WHO SHOULD REGULATE THE BANK INTERCHANGE FEE?

The RBA or the ACCC?

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It's run like a secret society. No one can explain why this [regulating payments, setting interchange fees] is a function retained by the RBA. The *Payment Systems Board* is the least transparent, most secretive and poorly understood government body that is responsible for every transaction that takes place in this country.

– Senator Sam Dastyari, Chair, Reference Committee on 'Matters relating to credit card interest rates' (Sept 2, 2015)

Summary

Since 1959 the Reserve Bank of Australia has occupied dual statutory functions in: (1) the central bank role of the setting and conduct of monetary policy, including ancillary roles of banknote provision and banking services to the Federal government; and (2) the regulation of the payments system. The case for RBA regulatory control of the payments system (including the bank interchange fee) was always based on its relation to the first function – its ability to promote stability and control risk in the financial system through a secondary role of promoting *efficiency* and *competition* in the payments system.

Yet there has never been a strong case for these two distinct functions – monetary policy, and regulating the payments system – to be contained within the same agency. It is a holdover from a more protectionist era. Indeed, economic theory suggests these are distinct functions should be separated because they draw upon distinct theory, specialization, and experience: the monetary policy function drawing on monetary economics and macroeconomics, and the payments function drawing on theory of competition and industrial organization.

Once we recognize that the ACCC, as a specialised competition regulator, is the appropriate agency to regulate the payments system and interchange fees, the issue then arises as to why the government would be engaged in fixing a market price. We suggest that the interchange fee does not so much need to be regulated as demystified, and that the RBA has systematically failed in this task.

This tension is seen in the consumer welfare losses and distortions to industrial organization caused by the RBA fee-capping regulation of the bank interchange fee in 2003 (IAEP/ATA 2015). It is also seen in the politically motivated demands that the RBA 'do something' about supposed hidden bank and card fees, when microeconomic theory suggests there is no problem here to solve.

We argue that the regulatory function over the payments system should be removed from the RBA and placed with a transparent specialist agency with capabilities and experience in regulating competition and industrial organization.

1. The Nature and Role of the Reserve Bank of Australia

The Reserve Bank of Australia (RBA) is Australia's 'independent' central bank. The primary function of any central bank is the conduct of monetary policy. In Australia monetary policy has since 1993 been conducted under an independent charter requiring inflation targeting and pursuit of macro-financial stability, using the tools the RBA has at its disposal, including setting the reserve cash rate, and the conduct of open market operations using its financial reserves. This role also includes issuance and management of banknotes, which are the legal tender required for payment of Australian taxes. A parallel role, occupied since it separated from the Commonwealth Bank in 1960, is to function as the Australian government's bank.

Two Boards

The Reserve Bank consists of two Boards: the Reserve Bank Board, which covers monetary policy, and the Payments System Board (authorized by Division 2, Part IIIA of the Act) which covers policy relating to the operation of the payments system.

Since the 1997 Wallis Report, the regulation of the Australian financial system is no longer based on status but is based on function. This resulted in the creation of new agencies. The Payments System board of the RBA was given responsibility for decisions that concern the payments system by the Payments System Regulation Act (1998). The Australian Prudential Regulatory Authority (APRA) (established by the Australian Prudential Regulatory Authority Act 1998) was created to take over a role previously exercised by the RBA of prudential supervision. And the Australian Securities and Investment Commission (ASIC) (formerly Australian Securities Commission) was given powers to regulate appropriate standards of market conduct by financial institutions, including the Electronic Funds Transfer Code of Conduct.

The RBA's own description of its role in the payments system is as such:

> 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. 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. The Bank also has a formal regulatory role to ensure that the infrastructure supporting the clearing and settlement of transactions in financial markets is operated in a way that promotes financial stability. In addition, the Bank has an important operational role in the payments system through its ownership and management of the Reserve Bank Information and Transfer System (RITS), Australia's real-time gross settlement system.
>
> (Source: http://www.rba.gov.au/payments-system/)

The efficient function of the payments system – in effect a mutual clearinghouse requiring interoperability – requires many different financial firms to work together, creating hazards of collusion. The Payments System Regulation Act (1998) allows the Australian Competition and Consumer Commission (ACCC) to override the Trade Practices Act (1974) that would otherwise make such cooperative agreements between competitors illegal. Since 2001, the Reserve Bank has been granted the power to regulate the payments system.

