Submission to the Reserve Bank of Australia

Credit Card Schemes in Australia

By

The Australian Retailers Association

CONFIDENTIAL

Prepared with the assistance of

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Contents

Executive Summary

The thrust of this paper by the Australian Retailers Association (ARA) can be summarised by a quotation from the RBA / ACCC paper 'Debit And Credit Card Schemes in Australia – A Study of Interchange Fees And Access'; Page 52 states:

" Simple economics shows that when a service is under priced, it tends to be over-used".

This statement in our view distills the essence of credit card pricing and use both here and internationally. From inception, the merchant community has been paying a disproportionate share of the cost of credit cards. Consumers have been paying less than the true cost of services provided to them by credit card issuers. This we believe was the result of credit cards at inception not having a viable economic rationale for the consumer and credit card issuers and acquirers structuring the product economics in order to enhance take up. Had credit cards been priced in a competitive environment, then it is highly likely that they would not have gained such a major global presence.

The global merchant community has, made a major contribution to the revenues and profits of credit card issuers and acquirers. Credit card services have been overpriced to merchants and under priced to cardholders.

Our paper will argue that:

1. interchange between card issuers and card acquirers should be completely abolished and replaced with activity bases fees or fees for service;

2. credit card interchange is passed on to merchants via the Merchant Service Fee. Our own experiences have seen interchange put to us as a 'floor' to the merchant service fee rate advanced by acquirers;

3. merchant service fees should be completely abolished and replaced with market negotiated activity based fees;

4. the current credit card scheme no surcharging or non-discrimination rule be abolished across <u>all</u> card types, and that merchants and the market not be restricted (subject to competition law) from setting their own pricing policies.

We would encourage the RBA to take this opportunity to address a major inequity in the Australian payments environment.

1. Introduction

1.1 Confidentiality

The contents of this report are confidential. Data relating to the business of the Australian Retailers Association (ARA) or its members and contained within this submission is confidential and is not to be released into the public domain.

The ARA upon request can make available a version of this document suitable for release into the public domain.

1.2 The Australian Retailers Association

The ARA is the nationwide voice of the Australian retail industry. In December 1998 the ARA was registered as an organisation under the Federal Workplace Relations Act 1996 with coverage of the retail industry across Australia. The ARA has state Divisions in New South Wales, Victoria, South Australia and Tasmania and affiliations with the Retailers Association of Queensland, The Retail Traders Association of Western Australia, the Northern Territory Retailers Council and the ACT Chamber of Commerce.

The ARA's membership comprises approximately 11,000 retail businesses, which transact an estimated 75% of the nations retail sales and employ around three quarters of the retail workforce.

ARA members operate around 40,000 retail outlets across the nation. Approximately 10,000 or 95% of the Association's members are small businesses (i.e. employing less than 20 staff) operating in only one state.

Larger ARA members are also responsible for significant investments in Australian payments infrastructure. Such retailers have invested tens of millions of dollars in providing consumers with the ability to reliably utilise multiple payment methods.

2. Objectives

The ARA has the following objectives in making this submission:

- to see the practice of a card issuer being paid an interchange fee by a card acquirer <u>eliminated</u>;
- to see ad valorem merchant service fees (MSF) completely abolished;
- to see the introduction of market negotiated fees for service in place of interchange arrangements in the Australian card market;
- to see the introduction of a fee for service that <u>accurately</u> reflects the relevant infrastructure investments and actual costs incurred by parties involved in processing credit card transactions;

- to see that organisations other than Approved Deposit taking Institutions (ADI) be allowed to issue and acquire credit card transactions;
- that the 'substantial card issuer' prerequisite for card scheme membership be removed;
- that Australian credit card acquirers and by definition the credit card schemes, be directed to allow market competition to determine the appropriate level of fees, subject to prevailing competition law.

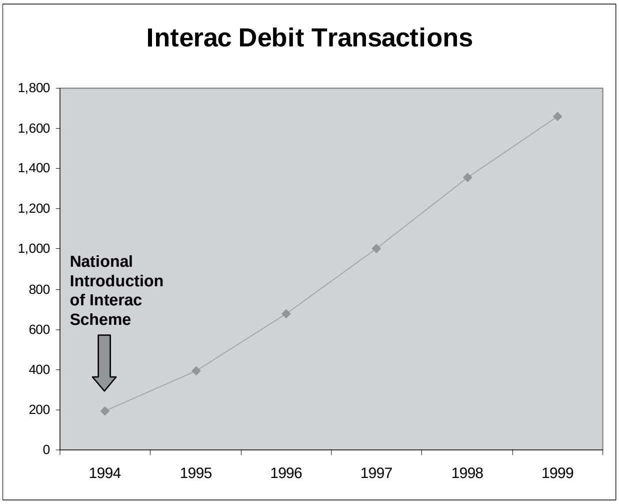
3. Credit Cards

3.1 Interchange Relevance

The concept of ad valorem credit card interchange between credit card issuers and credit card acquirers is purported as necessary by the credit card schemes, as a compensatory tool for costs incurred by the card issuer.

We would contend that there is no relevance for such a charge, in its current form (as a percentage based charge) and its current targets (the Australian retailing community). While we do not object to issuers and acquirers being paid a fair and reasonable flat fee for their services, this must be from the beneficiaries of those services.

We would also refute the 'balancing' argument in favour of interchange, which argues interchange fees are necessary to get a payment scheme established initially. The Canadian 'Interac' card payment scheme is a good example where there has never



Source: Interac.

