Australian Payments
Clearing Association

AUSTRALIAN PAYMENTS CLEARING ASSOCIATION

SUBMISSION TO RESERVE BANK OF AUSTRALIA

ON

"REFORM OF AUSTRALIA'S PAYMENT SYSTEM: ISSUES FOR THE 2007/08 REVIEW"

AUGUST 2007

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1 Outline of Submission

1. Australian Payments Clearing Association Limited welcomes the opportunity to make this submission in response to the Reserve Bank of Australia's review of its reforms to Australia's card payment systems.

2. The issues paper specifically invites responses to 3 questions:

   - What have been the effects of reforms to date?
   - What is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach? and
   - If the current regulatory approach is retained, what changes, if any, should be made to the standards and access regimes?

3. The issues paper (rightly) positions the review within an overall concern for the long-term promotion of competition and efficiency in the Australian payment system. Inevitably however, the issues paper and industry responses will tend to focus on the merits of the specific interventions, particularly interchange fee regulation. As an industry self-regulatory body, APCA's focus is different. We believe the time is right to step back from debates on specific solutions, and look at improving the overall regulatory process.

4. Beyond the reforms in card payments that are the focus of this review, other issues of market competitiveness and efficiency of the payments system will arise as the industry continues to evolve.[1] APCA submits that apart from establishing the way forward on past specific reforms, this review should be used to identify the lessons of regulatory process from those reforms – specifically, how the regulatory process can be enhanced to better identify and address future policy issues as they arise anywhere in the payment system.

5. APCA's submission will focus on how, through well-designed co-regulation, industry and regulator can work together to improve the regulatory process with a view to long term enhancement of the efficiency and competitiveness of the overall payment system. Our main

[1] In a series of speeches, Dr Lowe of RBA has already raised concerns relating to access, innovation and governance, to which the industry continues to respond See, for example, "Payment System Evolution: Where to from here?" Presentation to ABA and APCA Forum, 27 September 2006.

proposition is that joint attention to, and agreement on, the design of the process is crucial, and must be principles-based.

6. APCA's response to Q1, effects of the reforms to date, focuses on distinguishing effects of the regulatory *process* for card payment reforms over the last 5 years, from the effects of the particular regulatory *solutions* adopted (removal of merchant restrictions and interchange fee regulation).

7. APCA's main effort is devoted to Q2, establishing not only the practicality, but the desirability of a different long-term approach to the regulatory process. The key to this will be better industry/regulator cooperation – in other words, effective co-regulation.

8. Finally, we attempt to apply the thinking on a better regulatory process to the case for ongoing regulation of interchange fees, access arrangements and scheme rules (first part of Q2), and draw implications for the way forward on the existing regulatory package (Q3). We do so without taking any view on the merits of historical reforms.

9. Our central recommendation is that industry and regulator should now work together to design and formally establish a principles-based co-regulatory process, and use this process henceforward in addressing the underlying policy concerns that lead to RBA interventions in the past. As a starting point, APCA proposes to develop "Principles of Payment System Self-regulation Best Practice", available by November 2007, to facilitate debate on the design of the Australian process. This need not unduly delay the review timetable.

10. On the specific RBA reforms, APCA submits that:

- RBA should clearly and concisely articulate its underlying public policy objectives in terms of payment system efficiency. Specifically, it should clarify whether efficiency is exclusively to be measured in terms of competition in relevant markets for payment services and payment instruments, or has other (clearly defined) aspects;

- Assuming, based on RBA published material, that payment system efficiency is exclusively a matter of fair, free, efficient and competitive markets, RBA should clearly define both the relevant markets and the criteria for satisfactory competitive efficiency;

- With the benefit of this statement of policy success criteria, review of the reforms actually undertaken should then address both the ongoing need for the reforms, and any alternatives, against the extent to which

the proposed regulation both meets the criteria , and represents the minimum intervention required to do so.

11. For its part, APCA commits to support these processes to the fullest extent of its abilities.

2 The State of Play

12. Before specifically addressing matters raised in the issues paper, APCA submits that a broad perspective on the recent history of Australian payment system regulation provides important context.

2.1 About APCA

13. APCA is the Australian payment industry's principal self regulatory body. It is the primary vehicle in Australia for payments industry collaboration, with a mandate to improve the safety, reliability, equity, convenience and efficiency of the Australian payments system.

