Australian Bankers' Association

Submission to the
Reserve Bank of Australia

Banking Industry Response to RBA Consultation Document
Reform of Credit Card Schemes in Australia

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Executive Summary

ABA's View

The Australian Bankers' Association (ABA) supports reform of the Australian credit card system. In particular, ABA believes that interchange fees for credit card transactions should be set in an open, transparent and objective manner; and that these fees should be based on the costs of the services provided by issuers from which merchants derive benefit — either by avoiding costs they would otherwise incur for comparable 'buy now, pay later' products or by improving their competitive position. ABA also supports the principle that entry into the Australian credit card system by prospective issuers and acquirers should not be impeded by unnecessary restrictions. ABA believes that a vigorously competitive credit card industry that is prudentially sound is in the national interest.

ABA thus supports the basic principles of competition and efficiency that are articulated by the Reserve Bank of Australia (RBA) in its *Consultation Document* (CD) of December 2001. However, ABA does not support the proposed applications of those principles by the RBA, particularly proposed Standard No. 1, which would impose price controls under which interchange fees would be slashed by about three–quarters. For the reasons described in this submission, ABA believes that the RBA is embarking on a dangerous experiment — a leap in the dark — with Australia's payment system, an experiment which has no precedent anywhere or sound analytical basis, and which will have consequences adverse to the public interest.

Moreover, since the proposed regulations are to apply only to the 'open' credit card associations — Bankcard, MasterCard and Visa — they cut across the principle of competitive neutrality. They will 'tilt the playing field' in favour of higher cost 'closed' card systems (principally AMEX and Diners Club) and store linked cards.

The RBA's Proposals

In its CD of December 2001, the RBA has proposed three reforms to the Australian credit card system, or more specifically to the three 'open' credit card schemes which it has chosen to designate under the *Payment Systems (Regulation) Act* (PSRA) — Bankcard, MasterCard and Visa. These reforms are: a prescribed methodology for calculating interchange fees (Standard No. 1); regulations which disallow any Scheme rules that prohibit merchants from recovering from cardholders the cost of accepting credit card payments (Standard No. 2); and an Access Regime intended to facilitate the participation in Schemes of potential new entrants.

Of these, ABA's response strongly focuses on Standard No. 1.

The RBA's Arguments for Standard No. 1

In formulating its methodology in Standard No. 1 the RBA argues that individual merchants may benefit from accepting credit card payments, but at the expense of merchants who do not. The RBA asserts that merchants, in aggregate, receive no benefit from accepting credit cards (relative to cash or debit cards), with the benefits flowing essentially entirely to consumers. Thus in formulating a cost–based methodology for the determination of interchange fees, the RBA decrees that card issuers can only include a few costs that the RBA deems to be issuers' costs for providing services on behalf of merchants. These are issuers' transaction processing costs, fraud and fraud prevention costs and authorisation costs. The RBA thus has disallowed from the calculation all fixed costs and practically all costs that are common to services provided to cardholders and merchants, including any return on the capital invested in building and operating the credit card systems, as well as the interest–free period.

There is no justification in economic analysis for the RBA's methodology, particularly its exclusion of fixed and common costs, and the RBA provides none. It states that the proposal is simply its "opinion". The RBA does rely on a small number of theoretical studies of credit card systems, but then makes policy conclusions that do not necessarily follow from these studies. The RBA also errs in its statement that aggregate consumption spending is unaffected by the acceptance of credit cards. Several studies suggest that by relieving liquidity constraints, credit cards do in fact lead to higher consumer spending in total. In any case, the correct frame of analysis is not aggregate consumption at all. It is whether credit cards benefit *individual* merchants, which they clearly do.

Effects of Standard No. 1

Given the provisions of Standard No. 2 and the Access Regime, there is no need, as a matter of logic, to regulate interchange fees — and by extension, merchant service fees, (MSFs) — at all. If merchants are free to set prices to consumers for accepting credit cards as payment, and with liberalised entry into the credit card schemes, interchange fees and MSFs will find their efficient level as a result of competitive market processes. By regulating interchange fees at too low a level, which is what is implied by Standard No. 1, the credit card system will become distorted and inefficient.

These distortions and inefficiencies will be reflected in the following ways: cardholders will migrate to unregulated closed card schemes including store cards; banks will lose revenue and profit and stop investing in cards; Visa and MasterCard may leave the Australian industry; large retailers, which will be able to resist passing on to consumers reductions in their MSFs and price discriminate in favour of their own cards, will increase their already considerable market power; and consumers will pay higher fees, hitting low income consumers the hardest, as issuers of open scheme cards attempt to regain their lost interchange revenue.

Even on its own terms, Standard No. 1 omits a range of relevant costs and is totally unrealistic in expecting that radical change can occur in a matter of months. This ignores a range of complex system change and other transitional issues. Additional cost elements that should be included are (at least):

- the cost of the interest–free period;
- charge–back processing;
- GST;
- appropriate third party services;
- the cost of capital; and
- regulatory compliance costs.

Standard No. 2

ABA notes that Standard No. 2 is primarily a matter for the Schemes, but in any case believes that it will have little practical effect. One reason is that one of the weakest forms of these rules applies in Australia anyway: merchants can effectively surcharge by discounting for payment by cash, cheque, debit card etc. Under the proposed reform, apart from large retailers, who may choose to advantage their own store cards (or store linked open scheme cards) but surcharge for the use of other cards, or those with local dominance (as in rural and regional Australia), many retailers may be reluctant to explicitly pass on the MSF to their customers. This has certainly been the experience in other countries where credit card schemes' 'non discrimination rules' have been prohibited by regulatory authorities. Indeed, given the magnitude of the cuts in the MSFs implied by Standard No. 1, there will be rather less to surcharge.

To preserve competitive neutrality, Standard No. 2 should be widened to include the closed card schemes. Furthermore, in those instances where a merchant does surcharge when accepting a credit card, consumers should be protected by anti–gouging regulations that limit the surcharge to no more than the cost to the merchant of accepting that card. Consumer protections should indeed extend to ensuring that the windfall to merchants of some $500 million flowing from Standard No. 1 is passed on to their customers.

Access Regime

In its submission of 2001, ABA supported the principle that entities should have maximum opportunity to participate in credit card acquiring and/or issuing, subject to satisfactory prudential controls. ABA thus supports the principles of the Access Regime, provided that it results in a market environment that is truly competitively neutral (a 'level playing field'). However ABA notes that the Access Regime is a matter primarily for the Schemes, and that the Schemes have legitimate interests in defending their intellectual property, which may conflict with the Access Regime, as formulated — in that it governs not merely access of new entrants as users, but extends to governance (voting) rights. ABA also disputes the claims in the CD that profits in the industry have been excessive and has been supported by entry barriers. Entry to the various businesses in the industry is quite free now, and competition is fierce.

Moreover, ABA notes that Bankcard's entry rules, which clearly the Australian banking industry supports, are already more liberal than those of the Access Regime.

In addition, by driving out some existing smaller issuers, and deterring potential new entrants to issuing (other than big merchants), Standard No. 1 will significantly undermine the intent of the Access Regime to create more competition in the provision of four party credit card payment services.

The Exercise of Powers by the RBA

The RBA bases its reasoning supporting the proposed regulatory action to a significant extent upon erroneous and unreasonable assumptions such as the allegation that interchange fees are illegally collectively determined, and that the ACCC reached the conclusion that the arrangements were in breach of the price–fixing provisions of the *Trade Practices Act* (TPA).

The ACCC has not determined that there is a breach of the TPA and only a Court can make such a finding in any case. ABA members, moreover, have contrary views to those of the ACCC. The TPA excludes from its prohibition of price fixing the joint supply of goods or services provided in pursuance of a joint venture and in the Nabanco Case, the US Supreme Court held that the interchange arrangements between the bank members of the Visa scheme did not violate US competition laws because the arrangements were integral to a pro–competitive joint venture.

Further, the RBA will have acted beyond its powers under the PSRA in two respects. It will have sought to impose rules and procedures in relation to the level of interchange prices pursuant to a standard rather than an access regime. It will also have sought to apply an access regime to aspects of the credit card schemes unrelated to the ability of users to access those schemes as funds transfer systems.

For the above reasons and other reasons set out in this submission, if the RBA proceeds to determine the Standards and impose the Access Regime as proposed in the CD it will have acted beyond its powers, in disregard of the considerations and process directed by the PSRA and upon the basis of erroneous and unreasonable assumptions.

Conclusions

ABA submits that the RBA's Standard No. 1 is severely flawed for many reasons. It is based on the incorrect belief that merchants derive little or no benefit from credit cards; it has no sound basis in the reasoning of regulatory economics or any other economic or public policy analysis; it will severely distort the Australian payments system, to the clear benefit of the closed card schemes and large retailers, but to the cost of members of the Bankcard, MasterCard and Visa Schemes, small retailers and consumers, especially consumers who revolve the credit card balances — mainly the less well off.

These outcomes will not be in the public interest, and thus contrary to the intent of the PSRA. Moreover, what is proposed is not a valid exercise of the RBA's powers under the PSRA.

Chapter 1

Banking Industry Response to RBA Consultation Document *Reform of Credit Card Schemes in Australia*

1.1 The RBA's Proposed Interventions

In its *Consultation Document* (CD) released in December 2001, the Reserve Bank of Australia (RBA) set out proposals for intervention under the *Payment Systems (Regulation) Act 1998* (PSRA) in the market for credit card payment services. The RBA proposes to regulate in three areas: the setting of interchange fees (Standard No. 1);[1] merchant pricing for credit card purchases (Standard No. 2);[2] and an Access Regime,[3] for three 'designated' credit card schemes. The proposed interventions apply only to the Bankcard, MasterCard and Visa 'open' credit card schemes, and not to 'three party' or 'closed' schemes, notably American Express (AMEX) and Diners Club (Diners), or to proprietary store cards, such as the Coles Myer card.

1.2 Standard No. 1 (Setting of Interchange Fees)

The RBA states in the CD that it believes that the current arrangements for setting interchange fees lack transparency and have persisted because competitive pressures are lacking to align these fees with the costs of the services which they are meant to price, i.e. (in the RBA's view) payments services to merchants. An outcome of the current arrangements, it is argued, has been to provide an unjustified "subsidy to credit cardholders" (p iv, CD). The objective of Standard No. 1 is to rectify (what the RBA sees as) the inefficiency of the current arrangements by providing an "objective, transparent and cost—based methodology" (p 54, CD) which aligns fees with costs of the relevant services (where relevance is defined by the RBA).

Standard No. 1 proposes a methodology for calculating interchange fees which has the following features:

- Interchange fees must be based on credit card payment services that are provided to merchants (i.e. according to the RBA's definition of payments services which are provided to merchants). Only certain costs (the "eligible costs") incurred with respect to the following services can be included in the calculation of an interchange fee:
  - Issuers' costs in processing credit card transactions received from an acquirer that would not be incurred if the issuer was also the acquirer;
  - Issuers' costs in respect of fraud and fraud prevention; and
  - Issuers' costs incurred in providing authorisation of credit card transactions.