Diagram 1 – Interac Canada Volumes

been any interchange fee from inception. In 1996 the Canadian competition authority issued a Consent Order to mandate open membership of Interac beyond the founding financial institutions. Since that time, the Interac scheme has grown dramatically, and still with no interchange fees. Diagram 1 clearly illustrates the increase in Interac volumes from inception, without any interchange.

The principle of 'network benefits' may have some validity. There is no conclusive evidence however, to suggest that the benefits gained by merchants are greater than the benefits gained by issuers. Why should issuers not pay an interchange fee to merchants who agree to accept cards for payment? Without these merchants, the issuers would not have a business. If network benefits exist then all system participants should be expected to contribute costs. <u>The 'network benefits' theory does not justify the payment of a fee to an issuer</u>. If the principle of 'network benefits' argued by the card schemes could actually justify payments to card issuers, then this should flow to all other credit provision. A house builder gains a benefit from an institution lending funds to a house purchaser. Therefore the builder should pay an 'interchange fee' via his bank to the lender. This is not sustainable as an argument either in credit cards or in housing finance.

3.2 Interchange Cost Justification

The credit card issuer, it is alleged, incurs a number of costs in providing the utility of a credit card to a consumer and as the merchant and their acquiring bank derive benefit from such cards then the issuer should receive compensation by way of an ad valorem fee. Costs regularly cited as being borne by credit card issuers and used as justification for ad valorem credit card interchange fees include:

- the risk of extending credit to cardholders;
- the cost of the issuer processing the transaction;
- the cost associated with the interest free period attached to credit cards;
- the cost associated with providing a payment guarantee to merchants.

We would contend that the basis of the above cost justifications is incorrect and inequitable; we would further contend that the imposition of a fee in an ad valorem manner compounds this inequity. The concept of an interchange fee is <u>not</u> subject to independent assessment and negotiation from acquirers as they are all issuers under current card scheme rules, which prevent non-issuers from acting as acquirers.

We also believe that certain other costs, not usually disclosed as being fully or partly funded by credit card interchange fees, are built in to the inter-bank interchange fee setting process:

- the cost of funding credit card loyalty schemes;
- costs associated with credit card portfolio expansion. Credit card issuers wishing to expand card portfolios can lower entry criteria or increase credit extended as a result of having revenues under-pinned by interchange fee income.

We will now deal with each of the four main arguments put forward in support of interchange. That is, the costs allegedly borne by credit card issuers, passed to credit card acquirers and passed to merchants via acquirer merchant service fees.

Argument 1 - The risk of extending credit to cardholders:

- Provision of a credit card is a matter between the cardholder and the card issuer exclusively. Neither the merchant (nor for that matter the acquirer) is consulted on the credit worthiness of a given cardholder being provided with a card and a credit facility. Neither party is consulted on the accuracy of the credit facility extended to the cardholder. These are activities carried out solely by the card issuers and at their total discretion.

  The view that credit card interchange should support the extension of credit to the cardholder is therefore wrong. As the card issuer is making all decisions associated with extension of credit to an individual then they should bear the specific costs associated with this and not seek to pass on such costs to other parties. Should an issuer decide to lower its' credit requirements (thereby increasing its exposure to bad debt) in order to grow it's credit card portfolio, the merchant should not have to fund this increased risk. We would strongly contend that the costs borne by the issuer in the issuer / cardholder relationship should remain within that relationship.

  We would further argue that the cost of credit being provided to the cardholder is supported by the credit card interest rate levied on those who avail of extended settlement terms. The magnitude of credit card annual percentage rates (APR) is well above other unsecured lending rates. We would argue that APR also contributes on behalf of those cardholders who do not avail of extended settlement terms.

Argument 2 - The cost of the issuer processing the transaction

- The cost of the issuer processing a credit card transaction on behalf of their cardholder warrants a fee for service. For other payment types, such as debit cards and cheques the cardholder or consumer pays a fee for these. It is therefore reasonable for the issuer to seek cost recovery and a competitive margin for this service – from the cardholder with whom a relationship exists and for whom a service is being performed. Such a fee for service should reflect the exact nature of the services offered by the issuer to the cardholder. The fee should be 'internal' to that relationship.

  We would therefore argue that the cost of the issuer processing a credit card transaction does not warrant an interchange fee being levied to the acquirer and ultimately passed on to the merchant via MSF. We would cite a number of reasons in support of this:

  - the issuer is acting on behalf of their cardholder in processing a credit card transaction. The cardholder is instructing the issuer to perform the transaction;

  - it is the cardholder who is seeking to effect payment to the merchant via a credit card. It is at the cardholders' discretion to select a payment method.

The cardholder initiates the entire credit card processing cycle and should bear the costs of the party (the issuer) acting directly on their behalf;

- there is no additional transaction processing cost as the value of the transaction increases. The current interchange arrangement therefore directs charges incorrectly and exaggerates the magnitude of such charges.

Argument 3 - Costs associated with the interest free period attached to credit cards

- This is an extension of the 'risk of extending credit' rationale. The interest free period offered to cardholders is used to encourage credit card take up and usage. This it is argued is to the benefit of merchants who can then avail of a greater percentage of their customers utilising credit cards and in fact utilising these cards to a greater degree.

  We agree that the interest free period encourages potential cardholders to take up card products and existing cardholders to utilise their cards. It is <u>very</u> useful and beneficial for consumers to delay payment for goods and services for some 55 days. **We would point out that certain credit cards have zero interest free days, yet still attract identical interchange and MSF levels.**

  The interest free period is again, a card issuer / card holder relationship cost. The introduction and length of interest free periods was determined by credit card issuers to facilitate credit card take up and usage – both revenue generating activities for themselves. We find it implausible that issuers sought to introduce interest free periods for any reason other than to increase their own income levels.