14. APCA was established in 1992 as a mutual organisation for administering the technical and operational rules and standards between banks, building societies, credit unions and other payments organisations. APCA's role has since extended to managing and developing regulations, procedures, policies and standards governing payments clearing and settlement within Australia. It has around 80 members comprising the Reserve Bank, banks, building societies, credit unions and other participants in its five clearing systems. The 5 systems clear more than 98% of Australia's non-cash retail payment values.[2]

15. APCA's clearing systems provide definitive, participant-driven sets of rules and decision-making structures governing the conduct of clearing and settling transactions in relevant payment instruments. APCA does not process payments. In general, individual institutions participating in each clearing system are responsible for their own clearing operations which they must conduct according to APCA's rules.[3]

16. Historically, APCA's explicit strategic orientation was towards technical and operational matters within the 5 systems that it directly administered. However, in its 2006 review, APCA's Board adopted a new set of Core Principles focussing on a broader role: enhancement of the Australian payments system. The Core principles articulate 3 core APCA activities:

[2] Payments System Board Annual Report 2006, Table 1.
[3] More information about APCA can be found at: www.apca.com.au.

- **Industry policy development and advocacy,** where APCA's role is to facilitate the development of industry positions and views on the evolution and regulation of payment systems, and to communicate those views to government, regulators and other stakeholders as needed;

- **Industry standards and self-regulation,** where APCA seeks to ensure that system participants decide how they will operate and be governed, and members collectively set the self-regulatory framework for the industry; and

- **Industry change management,** where APCA coordinates and facilitates payments system development programmes as required by its members.

17. This enlarged strategic orientation is the basis for APCA's submission to the review: the first time APCA has made a detailed submission on this series of reforms.

2.2 The importance of co-regulation

18. The preamble to the Payments System (Regulation) Bill 1998 puts self-regulation at the heart of the intended payment system regulatory framework:

> *The philosophy of the Bill is … co-regulatory. Industry will continue to operate by self-regulation in so far as such regulation promotes an efficient, competitive and stable payments system. Where the RBA considers it in the public interest to intervene, the Bill empowers it to designate a payment system and develop access regimes and standards in close consultation with industry and other interested parties.* [4] .

19. The explanatory memorandum for the Bill amplifies this by asserting that any intervention will only occur "after substantial consultation with participants and after consideration of alternative regulatory approaches and voluntary arrangements have been exhausted".[5]

20. The RBA has repeatedly stated its own preference for a greater self-regulatory component in the regulatory process:

[4] At paragraph 11.
[5] Payment Systems (Regulation) Bill Explanatory Memorandum, at paragraph 5.13.

> *…the Reserve Bank is a reluctant regulator and we would much rather see an industry, than a regulatory, response to public-policy concerns…the Board is interested in the scope for the private sector to develop arrangements that address public-policy concerns about competition and efficiency.*[6]

21. The industry has expressed similar commitment to self-regulation. Last year, the then chair of Australian Bankers Association observed to an audience of global payments professionals:

> *"Our …ambition should be to maximize intelligent self-regulation and minimize government regulation … to demonstrate through our behaviour that, wherever it is practicable, self-regulation is better than government regulation."*7

22. Such unanimity is encouraging. And yet, in the recent history of payment card reform, self-regulation has had a significantly smaller role than in prior years.

2.3 Co-regulation in Australian payment system regulation

23. The vast majority of Australian payment system regulation has always been, and remains, self-regulatory. APCA's five clearing systems are themselves examples of effective co-regulation at an operational and technical level. Other examples of industry self-regulation are the EFT Code of Conduct, the credit card schemes, BPay, and most recently the EFTPOS access regime. There are other, less formal and purpose-specific examples of self-regulatory cooperation, such as the industry consensus, reached in 2003 in response to RBA's policy concerns on interchange fees in EFTPOS, to agree a zero interchange fee industry standard and secure ACCC authorisation for it.[8]

24. The evidence is that this framework has allowed the development of a world-class retail payments infrastructure for Australian customers. Specifically, by global standards, Australian retail payments are:
    - convenient and widely distributed;
    - used extensively and in rapidly increasing volume; and
    - safe and secure.

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[6] Lowe, Dr Philip, Deputy Governor of the Reserve Bank of Australia, in a speech to the 4th International Consumer Credit Card Summit, Sydney, 27 June 2007

[7] Morgan, Dr David, CEO, Westpac and Chair, ABA, Opening Plenary to SIBOS 2006, 9 October 2006.

[8] This initiative was ultimately frustrated by an adverse finding in the Australian Competition Tribunal, as RBA notes in the Issues Paper paragraph 36. This does not diminish the significance of the industry's self-regulatory efforts.

