

Submission to the Taskforce on Reducing the Regulatory Burden on Business

Visa International

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Introduction

Visa International welcomes the opportunity to present its views to the Taskforce on Reducing the Regulatory Burden on Business (the "Taskforce").

Visa believes that the Taskforce's enquiry is timely as Visa is concerned about the unnecessarily interventionist approach to regulating the Australian payments system that has been adopted by the Reserve Bank of Australia. Implicit in the establishment of the Taskforce is an acknowledgment by the Government that there are areas of over regulation in the Australian economy. While payments system regulation is not specifically mentioned in the Taskforce's terms of reference, Visa strongly believes that it represents a prime example of inappropriate and excessive regulation.

A sound regulatory environment is essential for the smooth operation of the Australian financial system. At the same time, given the central role performed by the financial system, regulatory practice that introduces unnecessary costs and constrains innovation will have an amplified impact on the efficient operation of the broader economy. Furthermore, markets have proved their ability to create and manage complex international networks and systems with limited intervention by governments or regulators. Visa believes that an appropriate regulatory balance has not been achieved in the regulation of the payments system, notably in the case of the credit and debit card networks.

The following reviews the fundamental principles that should inform the design and implementation of financial sector regulation and how the events of recent years have led to less than optimal regulatory practice. The discussion throughout concentrates on the regulation of payments system, especially as applied to electronic payments networks. It argues that of the Australian payments system is not well served by the current regulatory framework or its application and that new accountability arrangements for the regulators are needed.

Financial sector regulation

The basic principles and architecture of financial sector regulation in Australia is based on recommendations developed by the Financial System Inquiry (the "Wallis Inquiry").¹ Those principles and architecture continue to be appropriate.

In particular, the Wallis Inquiry stressed the desirability of the design and application of regulations being proportionate to the nature of the risks involved and the consequences of market failure (or, in the Wallis Inquiry's terms, the "intensity" of the promises involved). Also, in a market economy, intervention should only be contemplated when there is clear market failure and should be carried out in a manner that minimises the costs and any constraints on innovation.

¹ See *Financial System Inquiry, Final Report*, AGPS, Canberra, 1997.

The Wallis Inquiry emphasised five principles on which business regulation should be based, namely:

- **Competitive neutrality** which is especially relevant for the financial system given the convergence in products that is occurring. There should be minimal barriers to entry;
- **Cost effectiveness** or, more broadly, economic efficiency;
- **Transparency**;
- **Flexibility** which is important if the regulatory framework is not to inhibit innovation in what is a very dynamic sector; and
- **Accountability** including, as the Wallis Inquiry stated:²

... the regulatory structure must be accountable to its stakeholders and subject to regular reviews of its efficiency and effectiveness.

The Wallis Inquiry also recommended fundamental changes to the architecture of financial sector regulation. These changes included the establishment of APRA and a clearer mandate for ASIC in market conduct. The Reserve Bank was to have responsibility for financial system stability and, because it was intimately related to system stability, the payments system.

The Wallis Inquiry recommendations were, in the main, supported by both the Government and industry. However, the implementation of the recommendations was complicated by a difficult external environment (including the need to embrace a number of international initiatives on the regulation of the financial sector and the challenges that arose from some large-scale corporate failures). It also emerged that key regulators adopted a highly interventionist and legalistic approach which added to cost and complexity.

Regulation of Payments Systems

The Wallis Inquiry's recommendations on the payments system are reflected in the Payments System (Regulation) Act 1998 ("PSA"), which gives the Reserve Bank responsibility for the regulation of the payments system. Traditionally, the two principal roles for central banks have been the conduct of monetary policy and financial system stability. A robust and reliable financial system is fundamental to healthy market economies and, reflecting this, the core expertise of central banks around the world has been directed at system and monetary stability. Issues related to market structure and competition have tended to be the responsibility of other bodies, notably those authorities in charge of competition policy. Under the PSA, however, the Reserve Bank was given the additional responsibility of encouraging competition and efficiency in the payments system.

In particular, the PSA incorporates two tiers of objectives, namely that a competitive and efficient system should be encouraged *subject* to an overriding objective of the maintenance of financial system stability. The Act gives the Reserve Bank the power to "designate" particular payments systems if it deems that it would be in the public interest to do so. The provisions give the Reserve Bank considerable discretion as shown in the following clause:

² P198 of Financial System Inquiry, Final Report, 1997, at www.fsi.treasury.gov.au.

In determining ... if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:

- (a) being (in its opinion):*
 - (i) financially safe for use by participants; and*
 - (ii) efficient; and*
 - (iii) competitive; and*
- (b) not (in its opinion) materially causing or contributing to increased risk to the financial system.*

The Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so.