  On the matter of the interest free period encouraging card usage and therefore delivering utility to merchants, we would argue that merchants did not have input on the relative merits and costs of credit cards at introduction.

Argument 4 - The cost associated with providing a payment guarantee to merchants

- This argument in support of credit card interchange contends that provided card-processing guidelines are followed issuers guarantee payment to merchants. It is argued that issuers incur fraud and risk control costs, bad debt losses and other related costs.

  ARA members accept that, as merchants, they are guaranteed payment (except mail / telephone order transactions), provided agreed processing rules are followed – however the credit card issuer does not provide this guarantee. Merchants have a relationship with acquirers from whom they receive daily settlement monies.

  We would argue that the provision of a payment guarantee by an acquirer to a merchant does not warrant an interchange fee being passed back to the credit card issuer. The costs borne by the issuer in <u>specifically</u> providing a payment guarantee to the acquirer, support the following activities:

  - managing the charge back queries of a card holder;

- requesting proof of transaction from the acquirer / merchant;
- providing a refund to the cardholder where transaction proof is unavailable;

All these activities have discrete costs that do not increase as the size of a transaction increases. A $5 charge back request will incur the same issuer handling costs as a $50 charge back request. The issuer on behalf of the cardholder, not on behalf of the merchant, is performing these services.

We would expressly reject that any credit losses resulting to the issuer from this process (card holders lodging bogus charge backs and then not paying when proof of purchase is provided), should be passed back to the merchant via MSF that has interchange as a major cost component. This is an issuer / cardholder credit matter.

The two additional credit card interchange points we cite above (loyalty scheme funding and portfolio expansion), are often not openly cited by issuers as being under pinned by interchange, however, we believe these activities are supported by credit card interchange, at least to some degree.

- o *The cost of funding credit card loyalty schemes*

The calculated move by credit card issuers into credit card loyalty schemes over recent years has been an obvious tool for increased credit card take up and expenditure. Issuers, whose predominant income streams are credit extension, interchange and card fees, therefore derive significantly greater levels of all as a result of the success of loyalty schemes.

Diagram 2 illustrates the effect on credit card volumes of the introduction of widespread loyalty programs. Debit volume was overtaking credit in early 1995, however this trend was reversed and within four years credit card volumes were greater than debit volumes. Credit card growth has continued in the period 1999 ~ 2000 with debit card volumes beginning to plateau and indeed trend down.

We believe that merchants are contributing, via interchange, to programs designed to increase credit card income for the issuer. We would contend that such funding is unfair and inequitable. Card issuers wishing to expand card portfolios, receivables and profits should not do so at the expense of the Australian merchant community and ultimately the customer via higher prices. Where merchants choose to participate in credit card loyalty programs, then this should be a separate commercial arrangement between the parties involved.

We would further contend that the increase in credit card usage by the community, as a result of merchant contributions to loyalty schemes has skewed the Australian payments environment away from lower cost payment mechanisms. The RBA's Study of Interchange Fees And Access (October 2000) substantiates that debit card growth has tapered off in recent years as credit card usage has continued to increase sharply.

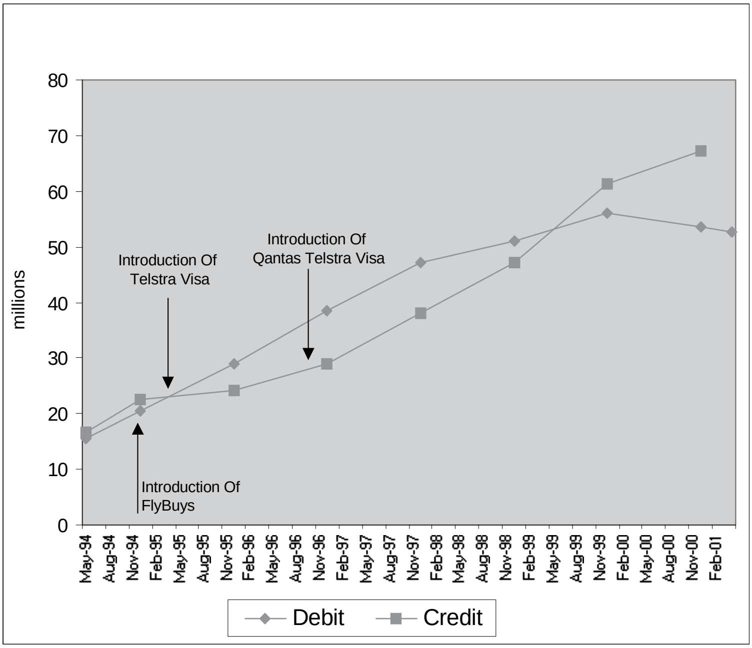


Diagram 2 - Credit & Debit Monthly Volumes 1994 ~ 2000

Source: Reserve Bank of Australia

- *Costs associated with credit card portfolio expansion*

The existence of credit card interchange in our view generates an increased propensity to expand card portfolios. We would contend that having a fixed revenue stream from a card issuing portfolio (interchange) must to some degree act as a motivator to issue further cards. In fact card issuing income is indexed by the existence of interchange. As prices rise over time, so does interchange income.