25. We support these propositions mainly by reference to Australian data collected by APCA and the Reserve Bank, and international comparisons derived from the 13 major economies (including the United States, United Kingdom, France, Germany and Canada) covered in the Bank for International Settlements "Red Book" series. Convenience is demonstrated by Australia's level of payments interconnectedness. For example, every holder of a debit card (around 18 million) or a credit card (12 million) can use those cards in any one of the 540,000 EFTPOS terminals or any one of the 24,000 ATM facilities. Australia has more EFTPOS terminals per million inhabitants than all the BIS Countries – at least 50% more than most countries, including the United States.

26. Australia has high usage rates per head of population for electronic transactions (including cards). Even so, growth rates in Australian retail payments broadly outperform international growth rates. In 2004, Australia had one of the highest rates of card transactions (all kinds) per inhabitant of all the BIS Countries. In the decade from 1995, growth in Australian credit card and direct debit volumes exceeded average growth in the BIS Countries by more than 8%.

27. Australia has an enviably low credit card fraud level which is at least partly the result of significant investments in fraud prevention measures. According to Visa International, the credit card fraud rate for signature-based transactions is around 0.04% in Australia, as against 0.09% globally. The Australian PIN-based debit card system does even better, at around 0.008%.

28. We submit on the basis of this data that Australian consumers and businesses are, by global standards, well served by electronic payments systems. A recent report from DCITA on the payments systems showed that both retail and business customers were very satisfied with Australia's payments systems.

29. The regulatory framework under which these results were achieved was co-regulatory in nature. Formal regulation was almost entirely self-regulatory, but with important contributions from public regulators in providing policy guidance, assessment and informal direction. For example, RBA was an important facilitator of APCA's early evolution.

30. The foregoing discussion is not intended to imply that the regulatory framework as it existed prior to RBA's use of its powers under PSRA was optimal. There are likely to be a range of views as to the effectiveness of self-regulatory processes at that time, but APCA certainly recognises the need for more specific attention to continuous improvement of industry

self-regulatory processes, particularly at the level of fundamental industry policy. This is evidenced by the new strategic direction outlined in paragraph 16 above.

31. There is also no suggestion that the evolution of card payment instruments presented no valid policy concerns requiring some form of regulatory attention. APCA's concern is to learn from past efforts to improve the efficiency of the regulatory process. APCA's submission is that self-regulation (supported by appropriate public policy oversight) can and has worked effectively, at least in areas outside the recent RBA reforms. Notwithstanding those reforms, and whatever one's view of the reasons for them, a co-regulatory approach should continue to be our shared industry goal.

2.4 Significance and impacts of the card reforms

32. Since 2003, the informal co-regulatory model been overlaid with specific government interventions in the form of access regimes and standards under the Payment Systems Regulation Act. Part II of the Issues paper summarises the history.

33. RBA has stated that this way of proceeding was never a preferred choice. From 1999 onwards, as the RBA undertook analysis into and, eventually, reform of payment card systems, there were repeated indications that intervention could have been prevented by a coordinated and effective industry response to the initial concerns raised by the government regulators:

> *… the Board eventually judged that if adequate progress was to be made in a timely fashion, regulation was required. Without getting into debates about history, I think it was fair to say that this outcome was not inevitable. The Bank's public-policy concerns could have been addressed by industry…*[9]*,*

34. These comments direct attention not only to the underlying policy concerns, but to the regulatory process: how do we establish the case for regulation, decide on the nature and scope of regulatory solutions, implement and administer the solution?

35. Without in any way suggesting that there was no need for regulatory action to address significant policy concerns, there is clear evidence of adverse effects from the way in which that action occurred. The challenge in assessing this claim is to separate evidence and analysis that relates to

[9] Lowe, *op cit.*; see also paragraph 21 of the Issues Paper.

the validity of the reforms that were actually implemented (removal of certain merchant restrictions, controls on the quantum of interchange fees) from evidence and analysis relating to how those solutions were arrived at and implemented (encouragement to self-regulation, extensive consultation followed by designation and direct regulation). In assessing the process, views on the validity of past reforms are relevant only to the extent that a different regulatory process might have produced "better" reforms. This will always be controversial.