[1] P 57, CD.
[2] P 80, CD.
[3] P 110, CD.

- Separate interchange fees must apply to (i) electronic transactions that are subject to a payment guarantee, (ii) other transactions that are subject to a payment guarantee, (iii) electronic transactions that are not subject to a payment guarantee, and (iv) other transactions that are not subject to a payment guarantee.
- The interchange fee for each transaction type is to be calculated using a sample group of each scheme member's costs, where the weights are each member's share of aggregate transactions within that scheme.
- The interchange fees so calculated will represent the maximum fee that each Scheme member can charge.
- The interchange fees must be published and recalculated every 3 years, or sooner if the RBA considers that changes in costs warrant an earlier recalculation.

1.3 Standard No. 2 (Merchant Pricing for Credit Card Services)

The motivation for Standard No. 2 is the RBA's belief that restrictions on merchant pricing are an unjustified restraint on trade and distort the relative prices of different payments instruments, and as such are inconsistent with economic efficiency, especially allocative efficiency. The RBA says that it intends with Standard No. 2 to create undistorted price signals, so that consumers can efficiently choose between different payments mechanisms.

Standard No. 2 states that the rules of a scheme must not prevent a merchant from recovering from a credit card holder the cost to the merchant of accepting a credit card issued by a participant in that scheme. That is, it prohibits the so–called 'no surcharge' rules under which credit card schemes typically require merchants not to charge extra to customers paying by credit card. This Standard is to apply only to Bankcard, MasterCard and Visa, so the 'closed' schemes are still free to impose conditions on merchant pricing when payments are made using their cards.

1.4 Access Regime

The RBA believes that current scheme restrictions on entry are anti–competitive. By easing entry via the Access Regime, the RBA intends to increase the contestability of the credit card industry and thereby reduce profit margins, which it implies are only sustained by anti—competitive entry barriers.

The Access Regime specifies that:

- Any authorised deposit–taking institution (ADI), or specialised credit card service provider (SCCSP) that is supervised by APRA must be eligible to participate in a Scheme in Australia, on a non–discriminatory basis.
- The rules of a Scheme must not prevent a participant from being an issuer, an acquirer, or both an issuer or acquirer, or impose any penalties on any participant on any matter relating to the extent a participant is an issuer or acquirer (based on the number or value of transactions in either role).

- The rules of a Scheme must not prevent a participant from being a self acquirer provided that participant can establish its capacity to meet the obligations of an acquirer as a self acquirer.

Chapter 2

The RBA Rationale for Standard No. 1: Setting of Interchange Fees

2.1 Analytical Basis Generally

At a high level of generality, the RBA argues that the interaction of three key features of the provision of credit card payments services cause the provision of these services to be inefficient and uncompetitive. These features are: the collective setting of interchange fees, restrictions on merchant pricing for credit card transactions; and scheme rules which restrict entry to issuing and acquiring. In particular, the RBA argues, these features lead to an excessive[4] number of credit card transactions (especially compared to debit card transactions).

The RBA argues that interchange fees, which are an acquirer cost, have been set too high, so that acquirers charge merchants too much of the cost of providing credit card services and too little of the costs are being paid by cardholders. The RBA goes on to state that because the price faced by credit cardholders is less than the resource cost of providing those services, they over–use those services. This distortion is reinforced by restrictions on merchant pricing that prevent merchants from passing on the cost to merchants of credit card services (the merchant service fee, MSF) to cardholders.

The RBA also argues that these distortions lead to above–competitive profits being earned in the credit card industry, and that these alleged excessive profits are protected by entry restrictions into the market, which inhibit normal competitive market processes that would otherwise drive profits down to normal rates.

The heart of the RBA's argument for Standard No. 1 is that merchants receive little or no benefit from the use of credit cards. The RBA argues that while consumers derive benefits from credit cards, this is not true of merchants. The RBA argues that while credit cards impart network *effects*, they do not impart network *externalities*, certainly not externalities that benefit merchants. The RBA argues that the availability of credit cards does not increase aggregate consumer spending, so credit cards do not benefit merchants in aggregate, though they may be of benefit to merchants individually who accept them. But according to the RBA, merchants who accept credit cards merely divert sales from merchants who do not accept them.

The RBA argument is, then, that merchants should not have to pay for a service from which they derive no benefit. Hence, in listing the costs that can be used to calculate interchange fees (and by extension, limiting payment services costs for which the acquirer would charge a merchant for an on-us transaction), the RBA has adopted an ultra–minimalist approach, including only those incremental recurrent costs for services which, in its estimation, merchants benefit directly (such as the cost of fraudulent use of the credit card). In its Standard No. 1, the RBA excludes *all* costs of providing services that benefit consumers and merchants *jointly*, including all the costs of the investment in

[4] On three occasions (p 29, p 30, p 32), the CD quotes from or cites passages from the report by the RBA's consultant, Professor Michael Katz, that interchange fees are set (or might be set) to encourage excessive use of credit cards.

building the system and much of the costs of running it. The implication is that merchants derive *no* benefit at all from the system being there, and only benefit from narrowly defined incremental processing and payment transactions.

In particular, none of the costs of providing a critical feature of most credit cards — the ‘buy now, pay later’ feature, reflected in an interest free period (until payment due date) — would be chargeable to merchants. In effect, only *debit card* type costs (and indeed only a narrow incremental definition of those) would be ‘eligible’.

2.2 Assessment

Incorrect evaluation of merchant benefits

The first of the RBA’s “competition benchmarks” (implicitly also efficiency benchmarks) is that

> “relative prices charged by financial institutions to consumers who use payments instruments should take into account the relative costs of providing those instruments”
>
> (p 11, CD)

There is no corresponding benchmark for the relative prices charged to merchants. Thus, from the outset, the RBA (apparently consciously) omits any reference to what might constitute efficient prices charged to merchants.

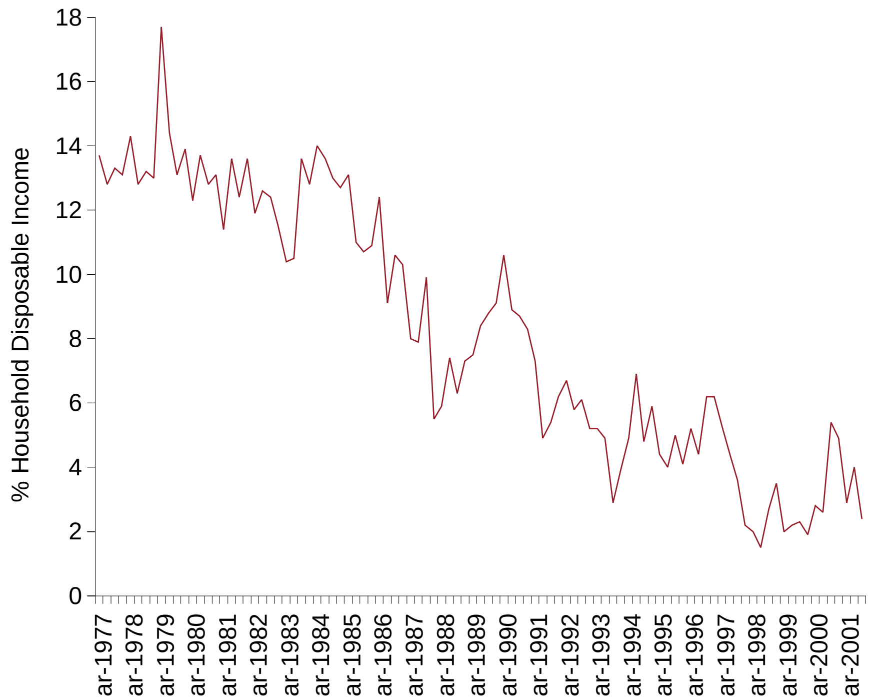
This omission, which is inconsistent with the objectives of the PSRA, and of the Wallis Inquiry whose report led to the PSRA, distorts the RBA’s discussion of the benefits that merchants receive from credit cards and the price they should pay for the receipt of those benefits, and ultimately colours the RBA’s methodology for the determination of interchange fees under Standard No. 1.

As discussed below, there are good factual reasons to believe that credit cards *do* in fact lead to more consumer spending in aggregate. In particular, the household saving ratio has fallen dramatically over the past two decades, just as more credit, notably over the 1990s in the form of credit card lending, has become available to households following financial deregulation. This can be seen in Figure 2.1, and there are studies (discussed later) identifying credit liberalisation as a causal factor. But even if the RBA is correct and credit cards do not benefit merchants in aggregate, this is beside the point. Merchants make *voluntary* decisions about whether to accept credit cards. For those who do, the benefits to them of acceptance must in their own estimation exceed the costs to them.[5]

[5] Some merchants make the rational decision not to accept credit card payments. Many merchants, depending on their area of business, choose not to accept the higher cost closed scheme cards while accepting the lower cost open scheme cards.

Figure 2.1

HOUSEHOLD SAVING



Source: Reserve Bank of Australia

The relevant economic entity in analysing whether and to what extent an externality exists is thus the individual merchant. While the size of the externality accruing to any individual merchant is difficult to quantify, its existence cannot be reasonably denied. Thus there is a good case charging an individual merchant who accepts credit cards an amount up to the benefit received by that merchant, which is greater than the incremental costs incurred by the acquirer in providing a credit card payment service to that merchant. These charges are levied only on individual merchants who make a benefit/cost calculation on whether to accept credit cards, and who voluntarily decide to accept them.

Moreover, the international 'open' credit card schemes in Australia have an important proviso to the 'no surcharge' rule: merchants may discount from posted prices for payment by cash, debit card etc — so if they wish. Indeed, Bankcard does not have a 'no surcharge' rule. Thus, merchants who choose to accept credit cards can equally choose to pass on some or all of the net cost (i.e. net of the merchant benefit). Some merchants differentiate between cash/debit and credit card payers. Most do not. Merchants who voluntarily decide not to accept credit cards are not charged anything, of course.

The RBA's argument that merchants do not benefit from the interest–free period that is an essential feature of the credit card product, is belied by merchants' behaviour and statements. The largest retailer in Australia, Coles Myer, provides an interest free period for its own card, and other apparently rational merchants use other forms of credit such as instalment sales to provide interest free terms for purchases made using other forms of credit without surcharging. Smaller merchants cannot readily provide their own 'store cards', and for them the open credit card schemes help to redress their competitive disadvantage vis–à–vis the large merchants who can offer such options internally.

