benefits. However, the Kalder-Hicks criterion does not require that compensation is actually paid, only that the potential for compensation exists.

Adoption of the Kaldor-Hicks criterion is not without problems. Professor Frank Michelman of the Havard Law School has contended that any economic harm resulting from government action will appear to be a capricious redistribution of wealth from those harmed to those who have benefited, unless those harmed are compensated for their economic losses (Michelman, 1967). Demoralisation costs are identified as the impairment of incentives to engage in socially productive pursuits and social unrest that will occur when those harmed, their sympathisers, and other observers concerned that they too could be subjected to similar treatment perceive uncompensated losses inflicted by efficiency-motivated government action. In order to avoid demoralisation costs by compensating for the losses, Michelman believed that it was necessary to incur settlement costs that include not only the cost of determining the amount of compensation to be paid but also the cost of identifying compensable clams. According to Michelman, government regulation will be efficient and should only proceed where the net benefits identified as part of the Kalder-Hicks criterion are larger than either the demoralisation costs or the settlement costs.

Demoralisation costs in regard to the regulation of the payments system may have translated into lower levels of innovation than may have otherwise been the case. ACIL Tasman notes that while the PSB has concluded that the regulation of the payments system has had little effect on the pace of innovation within the payments system, nevertheless some parties have raised concerns that the regulations have impeded innovation, with effort being diverted to managing interchange fees rather than developing new products. Demoralisation costs may have also manifested themselves through the lack of new entry in the provision of card payment services. In the preliminary conclusions paper the PSB has raised concerns regarding the prospect of industry participants engaging in activities to circumvent interchange fee regulation:

> If interchange fees continue to be regulated, it is likely that the schemes will devote increased resources to seeking out ways of transferring funds from merchants to issuers, possibly through increases in scheme fees combined with a system of rebates to issuers. (Payments System Board, 2008, p. 36)

Conduct of this nature by parties would also constitute a demoralisation cost associated with the regulation of the payments system and would have a detrimental impact upon welfare as it would direct resources towards largely unproductive economic pursuits that would amount to rent seeking behaviour. In its use of the Kalder-Hicks criterion, the PSB should probably have also considered the possible existence of demoralisation costs as part of its analysis.

3.1 Estimating welfare gains

ACIL Tasman is concerned that the PSB has not clearly articulated the methodology it has employed in arriving at its estimate of the welfare gain from the imposition of regulation of the payments system. In addition, ACIL Tasman believes that the welfare gain estimate of the PSB should have also been more carefully qualified than it has been.

In order to assess the welfare implications arising from the imposition of regulation of the payments system, it is perfectly reasonable for the PSB to attempt to make a quantitative estimate of the welfare change. According to Professor Richard Blundell of the University College London and Institute for Fiscal Studies:

> Measuring the responses of consumers to variation in prices and income is at the centre of applied welfare economics. (Blundell, 2005, p. 211)

To arrive at an estimate of the welfare benefit obtained through the regulation of the payments system in August 2002, the PSB has commented that it has used the principle of revealed preference. The principle of revealed preference was originally devised by prominent US economist Paul Samuelson who postulated that:

> By comparing the costs of different combinations of goods at different relative price situations, we can infer whether a given batch of goods is preferred to another batch; the individual guinea-pig, by his market behaviour, reveals his preference pattern – if there is such a consistent pattern. (Samuelson, 1948, p. 243)

The key assumption for the principle of revealed preference is consistency:

> … the individual always behaves consistently in the sense that he should never "prefer" a first batch of goods to a second at the same time that he "prefers" the second to the first. (Samuelson, 1938, p. 353)

The economic theory on revealed preferences has opened up the way for empirical studies of preferences based on observed market behaviour. Revealed preference has been developed into a tool for economic evaluation which relies on information about individual preferences that is revealed either through direct market transactions or through surrogate markets. In order to undertake a revealed preferences analysis in a market context, price and quantity information is required in two different periods.