The Payments System (Regulation) Act 1998 gives the Payments Board the power to address clearing and settlement issues, including the determination of standards, of the payments system. It is important to note here that, as a practical matter, the clearing system was owned by Australia's licensed banks, and the main issue for financial competition in payments was access to that system. The banks themselves argued that exclusion of non-bank financial intermediaries along with other exclusions from this system were justified on grounds of financial stability (echoing, obviously, the RBA statutory mandate). But it is also plainly true that this same behaviour clearly benefited the participants in the payments system by excluding competition. This regulatory issue, therefore, is manifestly one of competition policy.

Basic Economics of RBA scope and function

The RBA therefore has a legitimate role in the expert conduct of monetary policy in order to ensure monetary stability in Australia's official currency (the AUD), as associated with low, stable inflation. Monetary stability is a near perfect public good that can be expertly and efficiently supplied by a monopoly provider – the RBA.

While we do acknowledge that a free banking system (Hayek 1976, 1978, White 1999) also provides monetary stability through competitively issued currencies, and thus without the need for a central bank, this is not the line of our argument. By most accounts, the RBA has successfully furnished broad monetary stability over the term of its independent operation targeting inflation (1993 – present). In both theory and practice, there is a widely understood need for this role to be conducted autonomously and secretively.

But the economic reasoning contained in this argument does not extend to the payments system, which is *not* a public good, but rather is a suite of technologies and organizations, i.e. an industry. The payments system refers to a vast network of operations, agreements, rules and technologies that enable payments to be transacted between all parties in the Australian economy. Like the Internet, it is not a single system but a network of networks. It is also important to note that it is not a public network, but an interlinked web of private systems: it is an open private network. It is useful to think of the payments system as a network infrastructure that has cumulatively emerged from entrepreneurial actions, as the economy has grown and developed, in order to facilitate the transaction needs of a market economy. The payments system was not created by the RBA, and a payments system would exist without the supervisory oversight of the RBA.

From a regulatory perspective, the payments system is not a public good but rather is a technology, a network, a market, an institution, and an industry. This should be approached as a separate issue of industrial organization. Yet this is not what currently exists or what happens. The RBA has taken on exclusive responsibility to regulate the payments system, and furthermore does so under the same operational cover of secrecy and independence as the conduct of monetary policy, where such secrecy and independence are essential to ensure policy effectiveness (Kydland and Prescott 1977). But no such argument can be made for regulating what is, in effect, competition policy. Instead, there is the risk of unaccountable policy mistakes, what Djankov *et al* (2003) associate with the social costs of government intervention (or the "costs of dictatorship" in their terminology).

2. Is there a case for the RBA having regulatory authority over the Payments System in general and the interchange fee in particular?

On the face of it, it might seem entirely natural that the RBA, as the nation's statutory central bank, should regulate the payments system that interlinks all of the transactions in the economy, and that pass through all providers of payments services, which are largely composed of competing commercial banks and providers of financial services. The RBA has regulatory power over what would otherwise be private negotiations over contracts between competing firms in pursuit of mutual gains from trade – such as credit card interchange fees between acquiring and issuing banks – because this falls within its payments system remit.

But that logic does not make a case for the RBA in particular, just for any specialized agency. Rather, the reason for RBA involvement in regulation of the payments system in general, and of specific issues such as credit card interchange fees in particular, is because the RBA has historically been concerned about the cost of the operation of the price system. This is a macro-institutional concern, derived from the long 20th century battle between market capitalism (the price system) and communism (the command system). Monetary and price stability coupled with efficient operation of a payments system is essential to the flourishing of a market exchange system.