Absence of analytical foundation

The RBA's methodology for determining interchange fees in Standard No. 1 is based on nothing more than, in its words, its "opinion".[6] It offers no analytical or factual basis for its decision that none of the fixed costs incurred by issuers — including e.g. any return on the capital invested in the systems — and none of the costs of services that are provided *jointly* by issuers to cardholders and merchants (issuer common costs) should count toward the calculation of interchange fees.[7]

The RBA does not demonstrate, or even attempt to demonstrate, that the services identified in Standard No. 1, whose incremental costs can be included in the determination of the interchange fee, correspond to the benefits received by merchants. There is no basis in economics or public policy for asserting that the fixed and common costs of the credit card system should be borne only by cardholders — especially when merchants are already fairly free now to pass on any part or all of what is charged to them,[8] and they will unambiguously be able to pass on part, all or even more than these charges under the companion proposal (Standard No. 2).

The arbitrary RBA proposal, for allocation of nearly all common costs to one side only, lacks any foundation in economics, in particular the economics of networks. At a high level of abstraction, the RBA asserts the existence of market failure, leading to "excessive" use of credit cards. The basis for this assertion is the most favourable (to the RBA) possible interpretation of a handful of theoretical papers, mostly unpublished, on credit card networks. This literature is very rudimentary, and none of these models on which the RBA relies has been tested with any data. Indeed, the RBA itself (p 32, CD) states that:

> "In summing up, the economic literature on credit card networks is undeveloped compared to other branches of economics. Model results are highly sensitive to the assumptions made and, by focusing only on the choice between cash and credit cards, the models do not deal with the more general situation of competition between different payment networks."

ABA agrees with this statement, and believes that most observers would conclude that no strong policy conclusions could be drawn from such an immature academic literature. However, the RBA concludes that:

> "…the economic literature gives grounds for concluding that the collective setting of interchange fees has the *potential* to generate a fee structure that promotes overuse of credit cards." [emphasis added]

ABA notes the use by the RBA of the important qualifier "potential" in the above statement. At no stage has the RBA demonstrated that credit cards are actually being over–used. The RBA's consultant, Professor Michael Katz, also chooses his words carefully:

> " … merchants' willingness to accept cards … *may* be a poor measure of the overall effects of card acceptance on merchant welfare … privately optimal interchange fees *may* promote socially excessive card use." [emphasis added]

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[6] In fact, the phrase "in the Reserve Bank's opinion" appears 22 times in the *Consultation Document*. On not one of those 22 occasions does the Reserve Bank provide a satisfactory explanation, if any explanation at all, for its opinion.

[7] Section 2.6 below discusses in detail the RBA's choice of "eligible costs", and its errors of omission.

[8] I.e. by including a premium in posted prices and discounting to those who pay by debit card — while (ostensibly) obeying the 'no surcharge' rule. It is not uncommon, in fact, for merchants in some areas of business to surcharge explicitly, and this is rarely policed.

In other words, the theoretical literature is ambiguous: interchange fees set collectively by market participants might lead to excessive card use, but then again, they might not. This is a very flimsy basis on which to base radical regulatory intervention. With respect to its use of the fragmentary academic literature in this area, the RBA is clearly prematurely extrapolating.

No basis for arbitrarily allocating issuerfixed and common costs to one side (the cardholder)

Furthermore, and perhaps more importantly, the theoretical literature gives no support for the particular intervention advocated by the RBA in respect to Standard No. 1 i.e. with virtually *none* of the fixed and common costs associated with credit card services allowed to be counted in the calculation of the interchange fee.

As ABA has argued previously, credit card services are *jointly* produced by issuers and acquirers, and *jointly* used by consumers and merchants. The absence of any one of these four parties would render the system inoperable. With respect to interchange, issuers incur costs in the provision of services, each of which is used jointly by, and benefits jointly, consumers and merchants. Hence, each should pay a proportion of these costs.

As ABA has also argued, economic theory does not imply an unambiguous division of costs between merchants and consumers. However, the existence of positive externalities from credit card use by consumers implies that the majority of these costs should be borne by merchants; but ABA has *never* argued that merchants should pay for *all* of these costs. ABA has argued that no more than total costs should be recovered from both sides combined. Where this division is struck is not a matter for regulation or any principle of economics or public policy. It should be determined by the operation of competitive pressures in the market — including, crucially, competition from the closed schemes.

In contrast, the RBA has no basis — in theory or facts — for the cost assignment it decrees in Standard No. 1, other than an incorrect perception about what card payment services are provided to merchants, which ignores the services provided *jointly* to cardholders and merchants. For example, the RBA considers that the provision of statements to cardholders is of benefit only to cardholders; but without the information provided on cardholder statements, the credit card system could not function, which would be of detriment to *both* cardholders and merchants.

Logical inconsistency

A logical problem with the RBA argument arises when one considers the interaction of Standard No. 1, Standard No. 2 and the Access Regime. According to the theory cited and favoured by the RBA, interchange fees have no substantive effects when merchants are free to price as they like for credit card transactions (the object of Standard No. 2) and entry to the market as a credit service provider is free (the object of the Access Regime). But this being the case, Standard No. 1 becomes redundant, or more likely, harmful.

With free entry ensuring competition in the provision of credit card services (both issuing and acquiring) and Standard No. 2 removing restrictions on pricing by merchants, there is no longer a problem to fix (assuming that one existed in the first place). Interchange fees are just a price of a freely traded intermediate service. At best, interchange fees set by regulation should mimic the interchange fees that would be set in the market place, given free entry and unrestricted merchant pricing. More likely, if interchange fees are set by the regulator at the wrong levels then this will lead to market distortions. As ABA has argued previously, the most likely distortion will be a distortion of the competitive balance in favour of the unregulated closed card schemes, and especially, major merchant–linked cards.

2.3 The Core Issue of Merchant (and Consumer) Benefit

Benefits accrue to individual merchants and merchants as a whole

Somewhat surprisingly, the RBA has accepted uncritically the arguments put by the Australian Retailers Association (ARA) that credit cards are of no benefit to merchants, taken as a whole. The retailers' claims are plainly motivated by self–interest, i.e. they want to pay lower MSFs for credit card transactions, and also to divert sales towards EFTPOS, for which they pay little or noMSF (and in some cases *receive* fees); or towards their own store cards.

In other words, the ARA wants merchants to free–ride on the credit card system, by benefiting from its existence but not paying for any more than a minimum of its basic costs. This is understandable, but not socially desirable. The retailers (or at least those whose interests are represented by the ARA) also argue that they are forced to take credit card payments, because if they didn't they would lose sales to their competitors who did accept credit card payments. No doubt there is some truth in this, but this just reflects retail competition at work — albeit that concentration in retailing in Australia limits the intensity of competition.

Credit cards as an element of retailing competition

Credit card payments are a service offered by retailers to their customers in order to attract customers and enable them to spend more than they might otherwise at the time. The consumer benefits too, in being able to purchase items sooner rather than later. If a particular retailer chose not to offer credit card payments, the quality of service would be degraded to that extent, and some of that retailer's customers would choose to shop elsewhere. The same might be true if a retailer unilaterally raised its prices, or chose not to open on weekends.

Doubtless, some retailers would prefer to play golf on Sundays rather than open their shops, but they are "forced" to open their shops by competition in the market place. The same is true of offering credit card services. If it were true that credit cards do not lead to increased sales in aggregate, it might be profitable for retailers for more sales to be made by debit card (which nearly every customer carries these days) or cash, and fewer by credit card. But short of conspiring together not to accept credit cards, the force of competition obliges retailers to offer payments options that are actually desired by consumers.[9] Even retailers with substantial market power, like Coles Myer, feel sufficient competitive pressure to offer the option of credit card payments. In fact, the behaviour of such big merchants suggests they would offer some sort of 'buy now, pay later', option even without that pressure.

No 'fallacy of composition'

The RBA's "fallacy of composition" argument is simply wrong. Merchants decide on an individual basis whether to accept credit card payments. ARA representations notwithstanding, there is no meaningful economic entity that is the equivalent of merchants as a whole. Merchants who voluntarily accept credit card payments do so on the basis that they as individuals have decided that the benefits of credit card acceptance exceed its costs. The benefits are sales that they would not otherwise make in a competitive retail market or costs that they do not incur by not having to offer their own 'buy now, pay later' payment product. One implication, of course, is that there may be no *net* cost at all to 'pass on' to their customers in general: the benefits to them may well *exceed* any 'premium' in the MSFs that they pay (i.e. any *additional* cost *relative* to their costs associated with taking other forms of payment).

Credit cards* do *increase aggregate consumption

Quite apart from the *distribution* of aggregate sales amongst merchants, the RBA's argument that credit cards do not lead to increased aggregate spending by consumers is entirely unconvincing in any case. First, as noted above, as a factual matter, the household saving ratio has declined dramatically over the past two decades, i.e. households have spent more out of their incomes, and household use of credit has risen accordingly. This has occurred precisely at the time when, thanks to the liberalisation of the financial sector, access to borrowing by households, including and especially via credit cards, has increased.[10] *Revolving* credit, primarily credit card lending, has been by far the fastest growing form of credit to households over the past decade. It is perfectly reasonable to surmise that the lifting of previously repressed (by regulation) household borrowing has led to an increase in spending on a steady–state basis, and indeed there is an international literature on this.[11] The ARA apparently agrees with this assessment. In its submission to the RBA (*Reform of*

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[9] In its *Submission to the RBA on Credit & Debit Card Schemes* of 15 September 2001, Shell Australia states that "Credit card payment plays a large and increasingly important role at Shell's retail sites. Virtually all Shell company and franchise service stations accept the full range of bank issued cards". Shell's submission then goes on to complain about nearly all aspects of the credit card system — the very existence of interchange, card loyalty programs, the setting of MSFs, etc. ABA finds the general implication of the Shell submission — that Shell, one of the largest and most powerful corporations in the world, has been forced by Australian banks into commercial arrangements inimical to its interests, difficult to accept. ABA submits that Shell retail outlets accept credit cards because it is in their business interests to do so, and for no other reason.

[10] This been remarked upon by many commentators, not least from the Reserve Bank. See Marianne Gizycki and Philip Lowe, "The Australian Financial System in the 1990s", in Reserve Bank of Australia, *The Australian Economy in the 1990s*, 2000.

[11] See, for example, T. Bayoumi, "Financial Deregulation and Household Saving", *The Economic Journal*, 103(421), pp 1432–1443, November 1993.

Credit card Schemes in Australian Volume III, Submissions Received, Chapter H) the ARA states (p H.2):

> "We agree that the interest free period encourages potential cardholders to take up card products and existing cardholders to utilise their cards. It is very useful and beneficial for consumers to delay payment for goods and services for some 55 days." [original emphasis]

Second, credit card users who are 'transactors' (i.e. who tend to pay their statement balance when due) effectively receive a limited but free line of credit that would not otherwise be available. This must be of some value to them (in terms of additional income equivalence), which itself would promote spending, to the benefit of merchants.

Third, credit cards clearly facilitate spending at certain peak seasonal times, such as Christmas. Without credit cards, consumers would spend less at Christmas. According to the RBA arguments, if so, they would then spend more at other times. ABA submits that this is very unlikely.