36. Putting this to one side, the reform process itself has, APCA submits, produced some adverse impacts:
    - ***Delay:*** the formal co-regulatory model requires the public regulator to encourage self-regulation, consult extensively and only then engage in direct regulation. This process can, and has, taken several years to work through. Perhaps the clearest examples of this are policy concerns around access and competition in the ATM network, first raised in 2000 and still not resolved. These processes entail direct costs for regulator and industry;
    - ***Disputes***: the process adopted led to 2 court cases, a Competition Tribunal hearing and some lesser dispute processes. Again, substantial direct cost and effort had to be devoted to these disputes both by regulator and industry;
    - ***Distraction***: in addition to direct costs, delay and disputation have an opportunity cost: expert attention and effort is directed away from other, more productive activity to enhance industry efficiency or competitiveness;
    - ***Uncertainty***: Delay and disputation, together with lack of transparency of decision-making, also lead to regulatory uncertainty: industry participants know that the regulatory framework may change in significant ways, but cannot predict when or how. This tends to diminish investment and innovation.
    - ***Inflexibility***: Formal regulation takes longer to change, and tends to lag evolving market conditions.

37. Even if the same regulatory solutions were ultimately arrived at, a better regulatory process could have reduced or removed much of this "friction" impact. This is not to suggest that no regulation at all would have had better impact: the experience in the United States, of large, costly and highly uncertain court cases brought under general competition law, provides evidence of the desirability of some form of regulatory intervention.

38. There is no suggestion that these adverse impacts are the fault of any one party. Rather, the process has not worked as well as it could, partly

because in APCA's submission, both industry and regulator have not paid enough attention to ensuring the best possible process is in place.

2.5 Recent Efforts

39. Our submission, supported by evidence and analysis below, is that a well-designed co-regulatory framework and process (that is, one which maximises use of self-regulation subject to appropriate government policy oversight and cooperation) is most likely to resolve current policy issues effectively. More importantly, such an approach will over the long term address emerging issues more quickly and effectively.

40. As we have already seen,[10] both industry and regulator express a commitment to co-regulation. To support this, there is substantial recent evidence of willingness by industry and regulator to engage in a constructive co-regulatory approach to other policy issues.

41. APCA Board's commitment to a strategic reorientation, as outlined at paragraph 16 above, is one piece of evidence. On the basis of this commitment, RBA agreed to step down from APCA Board and committees (to reinforce their self-regulatory character) and engage with APCA in a clearly defined industry liaison process.

42. Contemporaneously, the Australian Bankers' Association established a Payments Subcommittee to address policy issues being raised by RBA in various public statements. This group, comprising bank chief executives, asked ABA management to work with APCA on responses to RBA's policy concerns.

43. Major industry participants and industry bodies have since worked effectively together on a number of regulatory policy issues:

- ***Responding to the Standing Committee Inquiry*** APCA and ABA provided a detailed response to the 2006 inquiry by the Joint Standing Committee on Economics, Finance and Public Administration into the Payment systems Board report;
- ***Research into comparative governance of payments systems*** APCA conducted research into the governance arrangements in comparable overseas payment systems This work is currently undergoing validation with the relevant jurisdictions, with a view to providing it to RBA as the basis for a broader dialogue on Australian payment system governance;

[10] At 2.2.

- ***EFTPOS Governance*** In late 2005, a group of executives of the major banks developed a discussion paper proposing that the owners of the EFTPOS system consider establishing a business development scheme for the system. They asked APCA and ABA management to assist in developing a proposal. This has since been considered by the ABA Council and APCA Board, which have both supported the development in principle. APCA is currently working on the detailed proposal to EFTPOS issuers and acquirers;
- ***ATM reform process sponsored by ABA and RBA*** In November 2005, ABA wrote to RBA proposing a way forward on long-standing policy concerns relating to access to the ATM network in Australia. This resulted in an industry consultation process sponsored by RBA and with the involvement of all major participants, ABA, Abacus (the newly-formed industry association for mutual financial institutions) and APCA. It now seems likely that APCA will be tasked by both industry and RBA to develop an ATM access regime addressing public policy concerns around access to the ATM network and competitive efficiency for consumers, and industry concerns around consumer disclosure and dispute resolution.

44. APCA submits that these developments are evidence of renewed commitment on all sides to a more effective co-regulatory process.

3 Designing a better regulatory process

45. The intent of the Payments System Review Act is explicitly co-regulatory, but in a sequential way: RBA has no formal regulatory role until it designates (with an attendant obligation to consult), and then has almost unfettered powers to act in the public interest. Contrast this with other regulatory models that give the public policy regulator an oversight role in self-regulatory processes. An example is the non-disallowance process in financial markets regulation,[11] where the public regulator has a clearly defined role in oversight of the self-regulatory process, allowing for transparency and certainty.

