Deloitte Access Economics

Competitive neutrality in payments

Visa Australia

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Charts

1 Competitive non-neutralities in Australian payments

In its Interim Report, the Murray Review has flagged this as an area of concern, observing that

> *"Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral."*

Since 2003, card payments in Australia have been subject to RBA regulations around interchange fees. These regulations were introduced to address the RBA's concern that there were insufficient price signals at the point of purchase, resulting in inefficient resource use.

The RBA decided that these regulations should not apply to three party schemes. This necessarily **introduced a competitive non-neutrality**; regulations were applied unevenly to different players, despite the fact that they provided substantially the same service.

The RBA's stated reasons for introducing this non-neutrality were two-fold:

- perceived difficulties in applying the regulations to three-party schemes, given that interchange fees were not set collectively by financial institutions under the traditional three-party model; and
- the higher market share of traditional four-party schemes was judged to be sufficient to ensure that they would still be able to compete effectively.

There is also another level of non-neutrality inherent in these regulations. Card-based payments are the only platforms subject to any specific price-related regulation in Australia. Other payment platforms – including, for example, BPAY, cheques, and PayPal, are not subjected to any similar regulations. The fact that **the burden of regulation falls more heavily on certain methods of payment** means that the competitive playing field is not even. This can have negative impacts on overall system efficiency.

> Current regulations have introduced competitive non-neutrality into the payments system. Regulations are not evenly applied across platforms or payment methods. This has competitive consequences.

Visa has asked Deloitte Access Economics to prepare a brief note highlighting the issues around interchange regulation, including:

- overarching questions about whether interchange regulation is welfare enhancing;
- the need for action on companion cards ; and
- the rise of concerns around technology neutrality.

2 Is regulation welfare enhancing?

The RBA's originally considered introducing interchange regulations as a means of addressing what it argued was an inefficient use of competing payment instruments. In particular, it argued that the incentives offered by card schemes to consumers were attracting them away from other payment mechanisms which processed transactions which were at the time at a lower cost (e.g. eftpos). The RBA argued that this was resulting in a higher cost payments system than socially optimal:

> *"Normal market mechanisms are not working effectively in the retail payments system in Australia and, overall, the community is paying a higher cost for retail payments than is necessary."*
> - RBA, 2002

The RBA acknowledged, even at the time of the reforms, that more expensive payment mechanisms are not necessarily worse, stating in Lowe (2006):

> *"amongst a myriad of possibilities, it may be optimal for one payment system to be priced more attractively to cardholders than another, despite that payment system having higher total resource costs."*

Further, there is no theoretical basis to support the assertion that costs are higher than optimal. In a literature review, Evans and Schmalensee (2005) conclude that:

> *"There is no apparent basis in today's economics – at a theoretical or empirical level – for concluding that it is generally possible to improve social welfare by a noticeable reduction in privately set interchange fees."*

Even if there was benefit to be had from regulating interchange fees, the method the RBA employed would be unlikely to land on an optimal price (Evans and Schmalensee (2005)):

> *"There is a consensus among economists that, as a matter of theory, it is not possible to arrive, except by happenstance, at the socially optimal interchange fee through any regulatory system that considers only costs".*

Clearly, there is no established theoretical basis for determining the optimal interchange fee, or system of fees, given that they should be largely determined based on a balancing effect rather than production costs. Hence, regulators cannot be sure whether a given fee cap will improve efficiency relative to a free unregulated outcome.

> To date, the RBA has been unable to demonstrate that its actions in regulating interchange fees will be welfare improving overall.

3 Companion cards

Competitive non-neutralities in payments have resulted in distortions in the market which outweigh the benefits which the RBA argues accrue.

> *CHAIR: At what point, Dr Lowe, would you decide that the distortion in the market is such that it outweighs the benefits to the consumers as you see them?*
>
> *DR LOWE: …There is no magic point here. The observation that I would make would be that if the **market shares of the three-party schemes were to increase significantly** and at the same time … there was **no reduction in the average merchant service fee** of those schemes, then that would raise the issue of whether the competitive positions of the different schemes were starting to undermine the benefits of the reforms.*
>
> - Dr Philip Lowe, former Assistant Governor RBA, in presentation to the House of Representative Standing Committee on Economics, Finance and Public Administration (2006) (emphasis added).