Fourth, it can be hardly denied that the existence of credit cards lead to increased spending by tourists, especially foreign tourists visiting Australia. To claim otherwise would be to say that tourists, who can spend up to their credit card limits in Australian shops, would spend just as much using, say, travellers cheques, if credit cards did not exist. ABA submits that this would also be very unlikely.

Buy now, buy less later?

At a more formal level of discussion, to support its claims that credit card usage does not lead to higher levels of aggregate consumption, the CD appeals to a body of economic literature which posits that consumption is determined by expected income and "wealth", itself a function of the economy's productive capacity. The CD's interpretation of this literature is that increased levels of consumption at the expense of savings reduce wealth, and so reduce consumption in the future. Thus, purchases that are made now using credit cards lead inevitably to fewer purchases later. Hence, credit cards do not affect the total quantum of consumption in the long term, merely its timing.

The CD cites as an authority on this question the RBA's consultant, Professor Michael Katz, according to whom the claim that credit card usage leads to a permanent and significant increase in aggregate consumption "is ill founded".[12] Professor Katz supports this claim by reference to the Samuelson (1958) consumption–loan overlapping generations model[13] which is based on the assumption that in any given period society has a fixed amount of resources which may be consumed. Borrowing and lending may allow an individual to smooth consumption, but this doesn't change the aggregate amount of consumption per period, which is fixed.

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12 CD, p 25.

13 P. Samuelson, "An exact consumption–loan model of interest without the social contrivance of money", *Journal of Political Economy*, vol 66, pp 467–82, 1958.

The problem with this model as an explanation for actual consumption behaviour in Australia is its assumption that society has a fixed amount of resources to consume and that there are no constraints which inhibit this consumption. In other words, if society is already and always at the point of maximum aggregate consumption, then the existence or otherwise of credit cards will not change this fact. This point is as obvious as it is trivial. ABA submits however that without the provision of credit cards (and other forms of consumer credit) the economy would operate less efficiently, national income would be lower, and aggregate consumption would also be lower.

Indeed, it was the efficiency–sapping effects of financial repression which largely motivated the financial liberalisation of the 1980s, before which credit, including consumer credit, was strictly rationed. Any larger purchase had to be 'saved up for' — i.e. much consumption was deferred. This point has made been made many times, including by the RBA itself. During the early 1990s, the RBA time and again defended the efficiency–enhancing effects of this liberalisation, when it came under sustained attack for having created the conditions which ultimately led to the deep recession of that time.[14]

Very recently, the Executive Director, Economic Group, of the Federal Treasury, Dr Martin Parkinson, in evidence to the Senate Economics Legislation Committee on 21 February 2002 said:

> "What we had always expected would happen is that, as financial deregulation occurred and households had greater access to various financial instruments, household debt would increase … It has increased dramatically in a historically short period of time, but that is a consequence of the fact that we did not really see the benefits of financial deregulation for households until this decade … Australia and New Zealand have quite strong growth in household debt as a share of disposable income. It coincides with the time, effectively, of our financial deregulation beginning to bring benefits to the household sector."
>
> *Hansard*, p E226–227

Curiously, now that the effects of liberalising consumer credit on aggregate consumption have been shown to have precisely the effects intended by the RBA, predicted by the RBA, and for the past decade acknowledged and defended by the RBA, it effectively seeks to deny that they ever happened!

International evidence

These effects have been noticeable not just in Australia but in many other countries where the provision of household credit has been liberalised. In an econometric study of financial liberalisation and household saving in the United Kingdom, Bayoumi (1993)[15] finds that liberalisation led to a sustained decline in the household saving rate of 2.25 percentage points over the 1980s — i.e. household consumption was raised by 2.25 per cent of income. In fact, somewhat ironically in the light of Katz's commentary, Bayoumi's econometric model is derived from Samuelson's overlapping generations model, according to which (in this context) financial repression leads to reduced consumption, especially by the young, who have not had the time to accumulate financial assets. Financial liberalisation leads to an increase in consumption for previously credit–constrained consumers. In Bayoumi's model, this effect is temporary, as consumers who were previously credit–constrained drop out of

[14] For a spirited defence of financial deregulation, see the collection of papers in Reserve Bank of Australia, *The Deregulation of Financial Intermediaries*, 1991.

[15] T. Bayoumi, *op. cit.*

the economy. However, the 'temporary' effect can last for many decades, so that consumption is higher effectively permanently — and certainly utility (or social welfare) is.

These results have been confirmed by a recent OECD study of financial liberalisation and consumption in several countries.[16] This study used advanced econometric techniques to distinguish between long run (co–integrating) and short run (dynamic) effects and finds that in nearly all cases, financial liberalisation which eased the liquidity constraints faced by households, had the expected effect of increasing aggregate consumption. This was true especially of the estimated long run effects.

In summary, contrary to the claims made in the CD, the economics literature supports the view that the existence of credit cards leads to more aggregate consumption than would occur in their absence, or would occur if their use were curtailed by regulatory intervention. This is because credit cards enable consumers to make purchases that they would not otherwise be able to make, because they would otherwise be liquidity–constrained.

Other Merchant Benefits

Credit cards enable merchants to sell over the Internet. No other form of payment is (effectively) feasible for Internet sales, especially Internet sales to consumers that are overseas. This is another instance where credit cards lead to more sales for Australian merchants that would not occur if credit cards were not readily available. But apart from this, Internet sales (properly managed) are less costly for merchants, because they reduce order processing costs and reduce inventories, amongst other reasons.

As discussed in section 2.4 below, credit cards are properly thought of as out–sourced store cards. Open card schemes were first developed in the United States. Their historical predecessor was a series of closed card schemes where individual financial institutions or associations signed up particular merchants to their own scheme. This was attractive to merchants who didn't have the capability of offering credit to their own customers, or who weren't very efficient at it if they did — consumer credit assessment and administration is a core activity of financial institutions, not retailers. Eventually, the shortcomings of a series of unconnected closed schemes became apparent and the open schemes developed, to the benefit of merchants (who only had to deal with a small number of schemes) and consumers (who only had to hold a small number of cards).

The development of open scheme (four party) payment systems necessarily separated the payment card business into distinct issuing and acquiring businesses even when financial institutions were active on both sides. Four party payment systems developed interchange fees as a means to ensure that revenues from the cardholder and merchant were matched appropriately with the payment services being provided when more than one bank is involved. For credit card transactions, the interchange fee was developed to match the merchants' revenue collected via the MSF with specific costs incurred by the issuer to provide the guaranteed payment to the acquirer (and it to its merchant), fund the transaction until the cardholder made payment (or interest started to accrue) and meet other costs that were not collected elsewhere.

[16] Laurence Boone, Nathalie Girouard and Isabelle Wanner, "Financial Market Liberalisation, Wealth and Consumption", OECD Economics Department Working Paper, No. 308, 26 September 2001.

From the merchant's point of view, open card schemes provide a key benefit that is absent when the merchant provides its own credit to its customers. Just as cardholders can 'buy now, pay later', merchants can 'sell now, get paid now' by their acquirer. A merchant that offers its own proprietary credit card services incurs the cost of financing the 'buy now, pay later' transaction until their customer pays. In addition a merchant (particularly a small merchant) that offered its own credit facilities often incurs greater costs in such areas as credit administration, fraud mitigation, credit losses etc.

In summary, the benefit to merchants was the fundamental driving force in the development of the open scheme cards. Merchants gain from credit cards in two respects documented above: the ability of consumers to 'buy now and pay later' and the ability of merchants to 'sell now and get paid now'.

Implications for 'eligible costs'

In terms of the costs that can be included Standard No. 1, this means that the cost of the interest–free period should be included as an eligible cost. The interest–free period — the ability to ease liquidity constraints at zero short term cost to the consumer— is absolutely fundamental to what is attractive about credit cards to *both* merchants and consumers compared to other forms of payment. If, as the empirical evidence suggests, easing liquidity constraints, especially if on favourable terms, allows consumers to spend more in aggregate (and of course, at individual merchants who offer those terms), then it is only reasonable that merchants should bear part of the costs of that provision.

Certainly, the Coles Myer organization appears to believe that an interest–free period is critical to the success of a credit card. *On its own store card*, Coles Myer offers up to 62 days free credit, which is more interest–free days than is typical for an open scheme credit card.[17] Presumably, in making this decision, Coles Myer has been motivated by its business interests i.e. Coles Myer believes the benefit to it of attracting more sales via its interest–free credit card exceeds the costs to it of offering interest–free credit for a limited period of time.

ABA submits that the same is true of all retailers who effectively offer interest–free credit via outsourced store cards i.e. Bankcard, MasterCard and Visa, in which case, their MSFs should recover at least some of the costs of providing this interest–free credit. For on-us transactions the acquirer incurs this cost directly; for not-on-us transactions this cost is incurred by another issuer who includes it in the interchange cost calculation.

According to the CD (p 49) because the terms and conditions of the interest–free period are set by individual issuers, interest–free credit is not a payment network consideration. This argument is wrong because it confuses a technical network (wires, switches etc) with an economic network, and it is the latter that is relevant. As argued above, the interest–free feature of credit cards has profound implications for the credit card network, because it enables higher levels of consumer spending, at individual merchants and in aggregate, than would otherwise be the case.

[17] "House of Cards", *The Age* March 4, 2002.

Virtually all economic networks contain pricing features that have proprietary features. For example, the price to a user of making a telephone call, or sending a facsimile, or sending electronic mail, is set by that particular user's telephone company or Internet service provider. Those prices will have very important implications for how much and how often that user accesses those networks, and thus (since the same considerations apply to all users) for the networks as a whole. But according to the argument of the CD, those prices would not be related to network considerations.

ABA submits that this would obviously be untrue of telephone, facsimile and email networks and equally untrue of credit card networks. Thus the cost of the interest–free period of credit cards is certainly a network consideration, and that cost should be counted towards the calculation of interchange fees.

Summary

ABA submits that the merchants do, in fact, benefit from credit card sales, both individually (which is all that is necessary to demonstrate in this context) and in aggregate. This does not preclude the possibility that particular merchants will benefit even more if the payments services market is distorted by the RBA's Standard No. 1. In particular, those large retailers who can afford to offer their own store, or store–linked cards will be net beneficiaries. Following Standard No. 1, these store linked cards will have an artificial competitive advantage vis–à–vis open scheme credit cards, as issuers will be forced to raise direct charges to cardholders (store cards are typically provided at no cost to the store's customers). Furthermore, following the imposition of the Access Regime, providers of store cards will be able to actively discriminate against four party credit cards by charging customers for using them (via Standard No. 2). Smaller merchants (who do not have the resources to offer their own store cards) will suffer competitively, along with four party credit card issuers.

2.4 Debit Cards as Benchmark?

The previously recognised 'outsourced store card' benchmark

The RBA's CD effectively uses debit cards as the benchmark against which it compares credit cards (e.g. p 2, where the growth of each over the 1990s is compared). In contrast, in the *Joint Study*, the RBA (and ACCC) made the more appropriate comparison of credit cards and store cards.

