# Travel Industry Downgrades Australia

(The Unintended Consequences of Regulations
for Credit Card Bank Interchange Fees)

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Australia is being accused of introducing some unworkable legislation to the world!

So, how did Australia get involved?

Well, Australians have got one extremely bad habit.

When anyone puts a proposition to us, we keep saying 'yes'.

For example, successive US Presidents have invited us to join them in dropping bombs on countries with which we were not at war.

We usually say, 'ok!'

So that's probably why our Reserve Bank of Australia (known as the RBA) said 'yes' to being a test case for these credit card bank interchange fee regulations.

Now, don't get me wrong, saying 'yes' is not always bad.

I've said 'yes' so many times that I've actually written a book about it.

The book is called *Heroic Misadventures* (www.HeroicMisadventures.com). I'm only telling you all of this for two reasons: … Yes, I have one copy of this book for sale here, so get in quick, but mainly I'm here today to show you how Australia's involvement in the interchange fee saga has developed into simply another 'heroic misadventure' as it forms a classic example of unintended long-term consequences flowing from short-term fixes.

One of the RBA's given responsibilities covers the integrity of the Australian Payments System. The RBA Payment System Board states that:

> "A safe, competitive and efficient payments system is essential to support the day-to-day business of the Australian economy. The Payments System Board of the Reserve Bank has a mandate to contribute to promoting efficiency and competition in the payments system, and the overall stability of the financial system."[1]

The catalyst for this RBA intervention was the mounting pressure from retailers to lower the cost of card acceptance. So, here we have the developing nightmare of two competing lobby groups—one from the retailers trying to lower the cost of card acceptance and one from the finance industry trying to clip as much as possible on the way through.

Now these lobbyists don't come cheap and the problem is that we consumers are slugged with paying the costs of the lobbyists on both sides of the debate. The net costly result, as each lobby group takes its turn to capture the regulators, is a labyrinthine maze of constantly changing regulations that leads us to today's discussion. (We should instead be discussing how we can be more effective at our chosen profession.)

A timeline of key RBA regulatory events so far includes:

- 2001 - Designation of the MasterCard and Visa systems - initial designation.
- 2003 - Merchant Pricing for Credit Card purchases - removing scheme rules that block a merchant's ability to surcharge.
- 2004 - Card scheme Access Regimes - establishes a new regulatory standard (under APRA) for potential new and non-traditional institutions into the Australian card payment's systems.
- 2004 - Designation of the scheme debit systems and the EFTPOS environment.
- 2006 - Setting of wholesale (interchange) fees in the designated credit card system - establishing a benchmark of 0.50% of the transaction value.
- 2006 - Setting of wholesale (interchange) fees in the designated debit card system - establishing a benchmark of 12 cents per transaction count.
- 2007 - Honour all cards rule - scheme rules cannot block a merchant from deciding whether or not to accept scheme credit or debit cards. A merchant cannot discriminate at a card issuer level.
- 2012 - Variation to Surcharging Standards - primarily empowers schemes to regulate surcharging by merchants by limiting the surcharge amount to 'the reasonable cost of card acceptance'.
- 2012 - Designation of the EFTPOS system - recognising the establishment of EFTPOS Payments Australia as the domestic EFTPOS scheme.
- 2013 - Setting of wholesale (interchange) fees in the designated EFTPOS card system - establishing a benchmark of 12 cents per transaction count.

Now, well actually last Thursday (7 November, 2013), Australia's Commonwealth Consumer Affairs Advisory Council issued a report on these credit card surcharges and non-transparent transaction fees. Our Minister for Small Business has commented that Australia already has enough laws, under the RBA guidelines, to police these surcharges. However, there is confusion over which government body, Australian Securities & Investments Commission (ASIC) or Australian Competition & Consumer Commission (ACCC), should be leading this policing process. Consequently, they are going to have another meeting to decide.

A number of the changes listed above are a consequence of earlier regulatory attempts—especially in the area of surcharging.

The continued existence of wholesale/interchange fees actually goes against the RBA's desire for transparency in fees, although the RBA would claim that the application of a surcharge would address this from a consumer perspective.

There is mounting concern with this fee and the RBA regulation arise from the following:[2]

Now, apart from the inequalities that are becoming obvious, the frequent review and adjustment of what is now a complex interchange fee structure is costly to all participants. The RBA requires the schemes to publish their interchange fees. The complexity of the Australian market and the schemes' attempts to meeting the benchmark can be viewed at:

- http://www.mastercard.com.au/merchant/getting_started/interchange_rates.html
- http://www.visa.com.au/ap/au/aboutvisa/interchange/interchange.shtml

I don't want to bore you with all this stuff! So, what are we going to do about this?