Card Numbers	Transactions Per Annum [1]	Average Sale [1]	Minimum Interchange	Interchange Revenue Per Annum
1,000,000	34	$110	0.80 %	$29,920,000
1,500,000	34	$110	0.80 %	$44,880,000
2,000,000	34	$110	0.80 %	$59,840,000

Note 1: Source: Reserve Bank of Australia

Table 1 – Portfolio Expansion & Ad Valorem Interchange

Table 1 while not intended to provide definitive data, does provide a simple depiction of the 'interchange only' benefits of an issuer expanding their credit card portfolio.

We would argue that credit card issuers are encouraged to expand credit card portfolios beyond levels they would otherwise reach due to interchange acting as a 'revenue floor' for issuing activity. Over 30% of card issuer income is generated by interchange (Source: Reserve Bank of Australia).

3.3 Five Party Credit Card Schemes

The relationships, which exist between merchants, cardholders, retailers, acquirers and issuers, are generally referred to as 'four party card schemes'.

We would contend that no such 'four party' schemes exist in reality. The parties constantly omitted from debate are the card schemes themselves. Diagram 3 below illustrates the role played by card schemes in processing the majority of credit card transactions globally that involve a card with a particular scheme brand. MasterCard (via BankNet) and Visa (via INOVANT), operate large and sophisticated global transaction processing systems. In addition, the schemes are paid a fee for each of these transactions by the member. These per transaction fees form part of the base cost that an acquirer passes to a merchant via the MSF. Schemes and scheme fees must therefore be included in the debate on the rationale and effect of MSF on merchants.

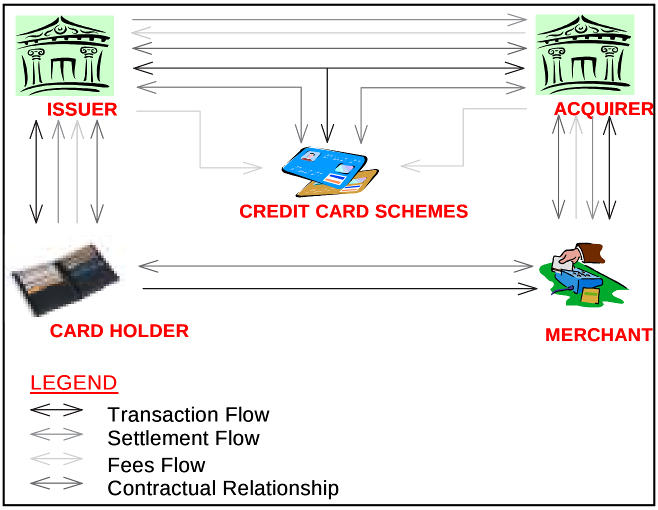


Diagram 3 – Relationships In A Five Party Credit Card System

The transaction processing role played by the card schemes is publicly available (on their respective web sites). What is not discussed is the magnitude and source of fees paid to the card schemes. We believe that both acquirers and issuers pay transaction fees to the schemes, for all transactions except 'on-us'.

This then substantiates the existence of five parties in the bulk of credit card transactions conducted domestically and internationally. Merchants are therefore contributing, via the MSF, to revenue and profitability of credit card schemes. We would again point out that we have been unable to accurately determine whether card schemes derive transaction revenue from both issuers and acquirers for the same transaction (that is, two revenue streams from most institutions in the Australian card market).

3.4 Interchange & Merchant Relationships

Having addressed each of the rationales seeking to justify credit card interchange we would now highlight the various relationships that exist in five party card systems as identified above. Diagram 4 illustrates these however we would highlight the particular point that at no time is there a direct relationship of any type between a merchant and an issuing institution in the conduct of a credit card transaction.

This is a key point in our argument that merchants are funding parties in the Australian credit card market with whom they have no relationship whatsoever.

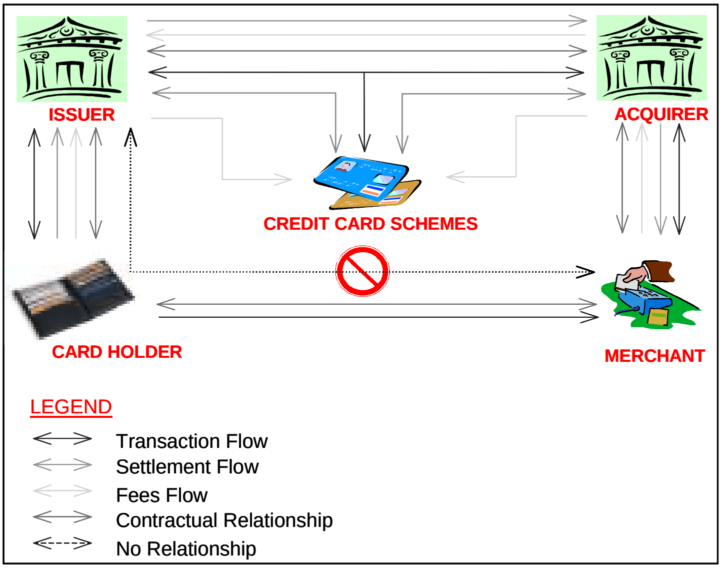


Diagram 4 – Merchants & Five Party Credit Card Systems

The merchant has obligations, physical and implied contracts with only two parties in a five party system – the acquirer and the cardholder. **The merchant however, is obliged to pay the MSF that has as its base the interchange percentage in existence between the issuer and the acquirer.**

Each party, as illustrated by Diagram 4 has its' own discrete relationships and it is within these relationships that financial responsibilities should lie. If an issuer is providing a service to a cardholder (card provision and credit extension) then the costs associated with that relationship should stay within it.