The *Joint Study* was correct (at least in this respect): credit cards are, in effect, outsourced store cards. In contrast, the CD's comparison of credit cards and debit cards is specious. It is irrelevant that credit card payments have grown much faster than debit card payments in recent years, and this does not reflect "excessive" use of credit cards.

Consumer value does not equate with 'cheapest'

Although credit cards and debit cards are in the same market, they offer different services to consumers. In contrast to debit card payments, credit card payments offer consumers a (short) period of free credit, and the option of taking out a longer term line of credit for the purchase; do not need to be supported by excessive idle balances in consumers' transactions accounts; and offer a money–back guarantee for non–delivery or non–performance.

That consumers have chosen to avail themselves of these high–quality payments services is seen, oddly, by the RBA as undesirable. While it may be true (although this is disputable) that the resource costs of credit card payments are higher than debit card payments, this is irrelevant, for it is not comparing like with like. Cheapest is not best.

Redressing competitive disadvantage faced by smaller merchants

In contrast, credit cards, can validly be seen as out–sourced store cards that not only benefit consumers, but merchants too — especially smaller ones. Prior to the introduction of open scheme credit cards in the 1970s, consumers only had store cards available to them, as well as now antiquated systems of credit like time payment, lay buy etc. This provided a significant competitive advantage to large retailers over small ones, who did not have the scale, systems or expertise to offer their own cards. Open scheme cards effectively became outsourced store cards for such merchants, which took away the competitive advantage held by large retailers (in respect of providing credit terms) up to that point. This is why the large retailers so strenuously opposed the introduction of open scheme cards, and for many years refused to accept them in their stores.

Since they were first introduced, open scheme credit cards have evolved and introduced new benefits to consumers, the latest being loyalty points. The globalisation of retail commerce (e.g. Amazon.com) has added further to the impetus of credit card usage. It is thus not surprising that consumers have increasingly chosen to use their credit cards in preference to other forms of payment. None of this means that credit card usage is "excessive".

Indeed the RBA itself has pointed out[18] that household use of credit in Australia is not high but mid–range (in international comparisons); and that servicing costs as a proportion of income have actually fallen over the past decade — when use of revolving credit (mainly credit card lending) rose relatively rapidly. (The RBA has also pointed out that margins on credit card interest rates in Australia are at the low end of the range internationally.[19])

2.5 Allocation of Common Costs

Significance of common costs in credit card networks

As a factual matter, the majority of costs incurred by issuers are common costs i.e. they are incurred in the provision of services to both merchants and cardholders (and they are incurred for on-us and not-on-us transactions. In Standard No.1, the RBA seeks to exclude virtually allthese common costs from the set of costs that may be used in the calculation of

[18] "Consumer Credit and Household Finances", RBA *Bulletin*, June 1999, p 11.
[19] *Ibid*.

interchange fees (and by extension from the costs that the issuer can recover from the merchant (via the acquirer).

The RBA provides no rationale for the exclusion of these common costs. It states that its methodology is "based on the credit card payment services which are provided to merchants, and for which card issuers recover costs through interchange fees" (CD, p42). Thus, implicitly, the RBA is either saying that there are virtually nocommon costs involved in the provision of services to merchants and cardholders (which is plainly not true), or that there are no services provided to merchants other than those listed in its Standard No. 1 (which is also not true**)**, or that merchants should not pay for any of the costs for services that are provided directly to consumers, but from which merchants benefit. Merchants should be treated, in the RBA's opinion, as if the system were 'just there' — paid for by someone else — and pay only the barest version of the incremental costs of their using it.

There is no basis in economic analysis for excluding the costs of services from which cardholders and merchants commonly benefit, from the calculation of interchange fees. The RBA indeed is careful not to claim any such basis. The only justification given in the Consultation Document is that "in the RBA's opinion" the only categories of costs are eligible for inclusion are: processing costs, costs for fraud and those associated with providing payment guarantees. But the RBA provides no reasons — no logic, no evidence — to justify its opinion.

The avoidable cost methodology

In its discussion of the ABA's avoidable cost methodology, the RBA argues that this methodology provides no incentives to recover *any* costs from cardholders (RBA emphasis) and that *all* issuers' costs incurred in providing the payment functionality of credit cards could be passed to merchants. This is a thorough misrepresentation of the ABA's proposed methodology, but in any case the RBA's Standard No. 1 does exactly this *in reverse*, passing virtually *all* common costs to cardholders, even costs like the general administration of the schemes, which are equally directly caused by cardholders and merchants. The RBA gives no public interest justification for this arbitrary proposal — presumably because none exists.

2.6 RBA's "Eligible Costs"

Interpretation Issues

ABA assumes that the following costs are intended to be captured by the current definition of eligible costs in Standard No. 1 but submits that they should be expressly referred to in Standard No. 1:

- GST on interchange fees for all not-on-us transactions;
- the cost of third party services associated with the current group of eligible costs, including scheme fees i for authorisations, chargebacks, clearing and settlement and third party charges for transaction switching, stand-in authorisations and referral authorisations; and
- the cost of capital of providing payment services to merchants (as recognised by the RBA at p 52 of the CD).

ABA submits that the RBA should clarify which eligible costs are to be included as part of the payment guarantee.

ABA also submits that the following interchange costs should be included as eligible costs in Standard No 1:

- costs associated with the funding of the interest free period;
- credit losses and other payment service costs such as statement preparation and collections; and
- costs incurred to meet the requirements of Standard No 1 and to ensure on-going compliance with it.

The RBA's basis for the inclusion of eligible interchange costs

When assessing the specific issuer costs that the RBA has included as "eligible" to include in the calculation of interchange costs, it is important to understand the basis for the RBA including some costs and excluding others. In other words, what framework, if any, was used by the RBA?

As noted above, the CD includes numerous references to economic studies that have investigated interchange — its rationale, how it should be determined, what costs should be included and how to arrive at the socially optimal interchange fee level that would be in the public interest. As discussed at some length in the CD (and the accompanying commissioned report by Professor Katz), for a variety of reasons, this body of knowledge is insufficient to provide a specific methodology for the calculation of interchange costs in an open (four party) credit card system.

The lack of a reasonable and specific methodology for the calculation of interchange costs based on economic theory leads the RBA to propose its interchange standard based simply on its "opinion". On p 116 of the CD the RBA states that "In the Reserve Bank's *opinion*, this package of measures will promote a *more efficient* and *lower–cost* payments system in Australia, from which the community as a whole will benefit" [emphasis added]. More specifically in regard to interchange costs, the RBA states (p 54, CD) that "in the Reserve Bank's *opinion*, only two categories of issuers' costs are eligible for inclusion in the calculation" [emphasis added].

As discussed earlier, at no place in the CD does the RBA clearly specify the basis on which it formed its "opinion". In particular there is no explanation of how the RBA determined which costs should be "eligible" to include and which should not. Based on what the RBA stated in the CD, its approach appears to have been a process of elimination — to attempt to find (some) fault with every proposed cost and deem 'eligible' only those costs with which fault could not plausibly be asserted.

What the RBA has done is quite arbitrarily assign a limited number of the issuers' costs as "eligible" interchange costs. There is no stated theory, methodology or process by which it arrived at this determination, except its broadly stated principles' that interchange fees should:

- "be based on the credit card payment services which are provided to merchants …"; and

- “exclude … costs that are not related to payment network considerations …”[20]

The RBA’s identification of the costs of payments services provided by the issuer to the merchant is badly deficient because it does not include all of the issuers’ costs that should be included, even against a fair interpretation of the ‘principles’ it asserts. In short it is the application of these principles that is sweepingly arbitrary, more than the principles themselves. The RBA’s interchange standard prohibits the issuer from recovering costs from the merchant that the merchant pays when it accepts three party cards and store cards (e.g. the interest–free period). As will be seen below, the standard results in product regulation and not merely price regulation. Australian consumers are likely to be denied a competitive ‘buy now, pay later’ product provided by the open (four party) schemes.

As a consequence, there must be considerable doubt as to whether interchange fees determined in this fashion will accomplish the objectives that the RBA has set for itself. In fact, the impact appears likely to be just the opposite — reduced competition and distortion of competition in favour of the closed (three party) schemes and store cards for provision of a buy now, pay later product to consumers. However, by extending the identification of issuers’ costs that can be recovered from merchants, some progress will be made towards determining an interchange fee that meets the RBA’s objectives for efficient pricing and provide a viable and competitive marketplace for four party credit cards.

The remainder of this section provides detail on the RBA’s eligible interchange costs and how they should be modified to make the interchange standard a commercially viable approach to establishing a specific methodology for the determination of interchange costs. These modifications relate to:

- the wording of the interchange standard;
- the need to confirm the inclusion of costs that are not expressly identified as eligible interchange costs (for example GST) but which ABA assumes are intended to be included within the current categories of eligible costs;
- the inclusions of specific costs that are not currently part of the RBA’s eligible interchange cost categories;
- clarification of costs to be included as part of the payment guarantee; and
- inclusion of conversion and compliance costs.

What the RBA proposes as eligible interchange costs and its wording

The RBA’s interchange standard provides for the calculation of interchange costs based on “payment services” provided to merchants. The RBA sees these payment services as comprising three primary cost categories.

> “ Interchange fees must be based on credit card payment services which are provided to merchants. The only amounts that can be included in the calculation of an interchange fee in a Scheme are the following costs in respect of that scheme:

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[20] p 42, CD. ABA notes that these ‘principles’ have been reworded from an earlier version put to the industry prior to the designation of the open credit card systems in April 2001. The current version puts a narrower emphasis on *payment* services.

> (i) issuers' costs incurred in *processing credit card transactions* received from an acquirer that would not be incurred if the issuer was also the acquirer in those transactions. This category includes the costs of receiving, verifying, reconciling and settling such transactions;
>
> (ii) issuers' costs incurred in respect of *fraud and fraud prevention*; and
>
> (iii) issuers' costs incurred in *providing authorisation* of credit card transactions, (collectively the "eligible costs")."[21] [emphasis added]

ABA completely agrees that all of these cost categories should be included in interchange costs. The sub–section immediately below provides a fuller description of these three payments services cost categories and, in one instance (processing costs), the clarification needed to ensure the standard correctly describes the relevant costs.

Processing costs

Costs related to "processing credit card transactions" are incurred by issuers for receiving, balancing, editing and posting the transaction information to the cardholder's account. Issuers incur these costs regardless of whether the issuer is the acquirer of the transaction (an 'on–us' transaction) or not (a 'not–on–us' transaction). Including these costs is entirely consistent with typical practices in payment systems in which merchants pay the cost of 'presenting' a customer's payment transaction to receive good funds. For example, the merchant pays the costs related to sorting, counting, transporting, insuring and depositing cash to their bank account.

