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THE CHANGING NATURE OF FINANCIAL SERVICES – REGULATORY AND POLICY RESPONSES

PAYMENTS SYSTEM REGULATION - AUSTRALIA AND ABROAD

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Payment systems have attracted a good deal of attention from policy makers over the last decade or so, both in Australia and abroad. Over that period there has been a discernable shift of policy focus, and in many cases a change in the policy authorities most directly involved.

Over the next few minutes I would like to do three main things:

- first, sketch out the nature of this shift in emphasis and set out some of the reasons why it has occurred;
- second, as background to discussion of developments in Australia, I will outline how some other jurisdictions have dealt with these issues – in particular, Canada and the UK, which provide both interesting contrasts and parallels to our experience in Australia; and
- third, I will set out the Australian policy response and outline how it is working. I will illustrate with particular reference to one of the issues you will have read about in the press, interchange fees and access to credit card schemes in Australia.

I. Payments system policy emphasis

Until the mid 1980s you would have been hard pressed to find lawyers and economists discussing payment systems at gatherings such as this in Australia – or indeed anywhere around the world. Until around that time, most payments systems were the exclusive preserve of operations divisions of banks. They were generally not seen as either profit generators or sources of risk by bank managements. Those unlucky enough to be consigned to running payment operations probably did not see that as a career-enhancing move, since senior management and bank boards paid them no attention.

That all began to change in the mid 1980s when central bankers and their counterparts in the commercial banks began to realise that there were quite significant **risks** embedded in payment systems. In particular, as specialised high-value electronic payment systems began to be introduced to serve the wholesale markets in government securities and foreign exchange, banks began to realise that they were guaranteeing many of their customers' payments during the day and receiving cover only at the end of the day; in the interim they were taking large exposures to some of their customers. Central banks in turn realised that they were often either explicitly or implicitly guaranteeing the banks' payments and by extension the banks themselves. These realisations left everyone pretty uncomfortable at the risks they were bearing.

There were two related reactions to this focus on risk in payment systems:

- central banks and commercial banks co-operated to improve payment system design to reduce the risks they all faced. In Australia, this resulted in the implementation of our real-time gross settlement (RTGS) system that settles transactions between banks and other financial institutions well in excess of $100 billion each day;
- it eventually lead to governments giving central banks increased formal powers to ensure that payment systems are designed and operated in a way that reduces the risk that they can spread systemic disruption. Previously, central banks had relied on moral authority and sometimes their operational roles to encourage reforms aimed at reducing risks. Importantly, most were able to achieve reform without much in the way of formal

powers, because the commercial banks also shared their objectives of reducing risks in the payment system.

At least in industrialised countries, wholesale payment systems have been reformed over the past decade. Most have significantly reduced risks by introducing, as we have done, RTGS systems for high-value payments. With this stage behind us, much of the policy focus has moved from an emphasis on risk to an emphasis on **efficiency and competition**. As a result, retail payment systems are coming under increased scrutiny.

Policy makers have become concerned that the nature of payment systems means that competitive pressures may not work in the textbook fashion to generate desirable outcomes for society. Payment systems differ in important ways from many other banking services. When banks offer mortgage products, for instance, they do so without any reference to their competitors. On the other hand, when they offer payment services – cheques, credit cards, debit cards – they need to co-operate with their competitors to ensure that their customers can use their payment instruments, even when those they are paying use a different bank. A cheque account or credit card which I could use to pay only someone who banked at the same bank as I do would be of little use.

But this need for co-operation between competitors necessarily raises questions about how good a deal consumers – both retail and business - are getting. In particular, is the co-operation compromising competition in some way? Not surprisingly, we are seeing a wider range of policy authorities – not just central banks – taking a close look at these questions. Most important are the competition authorities, such as the Competition Directorate in the European Union, the Office of Fair Trading in the United Kingdom and the Department of Justice in the United States.

II. Developments abroad

Let me turn now to sketch out some of the policy responses to this shift in focus from risk to efficiency and competition in a couple of other countries, before turning to how the issue has been addressed in Australia.

In the **United Kingdom**, the Bank of England has traditionally had oversight of payment systems. It has generally done so on an informal basis, in part through its membership of the United Kingdom's payment industry association, APACS. Throughout the 1990s, it used moral suasion to implement important reforms, including introduction of an RTGS system. The *Financial Markets and Insolvency (Settlements Finality) Regulations 1999* implemented in the United Kingdom the European Union's *Settlement Finality Directive,* giving the Bank and the Financial Services Authority some formal powers, but with a narrow risk focus.