Likewise, where the acquirer is providing a service to the merchant then the discreet costs associated with this relationship should stay within it.

The arguments in favour of interchange attempting to impose an obligation or relationship between the merchant and the card issuer are therefore erroneous.

We would also point out that the cost justification rationales are weakened further by the nature of the Australian card issuing and acquiring market. Our market sees a significant number of credit card transactions being acquired and issued effectively by the same organisation. In these 'same party' or 'on-us' transactions the acquirer pays no interchange (other than an accounting entry within the organisation) and therefore retains the entire merchant service fee. Diagram 5 illustrates how in the case of the major Australian Banks (and others) a five party card system is effectively a four party system where the institution is acquiring its' own cards from its' own merchant base.

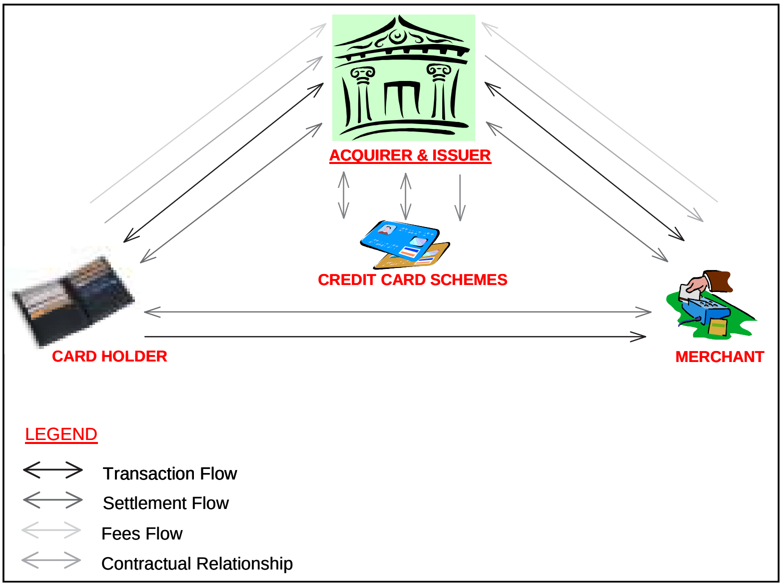


Diagram 5 – 'On-Us' Transactions In The Australian Credit Card Market

Fee flows in 'same party' transactions as depicted in Diagram 5, are from both the merchant and the cardholder to the one institution. The MSF received by the acquirer is the same whether they have to pay interchange or not. In these transaction types the relevance of interchange is undermined even further.

We would make a further point relating to the rationale for interchange; arguments have been advanced by the credit card schemes pointing out that:

- merchants are at no time asked to pay interchange;
- acquirers, while paying interchange to issuers are free to price their MSF rates as they see fit;
- by definition there is no relationship between interchange and MSF levels.

We would refute this proposition. Our member's experiences have seen interchange put as a 'floor' to the MSF rate advanced. ARA members have been advised that their MSF rate is comprised of the following:

- base interchange (for card present and card not present transactions);
- the acquirer's processing and other costs;
- the acquirer's profit margin.

In our view interchange is indeed related to MSF levels. It would not be economically feasible for acquirers to contemplate setting MSF levels for ARA members which are equal to, or lower than, the base interchange paid by them to the issuers (plus fees payable to the card schemes themselves). Therefore, it is clear that merchants pay the interchange fees.

3.5 Interchange Fixing Methodology

We now wish to address the matter of how interchange fees are set and reviewed. If an examination of the parties to credit card interchange setting is carried out only two emerge as having involvement:

- credit card issuers (and allegedly acquirers);
- credit card schemes.

When one looks a little further all credit card scheme members are issuers as only issuers are able to acquire credit card transactions. Therefore, the price which retailers, and ultimately the community, pays for credit card use via MSF is set by those who stand to gain most from its maximisation.

We would draw a parallel in the methodology of fixing credit card interchange to a scenario in any given industry where those who stand to benefit from a given price, are exclusively involved in setting it. If companies in any industry were to periodically convene and agree on the minimum wholesale price that each would charge their retail outlets there would quite rightly be community uproar and involvement from the ACCC.

This however is exactly the activity carried out by card issuers / acquirers in this country and elsewhere. The setting of interchange levels cannot in our view be interpreted as anything other than price fixing. Credit card interchange setting is characterised by:

- a lack of transparency;
- no obvious rationale for the rates set;
- no competitive market forces or other mechanisms encouraging lower interchange levels and;
- no effective competition between card schemes as their memberships are almost identical.

A querying of any acquirer in the country on the rationale for a given MSF quotation, inevitably results in 'the base interchange is a major contributor to your MSF' followed by 'this is out of our hands, interchange rates are set by the card schemes'.

We would strongly contend that this is no more than an excuse for wishing to maintain the status quo. Our members' experiences in acceptance of credit cards have:

- never seen a reduction in interchange fees and any flow on benefits;
- not resulted in a reduction in any way of their merchant service fee levels;
- not seen any attempt by issuers and credit card schemes to cater to the unique requirements of some of our members who operate in low transaction size environments. We are aware that in other credit card jurisdictions (for example, Europe) there are <u>specific</u> interchanges for certain industries, acknowledging their <u>low transaction size</u>. This has never been the case in Australia.

The above points are despite the fact that larger ARA members have their own sophisticated card-processing systems that deliver transactions electronically and securely to acquirers. Even smaller members utilise bank supplied electronic transaction processing systems. The bulk of transactions are therefore presented to acquirers in the lowest cost and least risk manner.