46. APCA's submission is that express commitment on all sides to effective co-regulation is not enough. In particular, it did not prevent adverse process impacts in the recent round of reforms. Effort needs to be devoted to designing an effective co-regulatory process, and ensuring widespread commitment and compliance.

47. There is a wealth of academic and empirical literature on the merits and attributes of successful self- (or, in our approach, co-) regulation. APCA

[11] Corporations Act ss793E and 822E.

has established a bibliography of over 300 books, articles and papers on the subject. We will summarise some of the key findings, and outline a proposal for developing an optimal system for the Australian payments system.

3.1 Optimising regulation

48. A core starting proposition for any modern regulatory framework is that the existence of free, open and competitive markets is the "first choice". The seminal study on competition in Australia, the Hilmer Report, articulates the primacy of competitively efficient markets in modern regulatory thinking:

> *The greatest impediments to enhanced competition in many key sectors of the economy are the restrictions imposed through government regulation*[12]

49. Regulatory intervention is only justifiable where:

- Market competition is inefficient, whether because of fundamental market dynamics (economies of scale of scope, network effects) or simply as a product of market evolution (in the economic jargon, there is "market failure"); or
- There are overriding social or industry policy objectives that would not otherwise be met in a competitive marketplace.

50. The kind of regulation adopted is just as important as the underlying case for regulation:

> "*It is a basic principle of industry efficiency and public welfare that the degree of intervention should be the minimum necessary to achieve the identified objectives. The manner of intervention should be that which imposes the least cost of compliance consistent with achieving the identified objectives.*"[13]

51. The reference is to a major report on self-regulation commissioned by the Australian Government. The taskforce reported in 2000 (the Collier Report), around the time of the ACCC/RBA Joint Study. The Collier Report provides an extensive review of self-regulatory frameworks across many consumer industries, and provides useful reference material both as

[12] Hilmer, Fred, Rayner, Mark and Taperell, Geoffrey: National Competition Report (The Hilmer Report), National Competition Report
[13] "Industry Self-Regulation in Consumer Markets", Report prepared by the Taskforce on Industry Self-Regulation, August 2000.

to the relative benefits of self-regulation over direct government intervention, and the attributes of effective self-regulation. The taskforce reported that:

> *Self-regulatory schemes tend to promote good practice and target specific problems within industries, impose lower compliance costs on business, and offer quick, low cost dispute resolution procedures. Effective self-regulation can also avoid the often overly prescriptive nature of regulation and allow industry the flexibility to provide greater choice for consumers and to be more responsive to changing consumer expectations.*[14]

52. There is now a sizeable body of academic literature that supports the findings of the Collier report:

> *self-regulation can solve a number of problems more effectively and more legitimately than traditional public "command and control" regulation in a variety of domestic and international settings.*[15]

53. There are two main reasons advanced for this effectiveness:

- *self-regulation is better informed*. The actors most intimately familiar with the workings of the relevant industry are involved in maintaining its regulatory framework;
- *self-regulation generates industry engagement*. Industry takes responsibility for effectively resolving industry policy concerns, and because of this ownership, individual firms are more likely to comply with the spirit and letter of the regulation, and encourage others to do so as well.

54. Against this, there are some well-recognised risks to be managed, particularly:

- misalignment of commercial objectives with overriding social policy objectives; and
- tendencies towards restrictions on competition, lack of credibility, and regulatory capture.

55. The best means to address these concerns is to ensure self–regulatory transparency and the active oversight of a public policy regulator – which is epitomised by co-regulation. Various studies have attempted to model

[14] Taskforce report p11.
[15] Porter, Tony and Ronitz, Karsten, Self-regulation as policy process: stages of private rule-making, Policy Sciences (2006) 39: at page 41.

and analyse the benefit of government involvement in self-regulatory compliance:

> *…government oversight of self regulation can benefit customers by leading the SRO to engage in more aggressive enforcement. The SRO would choose an enforcement policy that is just aggressive enough to pre-empt the government from doing its own enforcement.*[16]

56. APCA's proposition is that the cooperative engagement of public and private regulators needs to commence at the earliest stage of establishing policy objectives, and continue through to compliance. The challenge is to design a process that maximises self-regulatory benefits, while ensuring effective public policy oversight.