While the PSB has not revealed all the steps it has taken to arrive at its estimated welfare gain of $100-$150 million per annum from the imposition of regulation of the payments system, it does not appear unreasonable to infer that this estimate is based on a number of simplifying assumptions. The PSB has been forthcoming with its assumption on the reduction in the number of credit card transactions of 5 per cent arising from the regulation and assuming these transactions migrate over to the EFTPOS system. The PSB appears to be assuming a positive cross elasticity of demand between credit cards and the EFTPOS system.

If the PSB has had to rely on assumptions about the change in behaviour arising from the imposition of regulation of the payments system, this implies that this is not a genuine revealed preferences analysis. It could at best be described as a pseudo-revealed preferences analysis. Although the PSB can observe what the current situation is, it is entirely reliant on assumptions as to what the situation would be in the absence of its regulation. The PSB may have some solid factual or theoretical basis upon which it has arrived at its assumptions, but it has no actual observed behaviour in the situation where the regulation of the payments system had not been imposed. ACIL Tasman believes the PSB needs to provide further details on how it arrived at its estimate of the reduction in the number of credit card transactions arising from the imposition of the regulation.

Furthermore, the principle of revealed preferences is not without criticism. The 1998 Nobel Laureate in economics Amartya Sen (Sen, 1973) has made several criticisms of the theory underlying revealed preferences including the following:

- Comparisons have to be made within a fairly short time to avoid changes in tastes amongst agents. In its analysis, the PSB would appear to have overcome this problem by assuming what the change in behaviour actually is.
- Agents may still choose between alternatives even when they cannot rank those alternatives and are genuinely indifferent between them. In the event that consumers are genuinely indifferent but still decide to choose between alternatives then the PSB's observation "if the price increases then it can be inferred that those consumers that stop using the payment instrument receive a benefit less than the new price" (Payments System Board, 2008, p. 19) is invalidated.
- Agents may subvert their genuine preferences, falling prey to ethical persuasion, political propaganda, or moral rhetoric. For example, the removal of the no-steering rule in American Express merchant service contracts may result in agents switching to other forms of payment when they may still prefer to use an American Express card.

In 2006-07 the annual gross domestic product of the Australian economy in current price terms was in excess of $1 trillion (Australian Bureau of Statistics, 2008). Given the size of the Australian economy it would be extremely difficult to isolate and identify a welfare gain in the order of $100-$150 million per annum that is attributable to the PSB's regulation of the payments system. ACIL Tasman believes that the PSB needs to provide further details on how it quantified the magnitude of the estimated welfare gain arising from the regulation of the payments system in order to improve public confidence in the robustness of the estimate.

4 Competitive position of the three-party schemes

ACIL Tasman agrees with the conclusions reached in the preliminary conclusions paper that the regulatory changes to the payments system have not delivered a competitive advantage to American Express.

5 The no-surcharge standard

ACIL Tasman notes the PSB's conclusion that there is no case for allowing the credit card schemes to reintroduce no-surcharge rules as stated in subsection 5.3.2 of the preliminary conclusions paper. However, ACIL Tasman is disappointed that the PSB has chosen not to address the issue of allowing new entrants in the provision of payment cards to impose no-surcharge rules.

In submissions in response to the RBA issues paper, both ACIL Tasman and the Australian Bankers' Association argued that the PSB should allow new entrants to impose no-surcharge rules. In its submission to the RBA in August last year, ACIL Tasman argued that the prohibition on no–surcharging rules was a significant barrier to entry for new credit card schemes and that the RBA may have granted a first mover advantage to incumbents in perpetuity that was now incapable of ever being replicated, thus potentially creating a prohibitive barrier to entry. ACIL Tasman is concerned that the prohibition on no-surcharge rules for new payment card schemes will act in such a manner as to exclude new entry in perpetuity and entrench the position of incumbent payment card providers.

ACIL Tasman contends that the RBA/PSB may have inadvertently created a barrier to entry through the prohibition of no-surcharge rules for new payment card schemes. ACIL Tasman believes that enabling new payment card schemes to impose no-surcharge rules during their initial start-up phase is part of the solution towards creating a more competitive environment in the payments system. ACIL Tasman strongly urges the PSB to reconsider the prohibition on no-surcharge rules in the case of new entrants. This issue will be revisited later in the submission in relation to the PSB's Option 3.