We suspect that there is in fact NO real negotiation of interchange fees between credit card scheme members. We would cite the following points in support of this:

- scheme memberships have as a prerequisite, that an organisation be a substantial card issuer;
- credit card schemes are dominated by card issuers (by definition, all members must be issuers and even acquirers are required to be 'net issuers') and are therefore unlikely to vote for reduced income levels for issuers;
- in order to be an acquirer an organisation <u>must</u> be an issuer under card scheme rules. We see this as an obvious potential conflict of interest.

A further reality is that institutions would be negotiating with themselves in the first instant. The card issuing division of any organisation will want higher interchange fees while the merchant acquiring division of the same organisation MAY want lower interchange fees in order to attract greater merchant numbers. We would argue that this latter point <u>does not occur</u> in reality.

Acquirers currently faced with higher interchange fees from issuers simply increase their base costs within the MSF levied to merchants. This was borne out by the emergence of purchasing card products in recent years. Such cards had a higher MSF than other identically badged cards, as a result of issuers and card schemes setting higher base interchanges. Nearly all ARA members' merchant agreements contain a clause that specifically allows MSF levels to be re-negotiated if interchange rates vary. <u>This proves the connection between interchange and MSF unequivocally</u>.

We would further suspect that the relative number and strength (compared to acquirers), of card issuers in various regions around the world is one of the reasons accounting for the varying credit card interchange levels which exist globally for the same transaction types. There is a major disparity in interchange fees across a number of countries. While it has been alleged that Australia enjoys the lowest global interchange rates, we would cite a number of countries that have lower interchange than the Australian 0.8% electronic rate:

- Germany (certain industries)
- Hungary (certain industries)
- Czech Republic
- Finland
- Denmark

It is also interesting to note that the one country where Visa and MasterCard have differing interchange levels (Canada) is also the one country that does not allow duality.

Our contention would appear to be supported in the Australian environment which has mid range interchanges compared to the above examples. Australia has very large issuers that are also major acquirers. However, we also have in Australia a disparity between issuers. Certain issuers here are very large and yet have very small acquiring businesses. Conversely we also have very large acquirers that have relatively small issuing portfolios. This would suggest that Australian interchange levels have been set at levels to accommodate these issuer / acquirer relativities.

It is therefore reasonable to assert that interchange levels are set in an environment with no transparency, with no market forces coming to bear on deliberations and little logic to both absolute and relative interchange amounts. Further, there is no inducement for lower interchange fees and there is no competitive force coming to bear on these price fixing mechanisms.

We would contend that this is a most unbeneficial situation for ARA members, the wider merchant community, consumers and the economy in general.

3.6 Credit Card Issuing and Acquiring

The ARA is comprised of a number of organisations that have private label card portfolios and other retailers who may wish to enter the card issuing market. The current credit card scheme rules preclude our membership from placing the marques of the major card schemes, in their own right, on card products. In addition ARA members who may wish to, are prevented from acting as credit card acquirers in their own right. There are two specific card scheme rules that we believe must be removed as a matter of urgency:

1. That to be a credit card issuer an organisation needs to be an ADI as defined within the Australian financial system;

2. That to be a credit card acquirer an organisation must be a substantial credit card issuer (and also an ADI).

We would contend that these two rules effectively remove the ability, for organisations other than larger members of the Australian financial services community, to be directly involved in credit card issuing and acquiring. It is our view that credit card issuing and acquiring should have discrete and largely unrelated requirements in the interests of achieving real competition.

3.6.1 Credit Card Issuing

Submissions to the RBA have suggested that co-branded cards provide retailers with an opportunity to 'participate' in card issuing. This is simply not true. The bank, not the retailer decides who qualifies for one of these cards and the bank not the retailer, owns the customer details and relationship.

Credit card issuing with the marques of the major credit card schemes (MasterCard and Visa) should be allowed provided an organisation meets two key criteria:

- Prudential standards as determined by the RBA / APRA and <u>not</u> as may be determined by the credit card schemes

- Competition laws as determined by the ACCC

Market forces will then determine the success or otherwise of a particular program. The organisation wishing to enter the card issuing market may then decide to perform all functions relating to card issuing itself or to outsource certain functions to existing issuers.

Certain ARA members already have large private label card portfolios and the above change would allow them to provide added card usage benefits for their customers. For example, store charge cards could carry credit card logos under the direct auspices of the issuing retailer. Provided reasonable prudential requirements were put in place, retailers with card bases could elect to broaden the usability of these.

3.6.2 Credit Card Acquiring

An organisation wishing to perform credit card acquiring functions, in our view performs computing, data communications and transaction switching services as well as manage settlement values between issuers and merchants. For this reason we would argue that credit card acquiring should be open to organisations that are commercially sound and meet prudential criteria as determined by the RBA / APRA.

Organisations wishing to acquire credit card transactions should not be obliged to issue credit cards and should not be required to have ADI status.

As in credit card issuing (3.6.1 above) a number of ARA members being large profitable organisations, could elect to operate on a 'self acquiring' model. In addition, our proposed acquiring model would encourage a number of organisations to enter the pure acquiring market. Such organisation may be larger transaction switching companies or other service providers wishing to enter the transaction acquiring and switching market.

It is our view that the model proposed would have positive outcomes in the market. Service and pricing levels would improve as a result of increased competition.