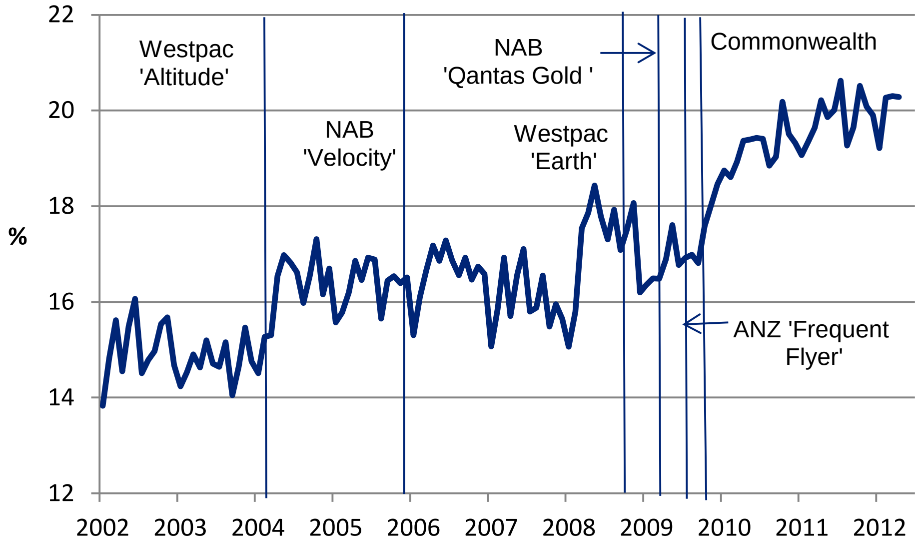
3.1 Increased market share

Traditional three-party schemes have developed new business models and products since interchange regulations were introduced. 'Companion cards' were first introduced by American Express, which is not covered by interchange regulation. This is a new four-party card model, with companion cards issued by financial institutions alongside cardholders' primary cards. These mimic the offerings of traditional four party cards. By being unconstrained by interchange fee regulation, companion cards are able to offer more generous rewards.

In adopting the new model, traditional three-party schemes have provided incentives to issuing banks to promote and distribute companion cards. In response to these incentives, all four major banks, as well as many smaller players, provide customers with companion cards alongside traditional cards as part of a rewards package.

This has been very successful. Customers have accepted companion cards, as a method of gaining higher rewards without the need to pay any additional fees. This had led to substantive growth in the market share of traditional three-party schemes, despite the fact that they operate a higher cost model. Growing market shares are illustrated in Chart 3.1.

Chart 3.1: Market share of American Express and Diners Club transaction value

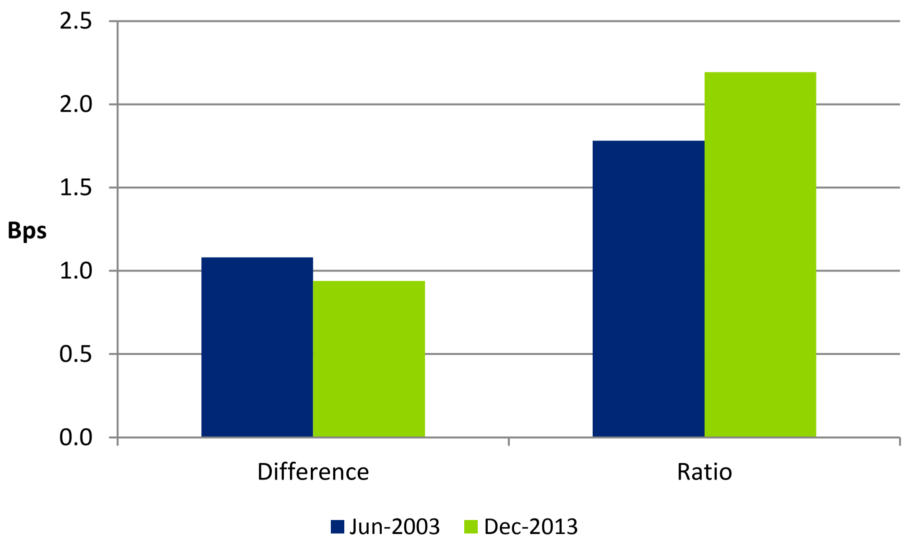


Source: RBA, DAE

3.2 Maintaining merchant service fees

The rewards provided through four-party companion cards are funded through relatively high merchant service fees (MSFs). While the MSFs charged by traditional three-party schemes have fallen in line with reductions from Visa and MasterCard, the ratio of traditional three-party scheme fees relative to traditional four-party scheme fees has widened (Chart 3.2). A higher ratio means that traditional three-party schemes are able to offer higher relative rewards. This will continue to drive their ongoing growth.

Chart 3.2: American Express MSFs relative to Visa/MasterCard



Source: RBA, DAE

Further details on this calculation are provided in the Deloitte Access Economics report attached to Visa's first round submission to the Inquiry.

These developments are distorting the credit card market in Australia, and artificially shifting the market back towards higher cost payment providers. Four-party companion cardholders are effectively being subsidised to switch to a higher cost scheme, which is opposed to the two stated aims of the RBA regulations, namely improving competition and efficiency.