6 Options regarding interchange fees

ACIL Tasman offers the following comments on the three options put forward by the PSB regarding the future price setting for interchange fees.

6.1 Option 1

Option 1 represents the continuation of the current regulatory arrangements in the setting of credit and debit card interchange fees.

Because of the risks posed by inappropriate regulation, ACIL Tasman (2007) argued in its submission in response to the RBA issues paper last year that it is preferable for a self-regulatory arrangement to be introduced for the setting of credit card interchange fees. This is still the position of ACIL Tasman.

One problem arising from ongoing price regulation in the payments system identified in the preliminary conclusions papers is that payment card schemes may devote increasing resources towards trying to circumvent the intent of the regulations (Payments System Board, 2008, p. 36). As previously commented upon in section 3 above, this amounts to rent seeking behaviour. Hence, continued regulation of the payments system under either Option 1 or Option 2 runs the risks of increased rent seeking behaviour that is detrimental to welfare. This should be a consideration for the PSB in deciding on the future course of regulatory intervention in the payments system.

6.2 Option 2

Option 2 is proposing the continued regulation of credit card interchange fees but changing the method of price regulation to one based on the relativities between credit card and debit card interchange fees.

ACIL Tasman's primary concern with the PSB's Option 2 is that it disregards and jettisons widely accepted best practice in linking credit card interchange fees back to the cost of providing the services financed through the imposition of the credit card interchange fee. Under the existing regulatory arrangements, designated credit card schemes are required to comply with a standard on interchange fees that is based on a cost-based benchmark using data on eligible costs which are limited to:

1. issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions
2. issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions
3. issuers' costs incurred principally in providing authorisation of credit card transactions
4. issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the Reserve Bank over the three financial years prior to the date by which the cost-based benchmark must be calculated.

Price regulation is generally reserved for markets where competition is not strong with some market participants able to exercise market power. When price regulation is imposed in some form, regulators generally attempt to emulate an outcome closely akin to that achieved in a competitive marketplace. The social-welfare maximising price that is achieved in a competitive marketplace is where marginal cost of production is equal to the sale price of the product, with market power defined as the ability to raise the sale price of the product above marginal cost. Because the price of a product is generally linked back to the marginal cost of the product in a competitive marketplace, price regulation usually operates with some reference being made back to the cost of production. This is consistent with the building block approach to price regulation adopted by various Australian price regulatory bodies as well as the current approach used by the PSB in regard to the cost-based benchmark standard for credit card interchange fees.

Under Option 2 the PSB is proposing that the benchmark applying to the credit card systems should be reduced from its current level of around 0.5 per cent to around 0.3 per cent. Based on the preliminary conclusions paper it appears that the proposed new benchmark of 0.3 per cent for credit card interchange fees has not been set with reference to consideration of any costs incurred at all. Instead it would appear that the standard on interchange fees is being changed from one based on a cost-based benchmark to one based on the relativities of interchange fees for debit and credit card schemes for, as the preliminary conclusions paper comments:

> While the Board recognises that there may be a case for interchange fees in some payment systems, it has not been presented with any convincing evidence to suggest that the various externalities that might justify these fees are sufficiently different in the debt and credit card systems to justify substantially different fees in these systems. (Payments System Board, 2008, p. 16)

If the PSB is proposing to change the standard for credit card interchange fees from a cost-based benchmark to one based on the relativities of interchange fees between payment instruments, then ACIL Tasman is concerned the PSB will be exercising its regulatory powers over the payments system to embark on an experiment in price regulation that currently has no precedent elsewhere. The theoretical foundations for this approach would also appear to be based on research that is not yet in the public domain (Rochet, 2007) and therefore has not been subject to critical review.

It would appear that the PSB is proposing to drop the well-established approach to price regulation of linking prices back to the cost of production in order to venture into a brave new world where the relativities between credit and debit card schemes will become the guiding principle for the future course of price regulation. ACIL Tasman foresees many potential pitfalls with this approach.