Then in 1999 the United Kingdom Government commissioned a review of banking services in the UK by Don Cruickshank. Cruickshank's report, released in March 2000, was highly critical of the extent of competition in the UK's payment system. A theme running through many of his conclusions was that the same banks ran all the payments networks and that as a result, there was little genuine competition between them. Moreover, the Bank of England did not escape Cruickshank's criticism. He argued that its focus on risk reduction meant that could not actively pursue competition objectives because they might increase risk. He described banking supervision in the UK as being captured in the "old regulatory contract".

Cruickshank recommended the creation of a new specialist payments system regulator with a brief to ensure that competition operated more effectively in the UK payments system. Moral suasion was not an option, since the regulator's objectives and those of the banks running payment networks were likely to diverge. In the event, the UK Government has decided that a standalone regulator would not be effective or viable, and has decided to establish a special group within the Office of Fair Trading, the UK equivalent of our ACCC. Details of the Government's plans are set out in *Competition in Payment Systems: A consultation document,* released by HM Treasury in December 2000.

The UK decision is to house the regulatory responsibility for efficiency and competition in the payments system with the traditional competition authorities and to give it the means to import the payments expertise. Responsibility for stability of the wholesale payments systems remains with the Bank of England. These new arrangements are not yet fully in place so it will be some time before they can be judged.

In **Canada,** the Government moved early to give the Bank of Canada statutory responsibility for regulating payment clearing and settlement systems that had the potential to generate systemic disruption with the passage of the *Payment Clearing and Settlement Act, July 1996.*

Since then, a series of reviews of Canada's financial system have touched on competition in the payment system – in particular, which institutions can have access to the payment system. The result is that new powers to regulate aspects of the payment system is one part of major legislation currently before the Parliament. Bill C-8 establishes a new financial consumer agency to ensure that financial institutions adhere to consumer protection policies, and gives the Minister of Finance the authority to deal with competition and efficiency in the payment system.

III. Regulatory arrangements in Australia

Until 1998 there were no formal regulatory powers directed explicitly at the Australian payments system:

- The Reserve Bank exercised only informal oversight of the payments system as part of its broad mandate for stability of the financial system. This meant that our focus was very much on risk in the high-value systems that serve our wholesale financial markets.

- The ACCC dealt with competition and access issues in the payment system as part of its general responsibilities under the *Trade Practices Act 1974.* One of its important roles was to authorise rules for a variety of payment arrangements operated by the Australian Payments Clearing Association, thus ensuring that its members would not be at risk of prosecution under section 45 of the *Trade Practices Act.*

Then in 1996, the Government established the Financial System Inquiry (the Wallis Inquiry) with a mandate to make recommendations "on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system …consistent with financial stability".

Wallis devoted a good deal of attention to the efficiency and governance of the Australian payments system and reached two important conclusions:

- The first was that Australia's payments system was not at international best practice in terms of efficiency. On the contrary, it was seen as being only in the middle of the field. Encouraging a change in the mix of payment instruments, especially the substitution of electronic forms of payment for cheques, offered the potential for substantial gains in efficiency. The amounts at stake are substantial. The inquiry itself lacked comprehensive data, but evidence from abroad suggests that the costs to financial institutions of providing payment services could be around half to one per cent of GDP. If the costs to consumers and firms are included, as much as three per cent of GDP might be absorbed in making non-cash payments. If these rough orders of magnitude are applied to Australia, an "efficiency dividend" of only 10 per cent would generate savings in resources of over $1.5 billion a year.

- The second was that it was unlikely that the then existing arrangements under which the payments industry largely regulated itself, with limited roles for the Reserve Bank and the ACCC, could be sufficiently responsive to the goals of public policy – particularly the goal of improving overall efficiency.

There is no indication that Wallis doubted what needed to be done or who was best placed to do it. The Committee concluded:

> "A clear and transparent framework is required for the resolution of these issues with greater emphasis on the efficiency of the payments system. This would be facilitated by the creation within the RBA of a separate and stronger structure charged with this function."

The Government accepted this recommendation and created the Reserve Bank's Payments System Board and gave the Bank a strong mandate and powers. (I will use the terms the Bank and the Payments System Board virtually interchangeably. In formal terms, the *Payment Systems (Regulation) Act* gives the Bank the powers, and the *Reserve Bank Act* gives the Payments System Board responsibility for determining policy on payments matters.)