3.2 Principles of an effective co-regulatory process

57. There are many different designs for self-regulation. In fact, this is one of its asserted strengths: that the regulatory process can be "tailored" to the particular needs of the industry, so that policy concerns are addressed with the minimum disruption to market forces and commercial freedom. It is therefore challenging to define the crucial features of successful self-regulation.

58. APCA has undertaken preliminary work on how to improve the regulatory process for the Australian payments system. We have been working on a set of principles of payment system self-regulation best practice, based on academic work and using international comparisons. This is intended to serve as a starting point for defining a better Australian approach. These principles include:

- ***Transparency:*** Are relevant aspects of the system known and understood by all stakeholders: regulated entities, government regulators, and the broader stakeholder community:
- ***Certainty:*** Are relevant aspects precise, reach a clear outcome, and not likely to be frustrated by delay or dispute;
- ***Flexibility:*** Are relevant aspects responsive to environmental change, capable of fine-tuning as the result of previous regulation becomes clear, able to identify new policy concerns as they emerge;
- ***Legitimacy:*** Is the regulatory process persuasive and authoritative; does it bind everyone who needs to comply; does it demonstrate

[16] Peter M. DeMarzo, Michael J. Fishman, and Kathleen M. Hagerty: Contracting and Enforcement with a Self-Regulatory Organization, at p32

appropriate regard for policy concerns, does it have mechanisms to prevent regulatory capture by special interests;

- ***Efficiency:*** Does the regulatory process generate the minimum interference with commercial and personal freedom achievable? Does it minimise process and compliance cost? Do the benefits of regulation clearly and continuously outweigh the burdens?

59. APCA proposes that all co-regulatory systems can be assessed against a matrix of objectives, which directs attention to the key features that will maximise the prospects of long-term success. The principles need to be applied at each step in the regulatory process:

- ***Formulation of policy objectives*** (what is the regulation trying to achieve and why?)
- ***Regulatory decision-making*** (what regulation needs to be imposed to achieve the policy objectives, and why is it the optimal way to do so)?
- ***Regulatory execution*** (how is regulation imposed? Who must comply, what are the incentives to comply, and the consequences of non-compliance?):

60. Our work on self-regulatory principles is not yet complete, and the foregoing represents preliminary thinking.

3.3 Developing co-regulation in the current review

61. Enough has been said above to indicate that the current regulatory process for the Australian payments system is not optimal co-regulation. Having regard to the undesirable impacts of recent reforms (2.2.2), and the existing evidence of effective policy cooperation in other areas (ref 2.2.3), APCA submits that RBA should now join with industry in adopting a different approach. Specifically, RBA should signal its willingness to step away from reliance on the "consult, designate, regulate" regulatory process, and engage with industry in the development of the co-regulatory solution to which all parties have expressed commitment.[17]

62. Our central recommendation is that industry and regulator should now work together to design and formally establish a principles-based co-regulatory process, and use this process henceforward in addressing the underlying policy concerns that lead to RBA interventions in the past..

63. By November 2007, APCA will build on the outline in section 3.2 to produce best practice principles of payment system regulation with a co-

[17] See section 2.2.1.

regulatory focus, drawing on overseas experience, and the lessons of other industries.

64. Thereafter, APCA proposes the establishment of a co-regulation forum comprising key industry stakeholders and RBA to detail the optimal co-regulatory process for Australia. Establishing the primacy of efficient, competitive markets as a starting point, the objective should be to identify a co-regulatory process (self-regulation with active appropriate public policy oversight) that will give RBA confidence to unwind its existing direct regulation (access regimes and standards) within a reasonable transitional timeframe.

65. We should aim to have the co-regulatory process in place by April 2008. It is possible that one outcome will be proposals for reform of PSRB, which of course would necessarily involve a substantially longer timeframe.

4 Implications for current policy concerns

66. If APCA's submission is accepted, development and implementation of a new co-regulatory process will take some time, as indicated above. In the meantime, the principles of effective co-regulation, as outlined in section 3.2, can in APCA's submission be applied to assist RBA's consultative process on past reforms.

67. The next two sections provide some observations on past reforms based on this approach. We do not attempt to present and analyse our own evidence, since we would much prefer to see this done in a co-regulatory way, consistent with the principles outlined above. Instead, our observations are directed at the policy analysis that, in our submission, must be applied to the evidence in order to form a view on the future of past RBA reforms.

4.1 Formulating the public policy objective

68. The biggest difficulty in developing a truly co-regulatory approach to assessing past reforms is that it is not entirely clear where the public policy goalposts are.