3.7 Credit Cards & Other Tender Types

The ARA has surveyed (July 2001) a number of its' members to ascertain the usage and cost of various tender types across a number of retail sectors. This follows a national survey of retailers conducted by the Association in November 2000. Table 2 illustrates the importance of credit cards in the tender type mix across a number of retail sectors.

	Cash (%)	Cheque (%)	Bank Issued Credit Cards (%)	Non-Bank (Charge) Cards (%)	Debit Cards (%)
Food/Convenience	56.0	1.0	14.5	1.5	27.0
Specialist/Computer	0	0	75.0	10.0	15.0
Men's Apparel	53.5	1.5	36.0	2.0	7.0
Women's Fashion	9.0	2.0	55.0	18.5	15.5
Fashion Accessory	75.0	0	12.5	0.5	12.0
Discount Dept. Stores	39.0	1.5	31.5	3.5	24.5
Regional Hardware	23.0	47.0	23.0	1.0	6.0
Dept. Stores	13.0	4.0	31.0	38.0	14.0
Liquor	49.0	5.5	14.5	1.0	30.0
Photographic & Toys	41.5	2.0	24.5	6.0	26.0
Jewellery	32.0	20.0	25.0	5.0	18.0
AVERAGE	**39.7**	**9.0**	**29.4**	**6.5**	**15.4**

Table 2 - Value Of Transactions As Percentage Of Sales (Nov. 2000)

The above figures clearly indicate the importance of credit cards in the mix of tender types and the integral nature of credit cards in the payment system. Tender type used depends on the nature of the transaction and is at the consumers' discretion. It is apparent that transaction size and nature of purchase drives the choice of tender. Larger ticket items are transacted with greater frequency via credit or debit cards. Whilst the ARA survey did not seek to determine the reasons for observed consumer behaviors it could be postulated that consumers are attracted to the convenience of cards (and credit cards in particular) by attached loyalty programs and removal of the need to carry large amounts of cash.

As part of the ARA survey, information was also sought from members on the actual dollar costs of each tender type. Table 3 provides the average across all retail sectors for the various tender types.

	Cash ($)	Cheque (Online Auth.) ($)	Bank Issued Credit Cards ($)	Non-Bank (Charge) Cards ($)	Debit Cards ($)
Retail Average	**0.12**	**0.49**	**1.04**	**2.01**	**0.17**

Table 3 – Actual Dollar Cost Of Tender Types (July 2001)

The following notes relate to the data in table 3:

- costs include staff costs based on the average time taken to complete a transaction for each tender type,
- cash costs include all cash handling, collection and deposit costs and account for the fact that cash transactions take the least average time to process,
- cheque costs include additional staff processing time and all bank fees. It should be noted that staff time taken for cheque payments can exceed that for cash, by a factor of 10,
- debit card costs include any rebates that retailers may receive. Debit cards (after cash) represent the quickest card payment at the point of sale,
- time to complete credit card transactions can take 50% greater than that for debit cards. Receipt production and signature verification being the cause of the time lag.

In addition to the above, the ARA survey gathered information on the relative costs of the various tender types. Table 4 illustrates these cost relativities.

	Cash (%)	Cheque (%)	Bank Issued Credit Cards (%)	Non-Bank (Charge) Cards (%)	Debit Cards (%)
Retail Average	**0.7**	**1.4**	**1.9**	**2.9**	**0.3**

Table 4 – transaction Cost As Percentage Of Sales (July 2001)

Table 4 compares the total cost of each tender type as a percentage of the sales attributed to that tender type. Debit cards are the most efficient form of tender for retailers. <u>It is incongruous that credit card costs are equivalent to or higher than labour intensive payment by cheque</u>.

We would conclude from the information above that current percentage based credit card MSF charges are inappropriate. MSF is currently set higher than would otherwise be the case in an open and transparent market as is evidenced by the relative cost of credit cards in Table 3. Credit cards represent virtually one third of the value of transactions conducted and are one of the highest in cost relative to other card tender types.

3.8 Consumer & Retailer Benefits

The ARA in putting forward and supporting an alternative credit card operating model in Australia, believes that there will be a number of benefits for both consumers and retailers. Retailers, via the ability to operate in a transparent and equitable issuing and acquiring environment will be able to generate benefits for both consumers and their own businesses:

- from an acquiring perspective card acceptance savings will emerge via the abolition of ad valorem MSF. Redirection of certain card costs, currently borne by retailers, will result in the passage of these savings to consumers via lower prices over time;

- we believe that such lower prices will result in a small stimulus to retail spending, thereby allowing reinvestment by retailers in services offered to consumers;

- the changes advocated in the credit card issuing market will enhance revenue opportunities for retailers wishing to establish a card base or wishing to further leverage existing non-credit card bases.

The retail industry is a progressive and competitive industry sector. The Productivity Commission Staff Research Paper "*Productivity in Australia's Wholesale and Retail Trade*", October 2000, found that the wholesale and retail sector "appears to be, on the basis of industry profit margins, highly competitive" and that the percentage of operating income available as operating profit was 3.4% in the retail industry. The retail industry has generally embraced technological change such as scanning and computerisation, and changed management systems all of which has lead to enhanced retail productivity. The Productivity Commission Paper noted that the retail industry has pursued productivity improvements, "with competition as the catalyst and technology the enabler".

In terms of passing on savings to consumers, the ARA would draw attention to the implementation of the GST. This is an example of the true impact of market competition. In many cases (particularly apparel) retailers did not pass on the full extent of net price increases, absorbing part of the GST in their margins.

In addition to this the impact of reduced MSF on the price of all goods would be minimal when applied across the broad range of products. Therefore the ARA believes that competition will see this cost reduction passed through to consumers.