Let's pause for a while before we fall into the trap of trying to solve this problem with even more fiddling!

One of my favourite economists, F.A. Hayek, would have recognized this as an example of the 'fatal conceit'[3] where bureaucrats feel they can make better decisions for us than would be made by a fully operational free market. As a matter of fact, people of the bureaucratic mentality have absolutely no concept of the workings of markets.

Now let me ask this vital question. Are consumers currently being ripped-off in Australia? The answer is, absolutely. A resounding 'yes' and let me give you just two examples:-

1. Airlines are ripping us off by charging $8.50 per leg of the ticket—that is, if you have to catch four separate flights to reach your destination, you pay for one ticket but get slugged four times with the $8.50 fee.

   Four good reasons to avoid credit cards!

2. The second example are Australia's (regional) monopoly taxi industries which charge a 10% surcharge for use of credit cards. (This translates to an 11% surcharge as Australia's consumption tax (GST) is added on top of the 10% surcharge).

   This problem is caused by various State and Territory governments licensing the taxi industry and preventing competition from entrants who may choose not to surcharge from gaining an advantage over the incumbents.

   This 10% credit card fee is giving Australia such a bad name that visitors are warned by travel advisors "don't use your credit card for taxis" in much the same way that you are warned "not to drink the water" in certain countries. (So, that's the market at work). If the media were doing their job by publicising these rip-offs, it would help. If the RBA wants transparency in pricing, it could require taxis to display a sign which reads: "Danger. Before you pull out your credit card, be warned that we will belt you over the head with a 10% surcharge."

   If the government did this, the taxi industry would immediately employ yet another lobby group and we consumers would be paying for three lobby groups instead of two.

   As I said, highlighting this should be the job of the media, but they remain silent.

A freely working market would help solve the problems, where we, as consumers, would refuse to use cards or banking facilities if we could get a better deal by using cash, gold or debit cards, or whatever alternatives we come up with in the future.

The answer is not this bureaucratic replacement of free markets in Australia. Bureaucracy is already the major challenge facing small to medium sized enterprises.

According to a study from the University of Newcastle, in Australia, one-third of start-ups fail in the first year; on a cumulative basis, by year three 62% have failed and, by year five, 74%.

One of the major factors driving small business to extinction in Australia is the overwhelming red tape thrown at them from Federal, State and Local Governments.

The cost of compliance in terms of the hours spent on useless documentation is anathema to the new generation of forward-thinking risk-taking entrepreneurs.

These people are hard working and they want to focus on productivity and building a business rather than an avalanche of form-filling.

Every newly elected Federal, State and Local Government promises to 'ease the bureaucratic burden on businesses' but they never do.

Regulation only serves and favours the regulators, and the regulators have completely captured the process at all levels of government.

To understand the size of the problem one has first to look inside the minds of the 'regulators'.

Why do the worst get to the top?

This question was again answered by F.A. Hayek, in his book *The Road to Serfdom,* where he illustrated the mentality of the people who had come to occupy the positions at the top of government hierarchies in a centrally planned economy.

Hayek showed how normally tolerant and productive individuals, like you and me, are never attracted to such work and he showed that it was for this reason that in any economy drifting towards socialism, 'the worst get on top'.

More recently, in their book *The Reason of Rules,* Geoffrey Brennan and James M Buchanan stated, "If institutions are such as to permit a selected number of persons to exercise discretionary power over others, what sort of persons should be predicted to occupy these positions?"[4]

Brennan and Buchanan explain why we should expect that the people most willing to work hard to attain political office will be those who expect to gain the most from holding such office.

Perhaps this explains why these regulations which have been such a failure in Australia are now being enthusiastically introduced to other countries.

When they wanted to find out how well the regulations were working in Australia who did they ask?

The regulators of course!

The same people who benefit most from these regulations.

They are comfortable in the security of their regulatory jobs where they are unaware of the collateral damage they have caused. [5]

**To summarize & conclude:**

Until the RBA decides to enlist the aid of the 'free market' to play its part in exposing greedy transgressors, it will continue to struggle to find a way out of the current complex and unfair interchange fee model that does not sit well with its transparency-in-pricing ethos.

Drawing attention to this problem should be the job of the media, but on this matter they remain silent. So this challenge is left with the think-tanks. So let's get it on to the front pages!

Thank you.