The Bank's responsibilities and powers are set out in four separate acts, the *Reserve Bank Act 1959,* the *Payment Systems (Regulation) Act 1998,* the *Payment Systems and Netting Act 1998* and the *Cheques Act 1986.*

The Bank's mandate is set out in the amended *Reserve Bank Act 1959.* It must exercise this responsibility in a way that will best contribute to:

- controlling risk in the financial system;
- promoting the efficiency of the payments system; and
- promoting competition in the market for payment services, consistent with the overall stability of the financial system.

Thus the Australian model places responsibility for both risk and efficiency issues at the central bank. This has two important advantages. The Reserve Bank has considerable expertise in analysis and operation of payment systems. It also places on the Bank the responsibility to weigh up the issues of risk and efficiency when considering regulatory initiatives.

I want today to focus on the *Payment Systems (Regulation) Act,* which is the main vehicle for pursuing competition and efficiency objectives. Under the Act the Bank may:

- "designate" a particular payment system as being subject to its regulation. Designation is simply the first of a number of steps the Bank must take to exercise its powers;

- determine rules for participation in a designated system, including rules on access for new participants. The Reserve Bank now has the capacity to decide on questions of access to the payments system, since access is an important determinant of efficiency;

- set standards for safety and efficiency for that system. These may deal with issues such as technical requirements, procedures, performance benchmarks and pricing; and

- arbitrate on disputes in that system over matters relating to access, financial safety, competitiveness and systemic risk, if the parties concerned wish.

The *Act* also gives the Reserve Bank extensive powers to gather information from a payment system or from individual participants.

The Government's intent was that the Bank would treat these powers as "reserve powers", to be exercised if other means of promoting efficiency and competition proved ineffective. Accordingly, the Government built considerable flexibility into the new regulatory regime.

Under this co-regulatory approach, the private sector will continue to operate its payment systems and may enter into co-operative arrangements, which may be authorised by the Australian Competition and Consumer Commission (ACCC) under the *Trade Practices Act 1974*. However, if the Bank is not satisfied with the performance of a payment system in improving access, efficiency and safety, it may invoke its powers. It may then decide, in the public interest, to set access conditions or impose standards for that system. In doing so, it is required to take into account the interests of all those potentially affected, including existing operators and participants. Full public consultation is required and the Bank's decisions can be subject to judicial review.

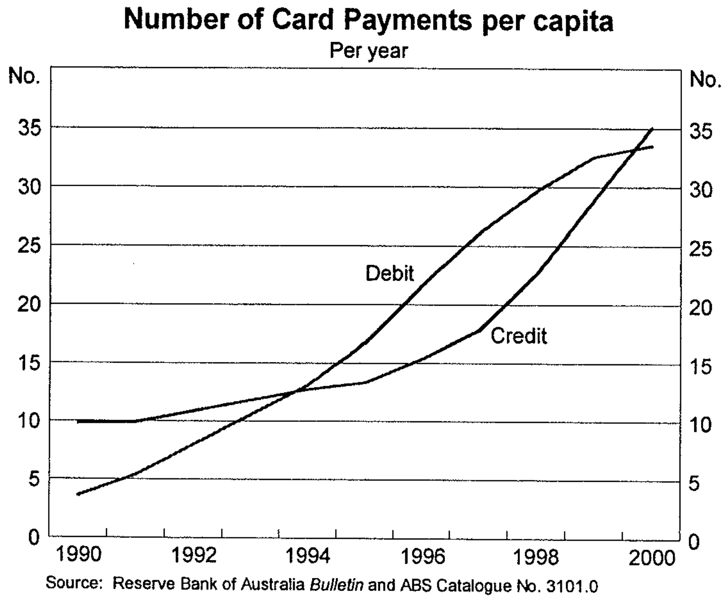
Developments over the past year or so illustrate how the Bank is exercising these powers.

When the Payments System Board was first established in 1998, it undertook a detailed stocktake of the efficiency of Australia's payment system. One of the things that most attracted its attention was:

- rapid growth in credit card usage and a tapering off of growth in debit card transactions from the mid 1990s. This is illustrated in Graph 1;

- combined with pricing mechanisms that at the margin had the effect of actually rewarding people for using credit cards while they were usually charged by their bank for using debit cards. This is illustrated in Table 1.