But there is no inherent reason, other than the payment of taxes, why this needs to be based entirely on a derivative of a cash payments system using official government money. Once it is appreciated that money is a technology, the institutional form of a financial technology (Menger 1892), and that payments is a market service, and that the issuing and operation of credit is a value adding market service, it becomes clear that public welfare in a market economy is best served not simply by minimizing the cost of the operation of the price system, but by maximizing the benefits of the price system.

Cost minimization is easy enough to achieve by prescribing a simple capped offering, but that has the (unintended?) consequence of constraining the commercial development and market offering of superior or varied credit and payments services (including for example, no fees cards, or those offering extensive rewards programs). A price cap on financial services works in exactly the same way a price cap does in any sector, effectively eliminating all possible market supply above that price, and therefore reducing the choice set facing consumers. By reducing the ability for suppliers to price discriminate, the market is made less efficient. Ultimately, this results in a less effective, less competitive, and less innovative market for money, credit, and payments services.

There is no strong case for the RBA to regulate the Payments System

The oversight and regulation of Australia's payments system has been with the RBA since 1959, where it accrued more or less by default, in the absence of a specialized regulatory agency. Indeed given the underdeveloped competitive state of the banking and payments system at the time there was no perceived need for such a specialised agency. The main argument for why the regulation of the payments system still remains with the RBA, through the various inquiries and reviews of its scope and ambit, can be summarized, in essence, as 'because it has been with the RBA since 1959'. In more technical terms the regulatory status quo has been determined by path dependency.

The payments system has evolved enormously since the 1950s, as a technology built no longer on paper ledgers or paper currency but on digital communications infrastructure and software, as complex business operations, in terms of interfaces and organizational complexity, and as a competitive market. The payments system is as different now from how it was then as, say, are the telecommunications or global logistics industries. Yet the regulatory function and organization remains unchanged.

There is no strong or explicit case for positioning the oversight and regulation of the payments system within the RBA. This can be seen in the RBA's own public defence of its function in speeches explaining the RBAs role and function, as we will observe below.

However, there are a number of weak and often implicit cases that are regularly made. These can be approximated as follows:

(1) That the payments system has some connection with the monetary system – *viz*. payments are made in money, and because the RBA controls money, it should also control payments.
(2) Interchange fees are connected to credit cards and credit cards involve interest rates – monetary policy involves interest rates, *ergo* the RBA should regulate interchange fees. (This is a variant of 1 above).
(3) The payments system is a utility (run by the banks). Therefore the central bank should regulate this.
(4) The RBA has acquired historical experience in oversight and regulation of the payments system, and so it should continue in this role.
(5) The RBA *should* regulate the payments system because it *can* regulate the payments system.

It does not require a great deal of logical skill to disassemble these arguments: (1) and (2) are fallacies of composition; (3) is a truth conditional (i.e. an empirical claim); (4) is the induction problem, and (5) is the naturalist fallacy. The point is that none of these are solid economic arguments, each can be picked apart logically and empirically, and all carry a large amount of expediency.

The RBA itself acknowledges as much

In a speech in 1996 by then Deputy Governor of the RBA Graeme Thompson on 'The Reserve Bank's Role as it Impacts on Business'[1], Mr Thompson concludes by noting (emphasis added):

> … there is talk from time to time of narrowing the RBA's focus, so that it would have only one or two 'core' responsibilities. In my view such a move would be misguided. There are significant synergies in having the responsibility for both price stability and financial stability in one place. Banking supervision is integral to our financial stability role, and provides information on market and institutional conditions which is helpful to monetary policy. Meanwhile, our operational activities in securities markets, *in the payments system and in conducting banking services give us some 'hands-on' experience in, and a better understanding of, pressures and constraints in the business world*. This, in turn, contributes to the better-informed conduct of our broader policy functions.

[1] Talk to the 1996 National Institute of Accountants New South Wales Congress, 'Maximising Your Business Opportunities', Sydney - 22 May 1996.

This is an instance of both (1) – 'it has something to do with money, so it is good practice for us', and (5) – 'we can do it so we should do it'. Which then supports (4) – 'we do it now because we did it then'.