3.3 The cost

DAE has estimated the cost of the rising market share of new entrant unregulated four-party schemes since 2003. This has been calculated on a quarterly basis, using RBA data, as:

- *The rise in the proprietary four-party schemes' market share (by value, measured in percentages) over the period*, multiplied by
- *the difference in merchant service fees between the regulated four-party schemes and the un-regulated proprietary schemes (proxied by American Express)*, multiplied by
- *total purchase value*.

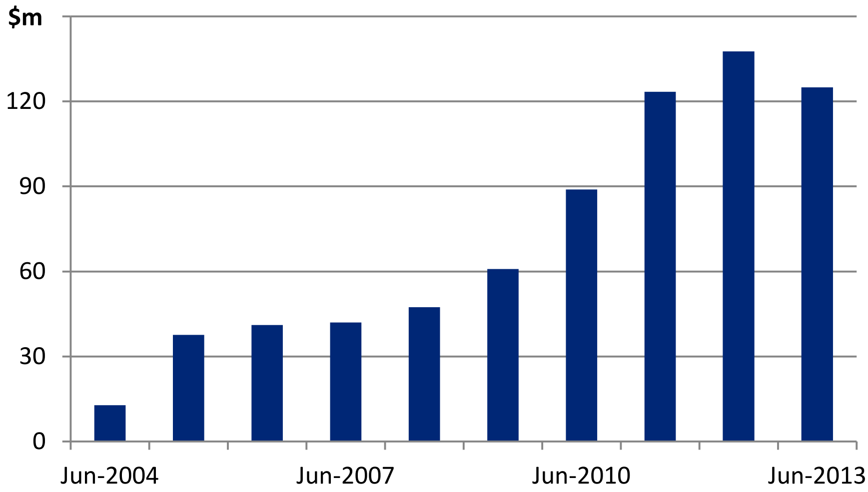
Quarterly results were then summed to provide annual figures, and discounted to present value as necessary. The estimated results are shown in the box below and Chart 3.3.

> The rising market share of such schemes since the first half of 2003 when the regulations were introduced has directly cost merchants at least $125 million in higher fees in the 2013 financial year and a cumulative $0.77 billion in 2013 dollars since the reforms were introduced in 2003.[1]

These fees are used to fund the more generous rewards for companion card holders, thereby undermining the RBA's original objectives.

[1] The market shares of American Express and Diners Club are not separately available. To the extent that some of the increase in the combined share is driven by Diners Club, which has the highest MSFs of the major credit card companies, the cost to merchants will be larger.

Chart 3.3: Direct cost to merchants caused by increases in American Express/Diners Club market share



Source: DAE, RBA

4 Technology neutrality

In its Interim Report, the Murray Inquiry also raised the question of technological neutrality. Like competitive neutrality, technology neutrality would require regulations that don't inhibit or discriminate against different technologies. This is important to fostering an economy which supports innovation, and ultimately generates growth.

This is not a new issue for payments. In the 1980s, when card payments were first being introduced and regulations were being considered, regulators had to think about the interaction between cards, cash and cheques. Different regulations were applied to each. Looking forward, the pace of change will continue to increase. New digital platforms will emerge to challenge incumbents.

Predicting how these will evolve is problematic. Regulators have previously struggled with this. For example, when introducing interchange regulations, part of the reason that the RBA declined to regulate traditional three-party schemes was the Bank's assumption that these cards would continue to operate as a small proportion of the market, used primarily for high-value transactions. Developments since then have contradicted this assumption, as highlighted in our previous report (DAE, 2014).

Further, many of these innovations may originate from overseas, developed in situations where incentives are quite different to those in Australia. It will be difficult for regulators to envision what these may be.

As the Interim Report emphasises, regulations should not vary according to the technology being used, unless there is a strong rationale for doing so. These differences are already pervasive. For example, while traditional four-party credit card schemes are subject to interchange regulation, no such restrictions exist for BPay or cash payments. The current framework is not set up in a way such that new platforms with similar offerings will be captured by regulation.

Technology neutrality should also apply to government and other legislatively required payments. Legislation should not specify a method of payment; this should be at the discretion of individual departments.

There is case to be made for a graduated regulatory framework. This would allow regulators to monitor innovations at the edges of the system, without introducing incentives for gaming existing regulations to create competitive advantage, as was the case in the establishment of the companion card models.

Conclusions

Existing RBA regulations are distorting the competitive landscape. They are neither technology neutral nor competitively neutral; regulations are applied to some modes of payment but not others, and even payments which have the same economic substance are not covered by the same regulations.

> The most effective and appropriate solution to remedy this would be the removal of interchange regulations. The RBA could instead use a monitoring regime. This would ensure both technology and competitive neutrality.
>
> At the very least, companion cards should be subject to interchange regulation, in order to ensure competitive neutrality.

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