Graph 1



Source: Reserve Bank of Australia *Bulletin* and ABS Catalogue No. 3101.0

Table 1: Cardholder costs of using debit and credit cards (\$A)

	Credit card payment	Debit card payment
Transaction fee	—	0.0 or 0.60
Interest free period	-0.42	—
Loyalty points	-0.30 to -0.62	—
Total	-0.72 to -1.04	0.0 or 0.60

The more we looked at these issues the more it seemed that at least some of the answers lay in the fees, known as interchange fees, that banks charged one another when customers used credit and debit cards. The rules of the various schemes that determined who could be involved in the card business also seemed relevant. The more we learned about how the system worked the more we realised we needed to know more. Nobody anywhere around the world had put any analysis of these issues on the public record in a comprehensive manner. Accordingly the Board commissioned a major study of the issues, which we conducted together with the ACCC, since as competition regulator it had considerable background in some of the issues.

This work culminated in the publication of *Debit and Credit Card Schemes in Australia: A Study of Interchange and Access*, in October 2000. On the question of credit cards, the Study drew three important conclusions:

- industry participants responsible under the schemes' rules for setting interchange fees could not explain how they had been set nor provide a justification for their current levels. The fees looked to be well above identifiable costs;

- scheme rules governing access appeared more restrictive than necessary to control risks in the credit card system; and

- the no-surcharge rule which prevents merchants accepting VISA, MasterCard, American Express and Diners Club cards from passing on the cost to cardholders, distorts price signals. It also means that some cardholders pay less than the cost of the services they consume while the costs of accepting cards are ultimately borne by all customers whether or not they use cards.

At the same time as we were undertaking this *economic analysis* of the credit card system, the ACCC was investigating a complaint from a merchant that led it to conclude that the collective setting of interchange fees by the banks that are members of the card schemes was a breach of section 45 of the *Trade Practices Act.* The ACCC wrote to the banks and the card companies telling them that they would have to seek authorisation for the *illegal behaviour* or cease it.

During the second half of last year the banks undertook some work which they presented to the ACCC in early 2001 as a basis for authorisation. After a series of discussions and a revised proposal, the ACCC concluded that that the work presented to it was not likely to lead, in a timely fashion, to a proposal that it would be able to authorise in terms of the net public benefit test required by the *Trade Practices Act.*

Accordingly, the ACCC recommended that the Payments System Board consider using its powers to designate the credit card systems and deal with public interest issues associated with interchange fees and access under its powers. Given the work the Bank had done in preparing its Study, the Board was well prepared to deal with this request. In terms of the government's intent that other avenues had been explored, the Board accepted the ACCC's judgment that authorisation was not likely to lead to a timely and satisfactory outcome. On 12 April, the Bank designated the three credit card schemes, VISA, MasterCard and Bankcard as payments systems subject to its regulation.

The Bank is now seeking views of interested participants – including card scheme members, retailers, billers and consumers - before it:

- sets standards that will govern the way in which card scheme members set interchange fees. The effect will be that the regulations of the scheme, under which banks and other scheme members that are otherwise competitors, co-operate to set fees which are passed on to end users, will be subject to a public interest test;

- imposes an access regime that will apply a public interest test to the scheme rules which determine which organisations can become scheme members and thus compete with existing members in the credit card business. It is in dealing with questions of access that the trade-off between risk and efficiency through greater competition is most stark; and

- determines whether no-surcharge rules, under which card scheme members constrain the freedom of merchants to set prices to recover the cost of accepting credit cards from those that use them, are in the public interest.

None of these are easy tasks, and we are getting plenty of advice, a fair bit of it conflicting. It will take us a few more months to sift through the issues. We will then release a consultation document setting out the views that have been put to us, our responses and our draft standards and access regime.

IV. End piece

Finally, let me try to put this work into perspective by asking a question that attempts to draw several of my themes together. The question is:

"Does all this amount to new and intrusive regulation or re-regulation of the payments system?"

I would argue not. The payments system has always had regulations. They are necessary to make it work, because payment systems require banks and other financial institutions to co-operate in order to provide payments services to their customers, and there have to be clear rules to make it all work in smooth and orderly way.

But the regulations we are talking about here are regulations of the card schemes. They are private regulations. They are not on the public record. In many cases scheme members did not understand them well enough to be able to explain them, let alone justify them.

What is now happening is that a set of private sector regulations in credit card schemes are being subject, for the first time in Australia, to a public interest test.

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