To further disassemble this argument is to acknowledge that if the RBA had an effective payments simulator, or required its executives to do apprenticeships in banks, the result would be much the same. In other words, this is not an argument about why the RBA should regulate the Payments system, but rather about the benefit the RBA itself gets from that regulatory function.

This is a common characteristic in the RBA's explanation. It explains the benefit the RBA gets from that function – including experience, synergies, and more employees – but these are not arguments about why Australian citizens, consumers, and businesses benefit from RBA regulation.

What is striking, even, is that this persists in the face of the RBAs plain and open acknowledgement that the payments system is clearly a technology and competition driven industry. In 2015, Assistant RBA Governor Malcolm Edey said this in a speech discussing the path from the Wallis report (1997) to the recent Murray inquiry (2014) (emphasis added):[2]

> …Third, and related to the first two points, Wallis foresaw the growth of payment systems as a business, in contrast to the utility-based model that I described earlier. If commercial realities were leading to the unbundling of payments from other financial services, *then it was to be expected that this business would open up to innovative and specialist providers. It also meant that existing players would need to put their own payments services on a more commercial footing*. And lastly, Wallis looked at the regulatory implications of these developments. Payments systems are networks which link service providers and their customers. That means that they need to have ways of ensuring adequate coordination among network members who would normally be competitors. *This in turn raises a whole suite of questions as to whether particular network arrangements are generating efficient outcomes*: for example, is there appropriate access to networks for new players, are network pricing arrangements efficient and are there effective coordination mechanisms to promote network innovation? Wallis concluded that there was a need for regulatory oversight of payment systems, and the recommendations that flowed from that formed the basis for the arrangements we have today.

And the Wallis Inquiry explicitly insists…

So the RBA acknowledges that the goal of Payment system regulation is competitive efficiency. This is also explicitly what the Wallis Inquiry recommends (61-63). The purpose of the RBAs regulation of the Payments system – through the Payments System Board (PSB) – is to promote competitive efficiency in the development of the payments markets, technologies and industry. It is not for the RBA to 'gain experience' or 'exploit synergies'. The Wallis Inquiry argued the case for the separation of Payments from the RBA's core functions.

In the Wallis report summary they say this by way of recommending the creation of the PSB (p. 23-4):

> Competition in the Payments System: Establishment of the Payments System Board

[2] Malcolm Edey, Assistant Governor (Financial System). Speech at the Cards & Payments Conference - "Card Payments Regulation: From Wallis to Murray" (Melbourne - 21 May 2015)

> The task of ensuring systemic stability is closely linked with maintaining the integrity of the payments system. The central bank itself plays a pivotal role in the final settlement of payments. Accordingly, it is proposed that the RBA remain the regulatory authority in charge of the Australian payments system, but with a separate subsidiary board established to oversee this function - the Payments System Board (PSB). The PSB would have some common membership with the parent board of the RBA, including the Governor and one deputy governor. It would make its decisions independently of the main board which would concentrate on monetary policy and economic stability.
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> The RBA should be empowered to set standards for the payments system, adopting the role of regulator. Any provision of payments clearing services to its customers in competition with the private sector should be clearly separated from the RBA's regulatory function and be subject to transparent reporting arrangements. The RBA should, however, retain its ownership and participation in those parts of the payments system where high level control and coordination is necessary to ensure maximum efficiency; for example, in the provision of the infrastructure for the high-value payments system.
>
> The clearing systems should be subject to access rules which are transparent and subject to approval by the competition regulator. There should be no presumption that any one class of financial institution should have exclusive rights to issue particular payment instruments, with the exception that only DTIs should be able to issue cheques in their own name. Conditions of access to clearing streams will vary and especially high standards may be mandated as necessary. Entry to payments clearing streams should be determined by the PSB and not be controlled by industry organisations.
>
> There should be no presumption that banks will be the only holders of ESAs. The right to hold an ESA should be determined by the RBA on the basis of clear and open guidelines, including the requirement that participants have extensive payments business with third parties.

The language Wallis employs is unmistakably describing a competition regulator, albeit a competition regulator within the RBA that would work with the ACCC. This is reinforced in the Report's summary recommendations – most notably recommendation 61 (emphasis added).