The ARA is therefore confident that retailers will pass on the benefits generated by credit card reform to the consumer, driven by the forces of competition.

4. Debit Cards

The Australian debit card market is, in our view, representative of a transparent, equitable user pays system. The financial arrangements in place in this system emerged as result of recognition that debit cards would provide significant savings and customer service opportunities to debit card issuers. Previously, bank accounts were costly and cumbersome to service (pass books, cash and cheques). Debit cards have allowed issuers to service large customer bases securely, efficiently and at significantly lower cost than the alternatives.

The fixed debit fees currently in place are therefore acknowledging the contributions made by acquirers in this equation. Acquirers have invested in secure, world class debit processing infrastructure for the benefit of debit card issuers. The ARA would argue that <u>retailers</u> have also been a key part of the equation and as such, along with acquirers, must continue to receive financial acknowledgement. This may not be in the form of the existing interchange arrangements.

4.1 Debit Usage

Despite the major uptake in debit cards in the Australian market over the past 10 to 15 years, there has been a shift in usage away from debit cards by Australian consumers.

As is illustrated in Diagram 2, debit card usage has in recent years started to trend down while credit card usage continues to increase at a relatively constant rate.

We believe that deceleration in debit card growth since late 1999, can be directly attributed to the success of the credit card loyalty programs operated by credit card issuers in Australia.

The ARA would argue that credit card issuers in Australia commenced an aggressive campaign to increase the usage of credit cards, at the expense of debit card usage, in the early to mid 1990's for several reasons:

- profit opportunities are greater in the credit card market than debit. Generating percentage revenues from credit card transactions (from retailers) is certainly more profitable than small fixed fee charges to consumers plus debit card interchange;
- debit card acquirers, in the case of larger retailers, pay a fee for transactions. While this is an equitable arrangement as we will detail below, sharing of a fixed debit interchange fee by acquirers is certainly less attractive than retaining the majority of a percentage fee in an expanding credit card portfolio;
- merchants are also a softer target in the generation of profits. Creating demand for credit cards results in merchants, as we have detailed above, picking up the majority of costs for both issuers and acquirers, via MSF. In the case of debit transactions consumers, in certain cases, are asked to pay for these.

5. Charge Cards and Designation

The non-designation of charge cards by the RBA also warrants comment in the current review process.

If charge card companies are allowed to continue operating as they do currently then they will be able to maintain rewards programs via the continued imposition of higher fees for merchants. Credit card issuers, faced with significant changes to the current interchange arrangements may seek to curtail customer reward programs as a result.

This will most likely result in consumers seeking to switch from credit to charge cards in order to obtain these benefits. This would result in merchants and consumers facing the same if not higher costs than those borne currently. In addition, **charge card take up may increase significantly and effectively negate any actions taken by the RBA**.

An extremely negative outcome would be the continued non-designation of charge cards and the continued existence of the no surcharging rule (detailed below). This may see retailers faced with significantly higher usage (and therefore cost) of charge cards and an inability to pass such costs on the end recipients of benefits, the consumers.

For reasons of equity and to remove the possibility of en-masse take up of charge cards, we would therefore argue that they must be brought within the current RBA designation process.

6. Surcharging (Non Discrimination Rule)

The subject of surcharging (or the non discrimination rule – NDR, mandated by credit card schemes and also enforced by certain charge card operators) is one that has been dealt with by a number of inquiries over the years both in Australia and overseas. Quoting the 1991 Martin Committee report, the RBA's Study of Interchange Fees And Access (October 2000) details the Martin Committee's conclusion that card scheme rules relating to pricing were unfair and the recommendation that merchants accepting credit cards should be free to set their own prices.

The ARA would strongly support the view that merchants have the option of reflecting the cost of a payment method to a customer if they so choose, for <u>all</u> card types.

The abolition of the NDR across all card types would in our opinion provide for:

- merchants <u>having the option</u> of pricing card transactions relative to other payment instruments (such as debit cards);
- consumers, by not having the true cost of payment instruments suppressed, making more efficient payment instrument decisions;
- equitable distribution of the costs of credit cards (where merchants choose to impose a surcharge), rather than imposing these costs on all consumers by way of higher prices;
- the opportunity for equal treatment of charge cards and credit cards by retailers.

We would argue that the Australian card market, being mature and consumers valuing the utility provided by credit, charge and other cards, is quite able to support the removal of the credit card and charge card scheme NDR. It would remain to be seen whether ARA members would take up the option of imposing a card surcharge, were it to be allowed. Market forces will influence retailers' decisions.

The removal of the NDR would be necessary to ensure that charge cards, not currently covered by the RBA's designation process, do not receive a competitive advantage over traditional credit card products that are subject to the RBA's designation process. Charge card companies traditionally charge higher MSF to merchants.

The abolition of the no-surcharge rule across all card types, would allow merchants to surcharge for charge cards, thereby negating any perceived advantage they may have gained from their exclusion from the designation process.

However surcharging is not a complete solution to the problems caused by interchange fees in the credit card payments system. Whilst the ARA would support the abolition of the no-surcharge rule, the underlying problems of interchange need to be addressed. The complete solution is therefore abolishing interchange.

It is our view that international credit card schemes in conjunction with local membership in these card schemes have been able to ignore both the views of retailers and various government bodies over the years, in relation to the NDR. It could be argued that global card schemes in relation to this matter at least, operate outside the wishes of various governments.

We would therefore strongly encourage the RBA to remove the no surcharging rule completely.