Within the reasoning of the PSB in moving towards a new standard for credit card interchange fees there appears to be an assumption that there is a high degree of substitutability between credit cards and debit cards and that they compete against each other. While there is some substitutability between credit cards and debit cards in regard to a payment functionality, there are also important differences between credit cards and debit cards which means that they are very imperfect substitutes for one another. While a debit cardholder finances any payment directly from their own resources, credit cards offer cardholders a line of credit. Certain credit cards offer cardholders other services such as automatic insurance on purchases as well as reward schemes which are not available to debit cardholders. Arguably credit cards have become a low transaction cost alternative for a personal loan. The ACCC suggested in 2000 that credit cards were popular for small personal lending requirements even up to a few thousand dollars (Australian Competition and Consumer Commission, 2000). Similarly MasterCard has opined:

> Credit card issuers in Australia have developed and promoted low rate credit card programs in order to attract customers that may have otherwise taken up a personal loan, or some form of store finance. (MasterCard Worldwide, 2007)

While the PSB has previously concluded that debit and credit cards are close substitutes for one another in regard to most face-to-face transactions, it has observed that credit cards and debit cards are not good substitutes in payments over the telephone and the internet where the PIN-based EFTPOS debit cards cannot be used (Payments System Board, 2006, p. 6).

Sujit Chakravorti, a senior economist in the economic research department at the US Federal Reserve Bank of Chicago, commented in 2003 that "little research has been done regarding competition between different payment products" (Chakravorti, 2003, p. 64). If the PSB has been able to fill some of this void in research in regard to competition between credit cards and debit cards, including estimates of the cross elasticity of demand, then it should release this research in order to clearly demonstrate that credit cards are substitutes for debit cards, and to make itself open to professional scrutiny, before embarking on its regulatory experiment.

The PSB appears to be engaging in a regulatory pricing experiment based only upon the presumption that credit cards are close substitutes for debit cards. So far there is no available evidence in support of this proposition. Whether credit cards are a close substitute for debit cards is something that can only be determined by the aggregate belief and consequent behaviour of consumers. However, the PSB appears intent to impose a new benchmark for credit card interchange fees based solely around a proposition that so far at least remains unproven. If there is no evidence on the extent of substitution between credit cards and debit cards, then this should be grounds for the PSB to take a much more cautious approach towards the regulation of credit card interchange fees. The Productivity Commission has warned of the dangers of a regulator in trying to impose price controls:

> There are severe limitations to the role that price control can play in areas where competition is not strong. In such markets, regulators attempt to set prices at the levels they estimate would occur if there were more active competition. Yet this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if

> they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment.
>
> These limitations suggest that governments and regulators should be wary of setting prices (either explicitly or indirectly). This is particularly the case in markets other than where there is natural monopoly, even if competition is not strong. (Productivity Commission, 2001, p. xvii)

Similarly, the Chairman of the Productivity Commission has warned:

> The informational difficulties facing regulators attempting to second-guess efficient market prices are legion. To be able to set efficient prices in circumstances of changing market conditions, a regulator essentially needs to know everything that the managers of regulated firms know…
>
> The critical importance of prices to decision making by producers and consumers, together with the informational and other constraints on regulators, mean that price oversight must always face the real risk of distorting investment and reducing incentives to be efficient and innovative, as well as placing a compliance burden on the firms subject to regulatory oversight. In other words, against the possible consequences of market failure need to be set the possible consequences of government regulatory failure. (Banks, 2000)

Changing widely accepted best practice in regard to regulatory price setting entails great risks that have not been fully considered in the preliminary conclusions paper.

Changing the standard for the setting of credit card interchange fees from a cost-based standard to one based on the relativities of interchange fees between payment instruments that will impose a 0.3 per cent credit card interchange fee effectively avoids public debate over what services should be funded through a credit card interchange fee. While the change in the standard that will reduce the interchange fee from 0.5 per cent to 0.3 per cent sends a clear signal to credit card issuers that the PSB wants certain services currently funded through the credit card interchange fee withdrawn, the PBS puts the onus back on credit card issuers in deciding what services should be withdrawn from cardholders.