> Recommendation 61: A Payments System Board should be formed within the RBA.
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> The payments system should be regulated by the RBA under a Payments System Board (PSB). The PSB should have responsibility for *implementing policies to improve payments system efficiency, including the adoption of the most efficient technology platforms, and enhancing the competitive framework*, consistent with overall systemic stability. The PSB should also have general oversight of the clearing streams.

Why do we not have a separate Payments System regulator?

Given the RBAs own somewhat hazy arguments about why it maintains control of the payments regulation function, and the Wallis Inquiry's recommendations toward separation in other areas, it is somewhat puzzling why the Payments System regulation still with the RBA (in the form of the PSB). Detailed analysis of this question is beyond the scope of this paper but in the next section we explain why the RBA is poorly suited for this task.

3. The Case for Regulatory Specialization, or Why the RBA is Poorly Suited to Regulate the Payments System

The RBA undertakes two tasks that on the surface appear related, because they are both about money, but are actually entirely distinct phenomena, based on different underlying economic theory, reasoning, and practical experience. The first argument for their separation is basic economics: namely, to exploit the benefits of specialization – in theory, analysis and experience. By this logic, while the operation of monetary policy is best done by the RBA, the regulation of the payments system is not. Indeed, a case can be made that precisely its lack of specialized understanding and experience in the domain of the competitive dynamics of industrial organization has led to some costly (although underreported) failures (IAEP/ATA 2015).

It is certainly not inconceivable that a single government agency can have multiple unrelated tasks based on distinct specialist functions. The Australian Defence Force, for example, both trains soldiers (a task focused about mental and physical education) and maintains materiel (a task focused about logistics and engineering). But these largely unrelated functions are gathered within a single organization for a compelling reason, namely that they are conjoint inputs in providing the service of security and defence. But this argument does not hold for RBA joint control of monetary policy and the regulation of the payments system. Regulatory control of the payments system is not a necessary co-input into achieving effective monetary policy or in the conduct of open market operations.

Monetary policy is a specialization based on the theory of both monetary economics and macroeconomics. Monetary theory of money in an exchange economy, the theory of money supply and demand, the theory of banking, credit and debt, an understanding of monetary history, and of the monetary transmission mechanism that connect monetary instruments to the macro-economy. Built around analysis of interest rates, and various indices (inflation, asset prices, aggregate demand, GDP, unemployment, industrial production, *et cetera*) the theory underpinning the effective conduct of monetary policy is broadly the study of emergent aggregates, mechanisms and macro-econometric models of economic systems. Both individual economists and also teams of economists or research departments specialize in this task and body of theory and practice.

Monetary economics and policy has its own scientific culture, a specialized language (and scholarly history), and is a branch of economics in the same way that quantum mechanics is a branch of physics and electrical circuits is a branch of engineering. The RBA, as with all central banks, is highly competent in monetary economics and monetary policy.

The economics of industry regulation – of any industry, including financial ones, such as the payments system – is a very different branch of economic theory and practice. First, it is entirely based in microeconomic theory (not macroeconomics) and is focused on market behaviour under different degrees of competition (from perfect competition to monopoly). This is called the theory of industrial organization, which since the 1980s has been extended to consider strategic interactions (through the application of game theory to the previous framework known as 'structure-conduct-performance'). This is based around the study of rational firm behaviour and action in a competitive market context. This approach often incorporates transaction cost economics, imperfect competition, models of technological and entrepreneurial competition, and models of strategy.

Regulatory economics is, in essence, the study of the social control of business. It began in the welfare economics in the 1920s (associated with the work of Arthur Pigou 1938) that diagnosed market failures arising from imperfect competition, particularly negative externalities, and sought to meet these with deliberate attempts by government to intervene in market outcomes to correct these. This is the public interest theory of regulation. In this approach, the government and its regulators are assumed to be benevolent, competent and wise, and act purely in the public interest. The RBA hews strongly to this model of regulation.