The Government's intentions in introducing these measures were reflected in the Second Reading speech:³

The Government has decided to strengthen, and make more transparent and accountable, the regulation of the payments system undertaken by the Reserve Bank.

and

The Reserve Bank will be the regulator of the system, given the importance of the payments system to the overall stability of the financial system and given the central role of the Reserve Bank itself in the core areas of the payments system, particularly settlement. As with all the other reforms I have announced, this decision highlights the Government's commitment to encouraging innovation and competition while not, in any way, jeopardising the stability and soundness of the financial system.

It is Visa's understanding that the Wallis Committee viewed the designation powers as being available as a last resort and that there would be a presumption for a light-handed approach to be adopted in this area of regulation. In particular, if an issue were deemed to emerge, the first course of action would be to rely on measures to improve transparency and minimise entry barriers to encourage competition rather than direct intervention. This is the approach generally adopted in the regulation of other sectors of the economy.

As it has turned out, the Reserve Bank chose to adopt an interventionist approach to the regulation of the card networks from the outset.

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Available at <http://fsi.treasury.gov.au/content/downloads/PublicInfo/Speeches/Speech.pdf> .

Regulating Card Networks

The Reserve Bank's approach to regulating the payments system is among the most interventionist in the world. It is not the purpose of this submission to evaluate the specific decisions adopted by the Reserve Bank but rather to outline some of the problems that have arisen because of what Visa views as a poor regulatory framework.

The Reserve Bank has designated three credit card systems, namely those operated by Bankcard, MasterCard and Visa, to impose three sets of regulations that:

- Required the card companies to set domestic credit card interchange fees at levels that reflect 'attributable' costs;
- Removed the 'no surcharge rule' for domestic transactions on credit cards; and
- Established an access regime that would allow so-called specialist credit card institutions (SCCIs) to participate as credit card issuers or acquirers (or both) in Australia.

The Reserve Bank decided against directly regulating the 'closed' card systems operated by American Express and Diners Club, although both agreed to remove their 'no surcharge rules'.

The approach adopted by the Reserve Bank involved a number of flaws.

First, the economics of two-sided networks is only imperfectly understood.⁴ Contrary to usual regulatory practice, the Reserve Bank introduced these regulations without clear support from independent experts that the measures would lead to an improvement in economic efficiency.⁵

Second, while Visa has no concerns with the specifics of the new access regime introduced by the Reserve Bank, it is not clear that the new regime is necessary. In particular, all the schemes already had long-standing membership eligibility regimes that have been essential to establishing their integrity. It is in the interest of the schemes for there to be as many participants as possible as long as they are financially and operationally sound. Visa considered that there were no artificial barriers to such entities, and the fact that the new regime has seen only one new licence granted supports this assessment.

⁴ Two-sided networks refer to situations where a 'network' or 'platform' provides a facility for producers and consumers to transact business. Examples of such networks include Adobe, console games, newspapers (which rely on both advertising and subscriptions for revenue) and car parks at shopping malls. The costs of the network can be borne by either party or shared, and the economically efficient structure of charging will depend on demand and supply characteristics on both sides of the market. It will often be efficient for the costs of the network to be primarily borne by one side of the market (as is the case for the Adobe system where Acrobat Reader is provided to users free of charge).

⁵ This experience can be contrasted with past economic reforms such as the tariff changes where decisions were based on a deep understanding of the likely economic impact.

Furthermore, there have been a number of complications in the implementation of the new access regime which have inevitably added to compliance costs. For example, the regulations as originally enacted did not cover debit cards and modifications were required for Visa Debit. Also, as currently drafted, the regulations would not allow a finance company to apply for a licence and further modifications may be needed.

This experience has important implications for the Taskforce's considerations on the role of self-regulation. In principle, self-regulation can provide a flexible and low cost means of meeting policy objectives. However, in this case, the regulator decided to override what has been a very successful form of self-regulation – one that fostered the expansion of open networks worldwide – without strong evidence of the need for doing so or the likely benefits.

Third, it is in the area of interchange fees – that is, the transfer of fees between 'issuers' and 'acquirers' on the two sides of the networks – where the new regulations have been most intrusive. The card networks have been successful in expanding their operations by being able to tailor their offerings to each side of the market – that is, to merchants and to cardholders – to best balance the demands of each. Interchange fees enable this flexibility to occur.