*Summary link from Iain Murray (V.P. Competitive Enterprise Institute) – "We Didn't Regulate Credit Cards, We Regulated People" –*
[*www.openmarket.org/2013/11/15/we-didnt-regulate-credit-cards-we-regulated-people/*](www.openmarket.org/2013/11/15/we-didnt-regulate-credit-cards-we-regulated-people/)

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[1] The Bank oversees the payments system as a whole, which encompasses a wide variety of individual payment instruments – ranging from cheques and payment cards to high-value corporate payments – and the usually unseen arrangements that ensure the smooth transfer of funds from accounts at one financial institution to another."

Under the *Payment Systems (Regulation) Act* 1998, the RBA has the power to designate a payment system, impose an access regime on a payments system and to establish standards to be complied with. Utilising this power the RBA has initiated a number of regulations over the years impacting the domestic card payments system.

[2]

- The fee is a pass through cost/revenue to the card schemes themselves yet they determine the applicable value.
- While not the primary source of card issuer revenue, the fees (at least for credit) represent a significant part of the funding costs for rewards programs
- The schemes utilise the interchange fee as an incentive to Issuers to issue specific scheme product - primarily the corporate and premium card products.
- Interchange fees are a scheme weapon in the control of the Australian debit card market. Credit card transaction growth is flat or even in decline with debit growth at around 12% pa. While the EFTPOS scheme remains the dominant party Visa and MasterCard per annum growth is triple that of EFTPOS

While some would argue that regulation of interchange fees has reduced cost of card acceptance it has not occurred equally across Australian retailers and consumers. Those with substantial market power (the major retailers and oil companies or specific industry groups such as Education and Government sectors) have benefited from the scheme application of interchange fees either below or on par with the RBA benchmark. The approval of 'strategic rates' remains solely at the discretion of the card scheme and not the institution acting as the acquirer. Such rates apply irrespective of the card product presented. While the average Merchant Service Fee has reduced from 1.45% in March 2003 to 0.76% in June 2013 the result is heavily influenced by the lower strategic rates applied to major retailers.
(See - http://www.rba.gov.au/payments-system/resources/statistics/index.html)

Smaller retailers without the benefit of a strategic or industry rates bear the brunt of scheme 'cost recovery' to balance the benchmark. A small retailer with an EMV-capable terminal that accepts and processes a PIN authenticated transaction may pay an interchange fee from .33% up to 1.98% depending on the card presented. It is technically very difficult to identify the interchange fee at the time the transaction occurs. To correctly surcharge each transaction is not possible and the merchant is forced to apply a weighted average surcharge across all card transactions. Again the smaller retailer is penalised by needing to apply a higher surcharge level compared to a larger competitor that benefits from a strategic rate.

In the same vein, consumers with standard card product will bear higher level of the surcharge costs than those with premium product. Given the obvious revenue incentive to card issuers many are actively encouraging consumers to adopt premium card products. However this may turn into a vicious cycle with merchants increasing surcharge amounts to compensation compensate of increased interchange fee costs.

While the RBA forwent its review of the benchmark results for 2012, they are looming for 2013. It is possible that small business associations may finally come to grips with the inequality of the current methodology being applied. An industry segment backlash will only force RBA into further regulatory adjustments that will again lead to other unintended consequences. Worse case is that the RBA drops the benchmark even further resulting in additional interchange fee modifications by the card schemes.

[3] www.therepublic.com/view/story/parker22/parker22

[4] Page 64

[5] If one were to take a different view on interchange and the funding of rewards programs a new model may ultimately evolve. The origin of the interchange fee stems back to the early days of credit card acceptance and represented a risk offset for the card issuer. Before EFTPOS terminals the primary record of a transaction was a voucher with a card imprint. Provided the retailer followed the processes dictated by his acquirer, same day value was received. The card issuer would not know of the transaction for approximately 3 days and would assume the risk for the value if the consumer could not pay. The decision to pay interchange also recognised the benefit to the retailer - lower cash handling costs, reduced cost of cheque acceptance and for larger purchases retailers, costs of providing an in-store credit solution.

Early interchange fees in the Australian market were in the vicinity of 1.2% to 1.8% based on issuer and not product derived. One view is that interchange fees should revert to a risk compensation setting with active merchant agreement to an incremental increase if the merchant wishes to support or participate in a rewards program. This would lead to a further reduction in card costs that could be accompanied by reinstatement of a 'No Surcharge' rule by the schemes with the RBA's permission. The downside to this is the sudden demise of the current reward programs so that any change would need to be signalled years in advance.