Beginning in the 1960s and 1970s a new economics of regulation developed associated with the Chicago school of law and economics. (This was developed by Ronald Coase, George Stigler (1971) and Richard Posner (1974), among many others.) The private interest theory of regulation argued that the main beneficiaries of regulation is not the public, but private firms, for whom it serves to restrict competition. A further line of argument, associated with Coase (1960), sought to emphasise that private bargaining and contracts, enforced through courts, can usually more efficiently internalise those externalities (Laffont and Tirole 1993). With efficient courts, there is no rationale for regulation (Posner 1972). A third argument, associated with the public choice school, was that government failure associated with regulation (particularly rent seeking) was much worse than market failure it sought to correct. This questions the assumption that the regulator is necessarily 'benevolent, competent and wise'.

Again, this branch of economic theory and application is a distinct and specialised part of economics – as regulatory economics and the economics of industrial organization. It also has its own culture, models, and history, and ways of seeing and understanding the world.

Monetary economists and regulatory economists are very different animals. They practice a highly specialised and difficult craft, drawing upon different theory, models and traditions, with little overlap between them. This is no less true of the applied policy domains of the conduct of monetary policy and effective regulation.

These two bodies of knowledge and experience can of course be combined in the same agency, but they must reside in different people, and different teams, with different cultures. There is little gain to be had from aggregation, and much mischief to be made from running the two together. An obvious problem with the RBA and its two separate boards is that the same person – the RBA Governor – is chair of both.

A final point to note here is that monetary policy and industrial regulation pursue very different functional objectives. The objective of monetary a policy is macro financial and price stability – as a public good. But payments system regulation is about promoting efficiency and competition, in order to drive out waste and encourage innovation. This is an economizing objective – to promote the efficient use of society's resources. These different objectives have completely different pathways of effect, and completely different measures of success. There is no overlap in the practical prosecution of the tasks of monetary policy and industrial regulation.

Regulation of the payments system rules, including the bank interchange fee, is an issue of industrial organization and competition policy. This is not the RBAs natural domain of competence. Instead, the RBA has a comparative advantage in monetary policy. Australian financial industry would be better served if payments regulation were handed off to a more specialized agency.

4. Competition regulators should not fix market prices

The Australian Competition and Consumer Commission (ACCC) is, because of its specialization in the economics of competition and industrial organization, the appropriate government agency to regulate the payments system in general and bank interchange fees in particular.

Competition regulators are usually mostly concerned with case-by-case rulings with respect to particular policing of anti-competitive practices, such as blocking mergers and acquisitions that create substantial monopoly power, or seeking evidence of collusion toward the same effect. Competition regulators seek to identify and prosecute firm behaviour that weakens competition and therefore threatens to harm consumer interests.

It is rare that this remit extends to endeavours to impose price ceilings (or floors) on what are otherwise market-determined prices. There are of course instances of this, and which are usually associated with producer-initiated lobbying (for example seeking to rule on whether retailer discounting of house-brand milk constituted 'predatory pricing'). There is no theoretical justification for a competition regulator to impose price floors or ceilings, or in any way determine a price that is otherwise competitively set through a process of market discovery. The role of the ACCC is to ensure an institutional environment which competition occurs in order that all relevant information, under competitive bargaining, is expressed in market prices (Hayek 1945).

The ACCC has no position (and nor has the RBA) of superior knowledge from which to advance a true and correct price that the market will not discover itself, if it is free to. Bargaining and economising in the process of competitive price discovery occur on many fronts, including not only matching of product features to segments of consumer demand, but also in finding the optimal specializations and boundaries of firms, across which payments will be made (Williamson 1985). The interchange fee is simply an instance of gains from trade made possible by separation of function between the incentives of acquiring banks and issuing banks in order to maximise the benefit of holding and accepting credit cards to both merchants and consumers (IAEP/ATA 2015).

The interchange fee, then, does not so much need to be regulated as rather demystified. The demand for interchange fee regulation has largely been created out of confusion about the nature of the fee in a competitive market, something the RBAs lack of transparency has exacerbated.