This flexibility is essential for the systems to develop in a manner that maximises economic efficiency. It also allows the networks to innovate and develop products that best meet the needs of customers. For example, there is an increasing need to invest in highly secure systems and artificial constraints on cost structures risk undermining this objective. The regulations limit this flexibility and do not seem to take adequate account of the need to be able to respond to changes in technology and the market.

Finally, by only directly regulating Bankcard, MasterCard and Visa, the Reserve Bank has provided American Express and Diners Club with a significant competitive advantage. While there are differences between the schemes, these differences are primarily ones of form rather than substance. There are growing signs of American Express and Diners Club benefiting from the changes, particularly given that several banks are now issuing "closed loop" American Express or Diners Club cards as companions to "open loop" Visa cards, leading to a higher cost, less efficient outcome.

Thus, in introducing these regulations, the Reserve Bank has breached the first of the Wallis Inquiry Report's five principles on which financial sector regulation should be based, namely the principle of competitive neutrality.

The way forward

As emphasised by the Wallis Inquiry, the regulatory framework employed should be proportionate to the task at hand. Robust payments systems are crucial for financial system stability and close supervision by regulators can help to provide confidence for individuals and market participants. Thus, it is important that the Reserve Bank is intimately engaged in this, the overriding, aspect of its role under the PSA.

In contrast, a more light-handed approach can be adopted to the competition and efficiency objectives of the PSA, making more use of market disciplines. Indeed, this appears to have been the view of the Wallis Committee and is reflected in more recent remarks by policy-makers, including members of the House of Representatives Standing Committee on Economics, Finance and Public Administration. For example, in questioning the Reserve Bank at recent hearings, Mr Ciobo questioned the Reserve Bank's interventionist approach in the following terms:⁶

But why not address the transparency issue, which to me seems to underline this? If there is greater transparency in the system, people could choose which niche they sought to operate in. I am concerned that this is going to have a distorting effect on the marketplace.

And

I believe you have removed the power of providers in the market place to determine the cost mix that they would like in their products.

The experience of the past few years has highlighted the Reserve Bank's wide-ranging powers. The Reserve Bank is not subject to the same checks and balances that, say, the ACCC faces. In the areas of the Reserve Bank's major functions – namely, the conduct of monetary policy and financial system stability – it is entirely appropriate that it does have considerable autonomy to take binding decisions.

In contrast, there is no reason for the Reserve Bank being less accountable than, in particular, the ACCC when it comes to objectives related to competition and efficiency. Given the degree to which not only market participants but also independent observers are uncomfortable with the framework that the Reserve Bank has adopted to regulate payments systems, it does appear desirable to change the Reserve Bank's accountability arrangements in this area. In this regard, it is worth emphasising that Wallis viewed the accountability of regulators and regulations to be sufficiently important to include it as one of the five main principles for financial sector regulation.

⁶ Commonwealth of Australia, House of Representatives Standing Committee on Economics, Finance and Public Administration, *Reference: Reserve Bank of Australia annual report 2004*, 12 August 2005, Melbourne.

In light of this discussion, Visa recommends that the Taskforce considers three options for the design of the regulatory framework for the competitive and efficiency aspects of the payments systems (2 and 3 are not mutually exclusive):

1. Remove the reference to competition and efficiency from the Payment System Act and give the ACCC responsibility of these aspects of payments system regulation under general competition law. The ACCC has greater depth of expertise in the area of competition and having centralising the regulation of competition within one agency should contribute to a more consistent application of policy throughout the economy. The ACCC's decisions are also potentially subject to effective scrutiny at the Australian Competition Tribunal (ACT).
2. Introduce an effective appeals process in relation to the Reserve Bank's decisions that can directly examine the merits of the decision, similar to the ACT's role in competition issues.
3. Encourage the Reserve Bank to fundamentally reassess its regulatory framework in its next review of the regulation of credit card networks due in 2007. The aim would be to remove intrusive regulations, especially related to interchange, and rely more on market disciplines. In particular, it is critical that the regulatory arrangements are sufficiently flexible to facilitate innovation and investment in new technological solutions to security and other issues.

Visa recognises that the specifics of these regulations extend beyond the scope of the Taskforce's work and that the Taskforce may not be in a position to recommend a detailed regulatory approach as suggested above. If this is the case Visa recommends that the Taskforce:

- (a) Reaffirm the desirability of regulation being proportionate to the nature of the policy objective at hand;
- (b) Stress that in the area of competition and efficiency, there be a strong presumption for light-handed regulation that fosters market discipline; and
- (c) Invite the Government to reconsider the implementation of payments system regulation along the lines advocated above. This may be part of a broader investigation in the implementation of financial system regulation that Visa understands has been advocated by other parties.