69. If the policy objective is efficient (that is, fully competitive) markets in payment services, it becomes crucial to establish the criteria for market efficiency, and then assess whether through market evolution or regulation these criteria can be met. If, on the other hand, there are overriding social policy objectives other than free, fair and competitive markets, then a different regulatory response may be needed – one which is not

concerned to promote competition. It is, in APCA's submission, simply impossible to decide a way forward without an unequivocal answer to this fundamental question.

70. Section III of the Issues paper summarises the rationale for the past reforms. The material on interchange fees and merchant restrictions (paras 28-47) presents a rationale based on price signals to consumers in respect of different payment instruments which were "not appropriate"[18], "inefficient"[19], or "distorted".[20] Interchange fees are identified as an important factor, and stated to be "not subject to the normal forces of competition".[21] RBA articulates concerns about the "effect of [interchange] fees on the overall efficiency of the payments system", expressly disclaiming other motives.[22] RBA also indicates a concern to ensure that access arrangements were not more restrictive than necessary to ensure financial stability.[23]

71. It seems clear that the key policy objective is payment system efficiency. It is less clear, but probable, that efficiency is exclusively defined in terms of efficient competition in markets for payment instruments and payments services. This is supported by the earlier RBA material.[24] If this is not the case, i.e. that there are public policy objectives other than free, fair, competitive and therefore efficient markets, these should be clearly stated, because the regulatory solutions appropriate for social policy that is not concerned with market efficiency are likely to look very different from those that are.

4.2 The importance of market efficiency criteria

72. Applying this in practice, the first step is to define with precision the payment services markets which must be competitively efficient if overall payment system efficiency is to be achieved. APCA submits that, based on the issues paper and earlier RBA material, there are three markets relevant to the past reforms:

    a. The market for cardholding services provided by issuers to consumers;
    b. The market for acquiring services provided by acquirers to merchants;

[18] Paragraph 28 states an evidentiary finding of divergence between effective prices to consumers of different payment instruments and underlying resource costs, with apparent disapproval. Para 34 refers specifically to appropriateness.
[19] Paragraphs 31, 32 & 33 refer to price signals promoting system efficiency,
[20] Paragraph 42.
[21] Paragraphs 29-30.
[22] Paragraph 40.
[23] Paragraph 48.
[24] See, for example, Credit Card Statement of Final Reforms, 2002, at p9; EFTPOS and Visa Debit Final Reforms, 2006, at p9.

c. The market for joint use of payment instruments by merchants and customers in their transactions with each other.

73. Of these, market c. has attracted the greatest policy concern, and because of the "joint choice" nature of payment instrument selection, is the most difficult to analyse in competitive terms. Competitive pressures act separately on both consumer and merchant, and each influences the choices of the other.[25] Another complication is that in this unusual market, some of the competing offerings do not have an obvious supplier, eg cash. Nevertheless, competition clearly occurs, as promoters of payment instruments vie to secure a larger share of transaction volumes. Understanding the dynamics of market efficiency in this market is, APCA submits, a critical element of establishing public policy objectives for the future.

74. APCA submits that a necessary task in assessing past reforms is to establish for each of these markets criteria for competitive efficiency. In simple terms, when will each of these markets be sufficiently competitive that there is no ongoing case for regulation, or for additional regulation?

75. Thus for example, Section V of the issues paper contains data generally tending to show an increase in competition levels in at least some of these markets. The RBA statistical studies, together with submissions on the issues paper, will no doubt provide more evidence. But for the purpose of deciding the ongoing need for regulation, how much extra competition is enough? Without clear efficiency criteria, we do not know.

4.3 Implications for specific reforms

76. When each market has been assessed against competitive efficiency criteria, there are three possibilities:

1. The market has "naturally" evolved into a state of efficient competition, in which case ongoing regulation is not required;
2. The market is now or will become competitive, but only if regulation is used to remove inhibitors to competition which would otherwise exist. In this case, the regulatory response should be restricted to ongoing removal of competition inhibitors; or

[25] A consumer chooses payment instruments based on what instruments she carries, and what the benefits and costs are of proffering each instrument to the merchant for each purchase; a merchant chooses payment instruments based on which instruments it will accept, whether it will surcharge and whether it will otherwise "steer" consumer choices through incentives, promotions, discounts or other means.

3. The market has no real prospect of becoming competitively efficient, and therefore regulation is required to, as it were, impose efficiency to compensate for lack of competition.