5. On the Issue of Transparency in Bank and Credit Card Fees

A final point to note relates to the issue of consumer-facing transparency in bank fees and credit card fees. The issue of 'hidden fees' has been widely and repeatedly raised as a problem with the private ordering of financial markets, which are thought to be subject to asymmetric information in which consumers know less about the structure of the costs of the financial services they purchase than the suppliers selling these products. The result is sometimes referred to as a "confusopoly", implying that banks and card issuers deliberately create complex information schedules in order to make product-to-product comparisons difficult, and to raise the information costs of switching. This creates rents from imperfect competition.

The credit card interchange fee, which occurs between acquiring bank and issuing bank in a four-party payments system is a good example of a fee that is largely invisible to consumers. This seeming suspicion that merchants and banks are exploiting the hidden nature of the interchange fee to exploit consumers is a major reason for RBA endeavours to regulate and cap the interchange fee.

But the economic theory of information in competitive markets does not support this position. Consumers do not need to see all the costs that go into all of the components of a product. The only information they need is on the attributes of the product, and its total price (Hayek 1945). The price system economises on information, and provided there is competitive entry and exit, there is little to be gained from regulatory requirement to post all input and component prices.

Indeed, there may be substantial costs to this, falling on the consumer. The confusopoly literature (e.g. Kalaychi 2015) points out that this sort of disaggregation of a price into components – for example also observed in phone plans and insurance, does not actually necessarily benefit bounded rational consumers because it creates more information to process, thus raising the cost of comparison. Firms seeking regulatory disclosure are a good example of private interest masquerading as public interest

Furthermore, a credit card, as with most financial products, is a complex commodity with many dimensions of value. The RBA is in no position to observe what consumers value and why – these are subjective preferences.

A more serious issue is the transparency of the RBA's Payments Board. This is a non-minuted society. Its decisions are completely non-transparent. This governance model is for very good reason with respect to monetary policy – namely to ensure effective independence and time consistency. But there is no basic in logic or experience to argue that this secrecy and unaccountability is appropriate for a competition regulator.

6. Summary and recommendations

The Reserve Bank of Australia has two boards: the Reserve Bank Board and the Payments System Board. Our immediate issue is not with the Reserve Bank Board. Rather, our problem is with the second part of its charter – the Payments System Board. The RBA should not be involved in regulating the payments system. They have no comparative advantage in industrial organization and competition policy regulation. The RBA should relinquish control of regulation of the payments system, and hand it to competition regulators, namely the ACCC.

Once this is done, it immediately becomes apparent however that the price-cap on the bank interchange fee, as imposed by the RBA, when translated into the space of the ACCC, is identical to legislatively fixing a market price. This is entirely without economic justification and achieves only political ends. The price-cap should be repealed, and the ACCC should then undertake to demystify, rather than regulate, this efficient value creating market exchange.

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Executive Summary

The Reserve Bank of Australia has been a world leader in interchange fee regulation. In this paper we suggest that this regulatory intervention has been based on wishful thinking at best and represents a failure to understand the actual working of the market economy.

In short, the Reserve Bank of Australia engaged in an extensive regulatory intervention based on poor theory, and no empirical evidence. Theory has not provided an unambiguous indication of market failure, and there is no empirical evidence to support the notion of monopoly pricing – other than a vague notion that interchange fees were "excessive". What the Reserve Bank identified as being "externality" any fair minded observer would label "gains from trade".

We argue that interchange fees are the outcome of an efficient bargaining process given that banks and consumers, and banks and merchants form long term relationships with each other. For as long as there is competition in the banking sector and competition in the retail sector, the interchange fee itself is subject to competitive pressure.

There is no market failure and no economic justification for government intervention. The $13 billion "saving" to merchants that the Reserve Bank identifies following its regulatory reform is simply a redistribution away from consumers (and banks) towards merchants. The Reserve Bank assumes that the saving has been passed onto consumers, but cannot provide any evidence to support that hypothesis.

It is not at all clear that consumers have benefited from interchange fee regulation. To the contrary is likely that consumers are worse off – while merchant fees have declined, so too have the benefits of using credits while the costs (including the interest rate premium over the cash) have increased.