Business Spectator

COMMENTARY

Published 6:28 PM, 15 Mar 2010
Last update 9:54 AM, 16 Mar 2010

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The reluctant regulator

The Reserve Bank's Malcolm Edey was surprisingly **candid** about the future regulation of card payments today. After a decade of considering and implementing reforms to card payment systems, the bank is unclear when and where the reform process will end.

Edey, assistant governor (financial system), **said** there were two possible approaches the bank could take for the next stage of its regulatory strategy. One was to strengthen competition from alternative payments methods, along with measures to increase transparency and voluntary undertakings that interchange fees wouldn't rise; the other was to maintain regulation of credit card schemes and cut the interchange fees further.

The bank, having already postponed a decision on its strategy last year, remains unsure about which is the better course. Edey said that the bank was a reluctant regulator. It believed there had been good progress made in promoting competition in recent years but it wasn't yet clear whether that would be sufficient.

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The reform process, which has been painful and painfully slow, started with a review of credit card systems in 2000, which led to what was at the time a quite controversial decision to directly regulate credit card interchange fees in 2002. Subsequently the bank intervened to regulate debit cards, EFTPOS systems and ATM fees. Credit card interchange fees have fallen from about 95 basis points to about 50 basis points.

As Edey said today, about half of household consumption, or $1 billion a day, is spent using one or another of the card system. From the outset the bank was concerned about the opacity and potential inefficiency of those systems.

The difficulty the bank had with the systems is that within them there are a series of asymmetries. The benefit a card holder gains from a card depends partly, as Edey says, on the scale and ubiquity of the particular network. Suppliers therefore want to expand their networks and adopt pricing strategies that promote that objective while merchants have little option but to accept the most widely used cards.

In the initial phase of establishing a scheme and building it to the point where it produces the self-generating network benefits of a mature scheme interchange fees are necessary incentives for third parties to cooperate to promote the scheme and the card's issuance and acceptance.

As Edey says the person who decides which card to use and when to use it isn't the one who receives the price signal – generally it is the merchant who pays the fees. They could refuse to accept particular cards but in a highly concentrated market that could be a destructive choice. That conferred significant market power on a relatively smaller number of issuers.

In the pre-reform period, the unusual structure of the card systems provided incentives for the issuers to make cards more popular by offering reward schemes that were funded by charging acquirers increased interchange fees. Once the RBA started cutting interchange fees, some reward schemes were abolished while banks and credit card companies started charging significant membership fees.

A major influence on the bank's approach was its recognition that usage of different payments systems was illogical. The EFTPOS system ought to have been the lowest-cost and most popular form of payment instrument and credit charges the most expensive and least popular. Yet usage of credit cards was vastly greater than use of EFTPOS systems – largely, the RBA assumed, because consumers were being given a perverse price signal.

Apart from the inefficiency, the bank may have been concerned about the build-up in household debt via the heady growth in credit card usage as consumers chased reward points.

Over much of the last decade the bank has been reluctantly forced to regulate the price and terms of the various cards. What it has done, in effect, is to use a cost-based approach to set prices and substantially narrow the relative costs of using different systems.

Whether or not that has produced direct consumer benefit is almost impossible to determine, but certainly it has produced slightly more rational use of the various payment alternatives.

It is unclear how or why the bank should disengage from regulating pricing. It says it could strengthen competition from alternative payment methods, like industry-based EFTPOS and online payment schemes, along with some changes to the detail of the rules for schemes and voluntary undertakings on pricing from the scheme operators.

Alternatively, Edey says, the bank could maintain regulation and cut credit card interchange fees to 30 basis points. That would probably be very unpopular with the banks and scheme operators but greeted warmly by merchants – unless there were also similar reductions in EFTPOS and debit card fees, where the merchants would be the losers.

Missing from Edey's list of options is one that the RBA was seriously considering earlier in the reform process – reducing all interchange fees to zero, as occurs in some other jurisdictions, to create neutrality between payment systems. The direct charging model introduced for ATMs as a substitute for bilaterally agreed interchange fees may not be popular but it has created true transparency.

While Edey said the bank took the view that good progress had been made by the industry in promoting competition, the very nature of the card systems, despite the reforms, works against the entrenchment of competition as a disciplining force.

The bank may be a reluctant regulator but it does appear likely it will be regulating, reluctantly, for some time yet and continuing to force fees down.

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