The wording of this section of the standard needs to be amended. It implies that there are costs that issuers incur for a not–on–us transaction that the issuer would not incur if the transaction was on–us. This is not the case. Except for scheme settlement fees (levied on transactions that are processed through a scheme's clearing and settlement systems) the cost for this payment service is the same for all transactions.

Fraud and fraud prevention

Many fraud–related costs involve initiatives by the issuers to prevent the fraudulent use of a credit card. These include transaction authorisation (discussed under *Providing authorisation* below), maintaining hot card files (which provide information on known lost, stolen and counterfeit cards), investigating fraud transactions to uncover perpetrators of credit card fraud, developing fraud prevention training programs for acquirers/merchants and so forth.

Regardless of the level of effort made to prevent fraud, fraudulent transactions do occur. Fraud losses can occur even when the merchant processes the transaction according to scheme operating procedures but the card is counterfeit, lost or stolen. In that instance, the issuer will settle with the merchant (because the merchant has followed appropriate procedures) but the issuer must bear the burden of the settlement amount (absorb the loss) because there is no valid cardholder.

A payment guarantee is provided to the merchant as a payments service when the merchant follows the appropriate procedures to accept and process credit card transactions. The guarantee can only be rendered at some cost to the issuers — the cost of fraud prevention and actual fraud losses are a component of that cost.

[21] p 58–59, CD.

Providing authorisation

Most credit card transactions are authorised by the issuer of the card. Typically the authorisation is performed by electronically transmitting a request for authorisation to the issuer who then determines whether to approve the transaction (based on such criteria as the existence of a valid and active card number). If the transaction is approved, the issuer electronically sends back an approval and the transaction processing can continue. For paper transactions above a certain dollar amount, the merchant is required to phone for authorisation. Often this call is not directly to the issuer but to a third party that is authorised to 'stand–in' for the issuer. Assuming the transaction passes the approval criteria, the transaction is authorised.

In addition, it is possible for various reasons that an authorisation request will generate a 'referral authorisation' in which case the issuer requests that the merchant call to answer specific questions or request additional information from the customer. An example of this is when a customer is asked to provide photo identification to verify that he or she is indeed the cardholder.

The process of authorising transactions is intended to prevent fraud and help ensure that the issuer will eventually be paid by the cardholder. As such, it is a part of the transaction processing that allows the payment guarantee to be provided to merchants. The merchant therefore pays the costs related to authorisations as part of the payment guarantee.

Thus the three cost categories the RBA has proposed as constituting payments services provided to the merchant are appropriate and logical, albeit incomplete. Only the wording related to processing costs needs to be changed to appropriately reflect the relevant issuer costs. However, one concern is that the RBA has not been sufficiently detailed in its description of what costs should be included in eligible interchange costs. The descriptions above provide some of that detail. Additional costs that are consistent with the CD are provided below.

Confirmation as to specific costs that are part of eligible costs

The RBA has not attempted at this stage to provide a detailed description of the specific cost elements that would be included in those three cost categories. There are at least two costs that are assumed to be included but are called out separately here because of their importance.

- Issuers must now remit to the ATO GST on the interchange fee for all not–on–us transactions. This cost to the issuer has not been identified in the interchange standard.

- Business activities related to the three proposed 'eligible' cost categories can include costs for third party services. These include such costs as scheme fees for authorisations, chargebacks and clearing and settlement and third party charges for transaction switching, stand–in authorisations and referral authorisations. These costs should be explicitly referenced in Standard No. 1.

In addition, the RBA has suggested a cost that should be included in eligible interchange costs (with which ABA agrees) but has not included the cost in the proposed eligible interchange costs. On p 52 of the CD the RBA states that:

> "There would be logic in individual issuers seeking from merchants a return on the capital committed to providing payment services to merchants (e.g. that part of the capital costs of chip technology aimed at fraud prevention) …"

Issuers invest substantial capital in regard to the payment services that the RBA has identified in its standard, namely, authorisations, transaction processing and fraud detection and mitigation. As the RBA suggests, there should be a cost category included as an eligible interchange cost that encompasses the costs of capital committed to providing these payment services to merchants.

In addition to necessary clarification to the proposed eligible costs there are payments services costs incurred by the issuers on behalf of the merchants that the RBA has not included in eligible interchange costs. These are discussed below.

Cost categories that should be added to eligible costs

As noted above, the RBA has omitted several cost categories that are at the core of the credit card product. The most important of these is the cost of the interest free period because the result of the omission is product regulation rather than price regulation.

The interest–free period

From the perspective of the consumer, a credit card (and three party charge cards and store cards) represents a 'buy now, pay later' payment option. Seen from the merchant perspective, the payment product represents a 'buy now, get paid now' payment option. If merchants want to provide this type of payment option they need to offer store credit or a proprietary store card. With store credit or a store card the merchant directly pays the cost of funding the transaction from the time the customer makes the purchase to when they later pay for that purchase.

This cost of funding the transaction for a 'buy now, pay later' payment product is typically referred to as the interest free period. It is one of the most important costs incurred in providing the buy now, pay later payment product.

There are only two sources of revenue for a provider of 'buy now, pay later' payment credit card and charge card products – the merchant and the cardholder. If the merchant does not provide revenue to recover costs then the cardholder must. For the interest–free period, if the funding costs are not paid by the merchant then the cardholder must pay. If the cardholder pays then the product is not a buy now, pay later payment product. Thus to suggest that the merchant should not pay this cost is to suggest that the product should not exist. This is a decision for the marketplace to make, not the regulators.

Credit card payment services offered to the merchant have not changed over time. As the RBA states:

> "The payment services of a credit card – in particular, its 'buy now, pay later' feature and guaranteed refund — have not changed since the credit card was first introduced."
>
> (p 50, CD).

It therefore is only logical that the cost of the interest–free period should continue to be substantially recovered from the merchant. In order to match revenue received from the merchant with the party that incurs the interest free period costs (the issuers), these costs should be included as an eligible interchange cost.

To deny that the merchant should pay the cost of the interest free period and to exclude that cost from eligible interchange costs effectively changes the nature of the product. In its simplest form it is a statement that "we do not want to allow the consumer to have access to a four party credit card that will compete with store cards and three party charge cards". If the interest free period costs are not included as eligible costs the RBA will have effectively regulated the product design itself, and will have removed the core feature that has defined the product around the world for over twenty–five years. This is not in the public interest and is certainly not in the interest of Australian consumers and, therefore, is outside of the powers the Parliament intended to grant the RBA under the PSRA.

Credit losses and other payments services costs

Apart from the most glaring omission of the interest free period costs, the RBA has also not included the cost of credit losses.

When merchants offer a store card or store credit they incur the loss if customers do not pay their bills. A buy now, pay later payment product such as a four party credit card or three party charge card eliminates these direct losses to the merchant. The merchant receives a payment guarantee (assuming they have followed the correct procedures when processing the card) which constitutes part of the payments services they receive.

Typically the cost of credit losses is paid by merchants through the inclusion of these losses in the MSF (and because the losses are incurred by another issuer for not-on-us transactions, in interchange costs). This is the method used to match the revenue received from the merchant with the party that incurs the costs (the issuers)..

The RBA has argued that credit losses are recovered from interest charges to the cardholders. Even if this were true, credit losses would be considered an eligible interchange cost but would be established as nil because they are paid by the cardholder. The fact that there is another source of revenue to recover the costs does not itself make the cost ineligible as an interchange cost. For example, many other costs such as statement preparation, collections and so forth are payment services provided to the merchant that are set as nil because they are costs that are recovered from the cardholder.

There are also arguments presented that the credit losses resulting from cardholders that revolve their balances should be excluded from eligible interchange costs because they do not relate to the basic payment services offered by a four party credit card. In that instance the credit losses would consist only of credit losses incurred from cardholders that typically pay their statements on time and in full and then suddenly default and not pay. While this may be a relatively small portion of credit losses, the lack of magnitude does not diminish the appropriateness of collecting the cost from the merchant and including the costs in eligible interchange costs.

ABA's submission of July 2001 stated that eligible interchange costs should be not less than the issuers' incremental costs and not greater than the stand alone costs of providing the payment functionality of a 'buy now, pay later' payment product. As such, a specific methodology to calculate interchange costs does not require that all of the issuers' costs be reimbursed by the merchant. The cardholder is willing to pay for some of those costs and the competitive market place has been used to determine what costs should be reimbursed by the merchant and what costs should be reimbursed by the cardholder.

There is no definitive point answer in economic theory on how to reflect common costs in pricing to different users of products that are jointly produced and jointly consumed. Economic theory only defines a range of solutions consistent with economic efficiency. ABA's proposal was based on the competitive marketplace working out the precise allocation within the efficient range. By contrast with the arbitrary RBA approach, the outcome would be founded on the realities of the marketplace and not untested opinion.

At a minimum the eligible interchange costs should include the issuers' actual costs for authorisations, payment processing, fraud and the interest-free period. The proposed eligible interchange costs should acknowledge that other costs could be included but that these be recoverable from the merchant only to the extent not recovered from other sources.

The RBA's "Specified Transactions" and costs related to the payment guarantee

Standard No 1 indicates that there must be different interchange fees for different transaction types. The RBA has stated these as paper and electronic transactions and that for each of these there would be a separate interchange fee for guaranteed and not guaranteed transactions (a total of four interchange fees for each four party credit card scheme). The RBA has described this as:

> "In a Scheme separate interchange fees must apply to:
>
> (i) electronic transactions that are the subject of a payment guarantee;
>
> (ii) transactions (other than electronic transactions) that are the subject of a payment guarantee;
>
> (iii) transactions (other than electronic transactions) that are not the subject of a payment guarantee; and
>
> (iv) electronic transactions that are not the subject of a payment guarantee,
>
> (collectively the "specified transactions") to take into account the difference in eligible costs incurred by the issuer."[22]

There are currently different interchange fees in Australia for electronic and "other than electronic" transactions. This is typical in many advanced credit card markets because the underlying interchange costs for electronic transactions are typically different than for non–electronic transactions.

The distinction the RBA makes between guaranteed and not–guaranteed transactions needs to more clearly identify the processing procedures and related costs of different transaction types that would lead to different 'levels' of guarantee and different levels of payments services costs incurred for the acquirer/merchant.

For example, it is commonly (and incorrectly) assumed that an Internet purchase made with a credit card should have among the lowest interchange fees because there is no payment guarantee. However the interchange costs for an Internet transaction are unlikely to be the lowest among all different transaction types. In general,

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[22] P 59, CD.

- The verified signature of the cardholder on a voucher is an important aspect of ensuring that the cardholder did indeed make the purchase. The probability that a transaction is fraudulent and/or will be disputed by the cardholder increases without the voucher (cardholder not present), without the signature ('signature on file') or without a voucher signature that is verified with the signature on the card.

- Fraud losses will be different depending on authorisation processes and whether the cardholder/card are present or not. Typically fraud losses are higher for other than electronic transactions and when the cardholder/card are not present.