77. Existing regulation on merchant restrictions and access to payment networks are clearly aimed at removing barriers to competition. To the extent that the evidence indicates increasing competition as a consequence of these reforms (eg increasing use of differential surcharging, new entrants to payment networks), then these reforms fall into category 2 above.

78. There may be other "category 2" reforms needed. Areas for future analysis should include:

- Extending the ability of merchants to steer consumer choices of payment instruments based on their competitive position (further regulation of honour-all-cards rules).
- Further encouraging access liberalisation of payment schemes.

79. Interchange fee regulation is not a category 2 reform. It does not remove barriers to competition. Rather, fee regulation has been justified on the basis that unregulated interchange fees are not subject to normal forces of competition,[26] so that there is insufficient competitive pressure on prices (interchange fees and through them, merchant service fees and ultimately consumer goods and services prices). Accordingly, it was deemed necessary to compensate for this failure of competition by adjusting prices directly.[27]

80. This is an example of category 3 regulation. In principle, it should not be a permanent feature of the regulatory framework unless RBA concludes that, for structural reasons, efficient competition between payment instruments can never be achieved. If this is the case, it should be clearly articulated.

81. APCA submits that one side-effect of interchange fee regulation (in common with all category 3 regulation) is, perversely, to limit competition in payment instrument markets. It does so by artificially fixing the differential cost to issuers and acquirers and, through them, cardholders and merchants, of different payment instruments. The review can adjust this fixed differential in any way it sees fit; but the effect will always be to limit, rather than promote, competition.[28]

[26] Issues Paper paragraph 30.
[27] Issues Paper paragraph 34.
[28] The "neutrality hypothesis" referred to at paragraph 33, is not inconsistent with this. In effect, the hypothesis says that preventing competitive variation of interchange will not affect competition

82. Another problem with long-term interchange fee regulation when viewed through the prism of competitive markets analysis is that it focuses attention on one out of many different levers used by promoters of payment instruments to compete with each other. Whatever the historical importance of this intervention, there is already evidence that other levers are being used: the market is reasserting itself despite intervention. Thus, for example, the card schemes now have incentive programmes direct to major merchants to incentivise card acceptance and promotion for particular purposes. In the absence of interchange fee regulation, this might have been done through adjustments to interchange fees, passed through to major merchants by acquirers.

83. APCA submits that the preferable course can and should be to create more competitive pricing pressure: it makes the market self-regulating, and avoids adverse side effects of regulatory intervention. The starting point for doing so is to establish the minimum acceptable criteria for market efficiency referred to above.[29] The objective should be that, once there is evidence of increasing competitiveness, interchange fee regulation should be phased out, both to increase the scope for competition and on the basis that the co-regulatory framework will continue to promote competition amongst payment instruments and as a result, market efficiency.[30]

84. APCA and its members are committed to working cooperatively with RBA on this, preferably through a co-regulatory approach developed as outlined above.

5 Conclusion

85. The long term key to success in Australian payment system regulation is a clear commitment by industry and regulator to a well-understood and universally applied co-regulatory process, shaped by an overriding policy concern for payment system efficiency delivered through fair, free, competitively efficient markets.

86. Our central recommendation is that industry and regulator should now work together to design and formally establish a principles-based co-

in payment instrument markets overall, because the markets will simply adjust for this restriction – other levers will be used to compete. This may or may not be true in practice, but there is no doubt that interchange fee regulation removes one of the avenues for competition between payment instruments.

[29] Section 4.2

[30] ie category 2 in paragraph 72 applies. It is worth noting that, on the available evidence, competitive efficiency may already exist.

regulatory process, and use this process henceforward in addressing the underlying policy concerns that lead to RBA interventions in the past. As a starting point, APCA proposes to develop "Principles of Payment System Self-regulation Best Practice", available by November 2007, to facilitate debate on the design of the Australian process. This need not unduly delay the review timetable.

87. In the current review, APCA submits that:

- RBA should clearly and concisely articulate its underlying public policy objectives in terms of payment system efficiency. Specifically, it should clarify whether efficiency is exclusively to be measured in terms of competition in relevant markets for payment services and payment instruments, or has other (clearly defined) aspects;
- Assuming, based on RBA published material, that payment system efficiency is exclusively a matter of fair, free, efficient and competitive markets, RBA should clearly define both the relevant markets and the criteria for satisfactory competitive efficiency;
- With the benefit of this statement of policy success criteria, review of the reforms actually undertaken should then address both the ongoing need for the reforms, and any alternatives, against the extent to which the proposed regulation both meets the criteria, and represents the minimum intervention required to do so.