If the PSB is determined to reduce the benchmark for credit card interchange fees, then it is preferable for it to do so by declaring certain costs no longer eligible for inclusion in the cost-based benchmark. Amending the cost-based benchmark will ensure there is a full and frank public discourse over the services financed through the credit card interchange fee and that the full effect and consequences of the PSB's proposed regulatory changes are better understood by the community prior to implementation.

6.3 Option 3

Under Option 3 the PSB is proposing to step back from the explicit regulation of credit card interchange fees. ACIL Tasman is supportive of this approach.

The recent speech by the RBA Assistant Governor for the financial system (Lowe, 2008) presented an encouraging assessment of the possibility that the PSB may step back from regulatory control. In using a sporting analogy for the current regulatory controls, the RBA Assistant Governor for the Financial System put the onus on participants in the payments system to embrace the changes that would provide the PSB with the necessary confidence in the competitive environment to step back from direct regulation of interchange fees:

> From the Reserve Bank's perspective, we hope that the ball will not be dropped, that the various players will co-operate where co-operation is required, and that there will not be a soft hand-over at the end of the tackle count due to a lack of progress. The goal, which I think many people share, is to put in place a regime that promotes competition and innovation, and that does so with as little regulation as is possible. (Lowe, 2008)

ACIL Tasman supports the proposition that competition is the best regulator of prices, and in the event that a more competitive environment prevails then the PSB should take the opportunity to step back from regulatory price controls. As indicated in the comments by the RBA Assistant Governor for the Financial System there are initiatives that industry participants can take to contribute towards the development of a more competitive environment in the payments system:

> The preliminary conclusions set out a number of possible steps that could be taken by industry participants to strengthen the competitive environment. These include: changes to the EFTPOS system; further modifications to the honour-all-cards rule; and greater transparency of scheme fees. (Lowe, 2008)

In this regard, the industry is already undertaking several initiatives. The Australian Payments Clearing Association has released a White Paper entitled *Reinventing Co-regulation: Improving payment system governance in Australia* which outlines several approaches that could be taken towards self-regulation in the payments system. In addition, the Australian Bankers' Association is proposing the establishment of a commercial governance structure that would be responsible for the promotion and development of the EFTPOS system.

If greater cooperation between participants within the payments system refers to measures such as a commercial governance structure for the EFTPOS system and the willingness of parties to embrace greater price transparency then ACIL Tasman is supportive of the PSB's approach. ACIL Tasman maintains that markets always work better when market participants are better informed.

In terms of suggestions as to what a more competitive environment for the payments system may look like, the Australian Bankers' Association (2007) has previously provided a useful roadmap. In its submission in response to the RBA's issues paper, the Australian Bankers' Association suggested that a combination of the following would provide sufficient competitive tensions within the payments system and between payment instruments to enable the RBA to deregulate credit card interchange fees:

- prohibition on no-surcharge rules for existing credit card schemes
- allowing new payment card networks to apply no surcharge rules
- the establishment of a commercial governance structure for EFTPOS.

One proposal suggested by the RBA Assistant Governor for the Financial System that could inject greater price transparency into the payments system is a commitment by the four-party credit card schemes (Visa and MasterCard) to a price cap for credit card interchange fees:

> One possibility that the schemes might explore here is to provide some sort of public commitment that their average interchange fees will be no higher than, say, the current 0.5 per cent benchmark for a number of years. I note here that in other countries, the schemes have agreed to cap their interchange fees, following discussions with the relevant authorities. (Lowe, 2008)

Commitment by credit card schemes to a price cap arrangement would give both the PSB and the community a level of comfort about future pricing arrangements for credit card schemes and an assurance against the future exploitation of market power by the four-party credit card schemes.

Under a price cap arrangement if the cost of providing services financed through the imposition of the credit card interchange fee were to rise, then credit card schemes should be entitled to recover those increased costs through raising the credit card interchange fee. In the event that the cost of providing services financed through the imposition of the credit card interchange fee were to fall, then by the same token credit card schemes would then be expected to pass on those cost savings through imposing lower credit card interchange fees. The introduction of such a price cap arrangement should obviate the need for the PSB to step in and reinstitute formal regulatory price controls, as it is proposing to do, in the event of a material increase in the level of credit card interchange fees.

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