- The cost of authorising and processing transactions for which the authorisation and transaction details are captured by swiping the card at a point–of–sale (POS) terminal are slightly lower than for other transactions (key entered and paper voucher).

Because of these differences in costs, the interchange costs for an Internet transaction in which neither the cardholder nor the card is present are higher than for an electronic transaction in which both the cardholder is present, the card is present and a verified signature is obtained.

Additionally the nature of the payment guarantee for Internet transactions is different than transactions in which the cardholder and card is present and a signature is obtained. All transactions have a payment guarantee subject to certain conditions. Conversely, it is possible to say that no purchase transaction has an absolute payment guarantee.

An important aspect of the payment guarantee is the ability of the card issuer to return a transaction to the acquirer/merchant if the cardholder disputes that they made it. This process of dispute resolution is typically called charge back processing and a key element of the process is whether there is a verified, signed voucher that is available to confirm that the cardholder made the purchase. Without this evidence, it is much more difficult to refute a cardholder denial. If the transaction cannot be verified the issuer passes the transaction back to the acquirer who in turn passes it back to the merchant.

Dispute resolution is expensive and merchant agreements with Internet merchants typically provide the acquirer the right to charge back to the merchant all transactions that are charged back to the acquirer from the issuer. Because there is no voucher and no verified signature for Internet transactions, the incidence of charged back transactions is relatively high as the issuer/acquirer typically have no other option than to refuse to honour the transaction if the cardholder denies the charge. The risk in this case for the cardholder not being present and no signature being obtained rests with the merchant.

As a result, the net cost to Internet merchants to accept credit card payments is relatively high because they incur higher interchange costs (than a cardholder present electronic transaction) and have more disputed payments that are not guaranteed. Internet merchants have the option of only accepting cash and cheques but these have their own set of issues (costs and delays) that diminish acceptance in most markets. Payment with PIN–based debit cards has not yet proven sufficiently feasible and secure to gain widespread use. As a result, there has been widespread competition among the four party credit card schemes, three party charge card schemes and other payments services providers to develop payment products for Internet transactions that are as secure and lower cost than credit cards.

The ability of the issuer and acquirer to charge back disputed transactions allows them to make a relative payment guarantee for those transactions that have been processed according to appropriate procedures. Therefore the issuers' cost of dispute resolution (charge back processing) is a cost related to the payment guarantee just as the issuers' fraud costs and authorisation costs are. These costs need to be included in eligible interchange costs.

Conversion and compliance costs

Regardless of the final form of Standard No 1 it is likely that the result will require expenditures on the part of the four party credit card scheme members to comply with the new regulations.

The types of costs that may be incurred are systems costs, changes to non–system business processes and the cost of the independent expert that will calculate the schemes' interchange costs.

These are costs that are imposed by regulation. They should be included in eligible interchange costs, including a reasonable period to amortise one–time costs.

Summary of appropriate revisions to eligible interchange costs

The RBA's approach to identifying payments services is generally consistent with the approach of matching revenues and costs for four party credit card schemes in which the product is jointly provided (by the issuers and the acquirers) and jointly consumed (by the merchants and cardholders). The merchant provides the revenue to recover the costs. For on–us transactions the matching of that revenue with the appropriate business units costs is an internal process. For not–on–us transactions the matching is accomplished by means of the interchange fee.

The problem with Standard No 1 is that it does not go far enough to recognise the costs that are recovered from (or incurred by) merchants for comparable products such as store cards and three party charge cards. The RBA interchange standard more than regulates appropriate interchange costs — it hinders competition and regulates the product.

To avoid this problem Standard No. 1 should be modified as follows

- The issuers' costs for providing the interest free-period (i.e. funding the transaction until interest begins to accrue) should be included as an eligible cost.
- The issuers' costs for relevant GST and third party services associated with eligible costs, dispute resolution (i.e. charge back processing) should be confirmed as eligible costs and explicitly referred to in Standard No. 1 as such.
- Capital costs related to the payments services should be confirmed as eligible costs and explicitly referred to in Standard No. 1 as such.
- The issuers' costs related to other payments services such as credit losses should be included as eligible interchange costs. If those costs are recovered in total or in part from the cardholder, the value in interchange cost calculations would be reduced accordingly.

- The costs of conversion to and compliance with the interchange standard should be included as eligible costs.

The interchange standard as modified above would meet the objectives of efficient pricing in a competitive payments product marketplace as exists in Australia.

2.7 Competition in Retailing?

Crucial to the public benefits assumed by the RBA to flow from Standard No. 1 is the assumption that the reductions in MSFs which will follow from reductions in interchange fees will, in turn, lead to lower prices for consumers.

Retailing 'highly competitive'?

As the RBA (p 125, CD) acknowledges, this assumption turns on the degree of competition in the retail sector. Incredibly, the CD claims that retailing in Australia is highly competitive. This idiosyncratic belief is not shared by many people with a detailed knowledge of the Australian retailing industry. For example, in August 1999, the Federal Parliamentary Joint Select Committee on the Retailing Sector concluded from a review that

> "… the market is heavily concentrated and oligopolistic in nature, where a small number of major chains (Woolworths, Coles and Franklins) each have a significant degree of economic influence or market power."

Australia's retail sector is in fact highly concentrated, with the Coles Myer group alone accounting for 28 per cent of supermarket and grocery sales and 50 per cent of department store sales. Woolworths, the second largest retail conglomerate, accounts for 37 per cent of supermarket and grocery sales and 17 per cent of department store sales.[23] There are only a few more large retail chains (e.g. Harvey Norman, David Jones) before the rank order reaches a long tail of smaller and smaller retailers. The RBA attempts (p 126, CD) to refute the claim that retailing is concentrated by acknowledging that Coles Myer and Woolworths have a large share of the grocery market, but arguing that grocery items account for only 34 per cent of retail trade in Australia. This argument ignores of course the large non–grocery businesses owned by Coles Myer (Myer department stores, Kmart, Target etc) and Woolworths (Big W, Dick Smith Electronics etc). Both continue to increase share in many segments: e.g. both have bought up liquor store chains in recent years. In short, virtually every relevant segment of retailing is similarly concentrated.

In sectors selling either 'small ticket' items (e.g. sandwich bars) or 'very big ticket' items (e.g. motor vehicles), credit cards are not particularly relevant. The most concentrated areas, like department stores — or supermarkets, if the whole trolley is viewed as one purchase — are the very ones where moderately big–ticket items are sold, and where credit cards are most relevant to the ability of smaller players to compete with the big merchants.

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[23] These supermarket and grocery figures are from 1997/98 and understate the current market shares of the large retailers. In 1997/98, Franklins had 11 per cent of the grocery market. Franklins has since left the industry. Department store retailing has also become more concentrated, with the departure of Harris Scarfe and the impending departure of Daimaru.

The industrial structure of the retail sector — a relatively small number of very large retailers and a large number of very small retailers — means that the effect of reducing interchange fees (and hence MSFs) would be asymmetric. Small retailers will probably have to pass these reductions on; large retailers will probably increase their margins. The absolute amounts per transaction will be small enough for consumers not to notice. This asymmetry goes to the implications of Standard No. 1 for the marketplace, which are canvassed in the following chapter.

Chapter 3

Implications of RBA Standard No. 1

3.1 Distortion of Competition in Payments Services

The main effect of the RBA's Standard No. 1 will be to distort competition in the payments market, which is contrary to the objectives of the PSRA. This will happen in four distinct ways.

First, some cardholders will migrate to the unregulated schemes (American Express, Diners Club and store cards to the extent that they structured as three party (closed) schemes). This will occur because the issuers of four party (open) scheme credit cards will necessarily have to raise direct charges and reduce benefits to cardholders to mitigate the revenue lost if open scheme interchange fees are cut as dramatically as implied by Standard No. 1. If issuers of open scheme cards can no longer afford to offer the present interest free period on card purchases, because the RBA has proposed that none of the cost of this interest–free period can be included in interchange fees, many transactors will migrate to the closed scheme cards that will still offer interest–free short term credit.

Because the system costs of the closed schemes will be unchanged, there is no reason to expect that closed schemes will lower their MSFs much in response to any lower MSFs of the open schemes. Merchants may seek lower closed scheme MSFs, but they will be in a weak bargaining position, since their own customers will be increasing their demand for closed scheme payments, and generally, the closed schemes offer merchants an exceptionally attractive cardholder base (business travellers etc). Thus closed schemes are likely to be able to retain relatively high merchant fees — and no surcharge rules, explicit or otherwise.

Second, consumers will migrate to payments instruments that are less desired at the current levels of charges for different instruments but more desired at distorted, post RBA intervention, charges. These instruments will include EFTPOS, cheque and cash. ABA emphasises that this outcome will be as a result of the distortions introduced by the RBA's intervention, and contrary to the public interest.

Third, there will be a loss of income for cardholders that revolve their balances (mainly consumers with low incomes), particularly if the interest–free period disappears. Revolvers will only have very limited options to migrate to unregulated cards, because few of these provide a line of credit. Card fees to this group would rise, as issuers try to recoup losses from reduced interchange fees, so they would be worse off.

Fourth, given the competitive advantage (i.e. market power) delivered to them by the regulation of open scheme cards, the closed scheme cards will be able to charge more to small merchants, who will be unable to resist since their customers will have and use these closed scheme cards. Large retailers will be able to have the best of both worlds by issuing ostensibly open cards, but with features/rewards tied to in–house use.

In summary, the RBA's Standard No. 1, by redistributing income from consumers to retailers, will undoubtedly lead to fewer payments being made by credit card, and those that are made will be more profitable for retailers. It will lead to more payments being made by store (or store–linked) cards, which can realistically only be offered by large retailers. The advantage given to store card issuers by Standard No. 1 will be reinforced by Standard No. 2 which will permit them to surcharge for transactions made using other cards (but not surcharge for transactions made using their own cards).

This advantage will be further reinforced by the Access Regime that will allow holders of store cards to use those cards when purchasing from other merchants. Small merchants, who cannot afford to issue their own cards, will thus be disadvantaged vis–à–vis large merchants. It is not obvious why the RBA's payments policy should be so skewed against the interests of consumers and small merchants towards the interests of large merchants.

3.2 Financial Implications for Banking Industry

Effects on issuers revenue

Standard No 1 will result in a significant decrease in interchange fee revenue to issuers.

- Based on RBA data, the dollar value of credit card purchase transactions for the 12 months ending November 2001 was $81.7 billion. The ABA estimates that 93 per cent of the transactions (based on dollar value) were related to domestic transactions. The dollar value of domestic transactions is thus estimated to be $76 billion.[24]
- In the *Joint Study* the RBA stated that the average interchange fee was approximately 0.95 per cent and that the average transaction value was about $100.00. Table 5.1 of the Joint Study contained the following per transaction costs for three issuer cost categories:
  - Authorisation: $0.04
  - Processing: $0.17
  - Fraud: $0.07.
- These cost categories appear to be consistent with the cost categories proposed to be included in the interchange standard.[25] These per transaction costs total $0.28. With an average transaction value of $100 the interchange fee as proposed by the RBA using this Joint Study data would be 0.28 per cent, a decrease of 0.67 percentage points from the current level of 0.95 per cent as reported by the RBA in the Joint Study. If adopted this would result in an immediate percentage decrease in the interchange fee of 71 per cent, or nearly three–quarters (0.95 less 0.28 divided by 0.95).[26]

[24] Standard No 1 applies to transactions for which the issuer is an Australian institution and the acquirer is an Australian institution, which are set by the schemes and not their member banks. As such, the proposed reform is not applicable to the interchange fees on international transactions.

[25] As discussed in section 2.6 of this document, more detail is required in regard to the specific costs that will be included in those three categories to determine specific cost levels.

[26] The interchange fee calculated in this section is for illustration only. There is no way to determine a future interchange fee under the RBA's proposed standard until it is finalised.

- Applying the reduction in the interchange fee (0.67 percentage points) to the value of domestic purchase transactions ($76 billion) results in a loss of interchange fee revenue to the issuers of $509 million, or say around $500 million. This estimate is subject to refinement based on the actual detailed costs that would be appropriately included in the calculation of interchange costs under the interchange standard.

The immediate impact would obviously be on the issuers and not the acquirers.. The only cost of the acquirer that decreases is the interchange cost. Initially the acquirer may be able to keep some of the reduction of the interchange fee (i.e. not reduce the MSF fully). This is unlikely to continue because the acquiring business is highly competitive and a reduction in the interchange fee is likely to be passed on to merchants. This then will provide the merchants with a reduction in their costs. Whether merchants will pass on these savings to their customers is doubtful, as already noted.

The issuers in aggregate will be faced with an immediate and substantial decrease in revenues. This represents a significant percentage of total bank pre–tax profits, and although issuers will seek to mitigate this decrease, the result is likely to be an immediate decrease in profitability.

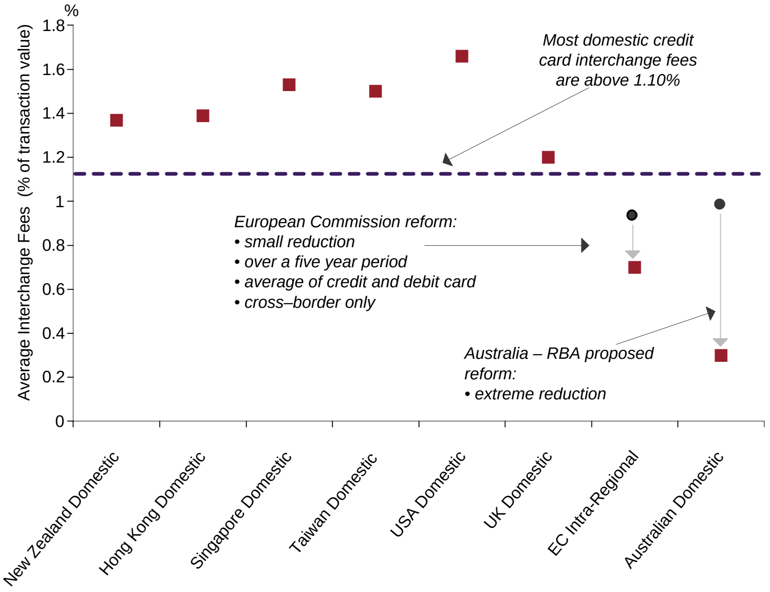
The issuers will then have several options available.

- They may seek to increase fees to cardholders.
- If the entire loss were offset by an increase in interest charges (assumed to average 15 per cent), the interest rate charged would need to increase substantially. That, however, would be a highly improbable result, given the strong competition prevailing in consumer credit provision.
- More likely, cardholders would make up for the loss in the interchange fee revenue through both higher fees and lower benefits — eliminating or reducing benefits enjoyed by their cardholders such as the interest free period, loyalty programs, customer service and so forth.

In summary, the RBA's standard implies a radical reduction in interchange fees that will immediately lead to a significant fall in revenue for issuers. Australia's interchange fees, which are already at or close to the lowest in the world, will become very much lower than elsewhere — including in Europe *after* the regulatory intervention by the European Commission. This can be seen in Figure 3.1 below.

Figure 3.1

INTERNATIONAL COMPARISON OF INTERCHANGE FEES



Effects on merchant pricing and consumers

The RBA states that Standard No 1 will benefit consumers and merchants. The following tables illustrate the impact on these two parties. Table 3.1 shows the economics of an example purchase transaction under current commercial arrangements.

- The merchant is charged an MSF of 1.75 per cent of the transaction value for a credit card transaction. The merchant fee includes the acquirer's interchange cost of 0.95 per cent.[27]
- The merchant incurs costs to accept cash payments that average 0.70% of the value of cash received.
- The merchant marks up its prices to recover its payments related costs (e.g. MSFs and cash handling costs)
- The merchant sells two units of an item that typically would be priced at $1,000 each if there were no payment costs.
- There are two customers and each buys one unit from the merchant. One pays with a credit card and one pays with cash.

[27] The amounts for the merchant fee and the interchange fee are averages taken from the Joint Study.

Table 3.1

PURCHASE TRANSACTION: CURRENT COMMERCIAL ARRANGEMENTS

(2 units sold)	Merchant		1 unit purchased (each)	Cardholder Customer	Cash Customer
Price Received	$2,024.80		Price Paid	$1,012.40	$1,012.40
Merchant Fee Paid (1.75%)	($17.72)				
Cash Handling Costs (0.70%)	($7.09)				
Net Amount Received[28]	$2,000.00		Net Price Paid	$1,012.40	$1,012.40

Under the proposed reforms, the RBA has assumed,

- Merchants can surcharge credit card users for the merchants' cost of accepting credit cards; and
- MSFs will decline because interchange fees will decline.

Based on data contained in the Joint Study and CD, average interchange fees would decline from 0.95 per cent to around 0.28 per cent (say 0.30 per cent) or a decrease of 0.65 per cent; as a result, the MSF in the example may fall to 1.10 per cent. Using those assumptions and data, the economics in the example would change as indicated in Table 3.2.

Table 3.2

PURCHASE TRANSACTION: RBA PROPOSED REFORMS

(2 units sold)	Merchant		1 unit purchased (each)	Cardholder Customer	Cash Customer
Price Received	$2,007.02		Price Paid	$1,003.51	$1,003.51
Merchant Fee Paid (1.1%)	(11.04)[29]				
Surcharge Fee	11.04		Surcharge Paid (1.1%)	11.04	–
Cash Handling Costs (0.70%)	(7.02)				
Net Amount Received	$2,000.00		Net Price Paid	$1,014.55	$1,003.51
			Increased issuer charges to cardholder	$6.68	
			Total charges	**$1,021.23**	**$1,003.51**

- In this example the decrease in the MSF paid by the merchant results from the decline in the interchange fee. That amount must be recovered from the cardholder. This is required because there are only two sources of revenue in four party credit card schemes — the merchant and the cardholder. If the revenue from one source declines (MSFs) it must be offset from an increase in revenue from the other source (cardholder fees).

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[28] Columns may not add exactly because of rounding.

[29] In order to simplify the example (without changing the indicative results) it is assumed the merchant fee is applied to the price before the surcharge applied.

- The merchant would receive the same net amount ($2,000). The cardholder would pay more ($8.83) and the non–cardholder would pay less ($8.89). The difference between the increased cost to one and the savings to the other is virtually nil[30] because the proposed reforms shift all of the costs of accepting credit cards to the cardholder. This is unique because customers who pay with other payment products such as cash and cheques do not pay the entire cost of the merchant accepting those payment methods.

- The surcharge is assumed to be the cost of the MSF for the credit card transaction. This is what the RBA has proposed but the correct approach is to allow the merchant only to surcharge their incremental cost of accepting a credit card and other payment products (in this case cash).

The example under the RBA proposed reforms is based on the assumptions the RBA has made in the CD. It is not clear that the RBA assumptions will be valid in actual commercial practice.

- The RBA states at p ix of the CD that "gains to merchants would not be passed onto consumers — are, at their heart, a vote of no confidence in the competitive process in Australia. This is a view that the Reserve Bank does not share". However, as discussed in Section 2.7 above, the Australian retail sector is not generally viewed as highly competitive. The Report by the Joint Select Committee on the Retailing Sector (August 1999) at p vii states that "the market is heavily concentrated and oligopolistic in nature, where a small number of major chains … each have a significant degree of economic influence or market power".

There are significant risks that the reforms will be implemented without the marketplace responding consistently with the RBA's assumptions that underlie and provide the foundation for the reforms. A more gradual change in the marketplace with the ability to test the assumptions would be a more prudent financial and regulatory response. This is what is occurring in Europe.

If the RBA's assumptions are not valid, the impact on cardholders and non–cardholders would be significant and the merchants would reap a large windfall financial benefit. Table 3.3 shows the impact if:

- The merchant surcharges 2.5 per cent when their MSF is 1.1 per cent; and

- The savings in MSF resulting from lower interchange fees are not passed on to the customers. The consumers pay the same prices as they did pre–reforms.

[30] The exact difference in this example is not nil because the simplifying assumption discussed in the footnote above.

Table 3.3

PURCHASE TRANSACTION: RBA PROPOSED REFORMS – DIFFERENT ASSUMPTONS

(2 units sold)	Merchant		1 unit purchased (each)	Cardholder Customer	Cash Customer
Price Received	$2,024.80		Price Paid	$1,012.40	$1,012.40
Merchant Fee Paid (1.1%)	(11.04)				
Surcharge Fee (2.5%)	25.31		Surcharge Paid (2.5%)	25.31	–
Cash Handling Costs (0.70%)	(7.02)				
Net amount received	$2,032.05				
			Net Price Paid	$1,037.71	$1,012.40
			Increased issuer charges to cardholder	$ 6.68	
			Total charges	**$1,044.37**	**$1,012.40**

This table demonstrates that the merchant receives an additional net amount of $32.05 if the RBA assumptions prove not to be valid in commercial practice. The cardholder sees a substantial increase in total charges (over 3 per cent) and the non–cardholder is no better off than he or she would have been without the reforms.

- Even the RBA states

> “The cost of accepting credit cards is embedded in a myriad of retail prices and the impact of lower merchant service fees on individual prices may not be obvious; moreover, to the extent they offset cost increases from other sources, lower merchant service fees may have the effect of tempering price increases that would otherwise have taken place that it may be difficult to observe any decline in prices” (p 127, CD).

- This leaves the door open for merchants to claim reform driven price reductions are actually reflected in price increases lower than a price increase otherwise would have been. If they don’t pass through any cost reductions resulting from a decrease in MSFs it could yield a significant merchant benefit.

- Under the proposed reforms the merchant is not required to post his or her MSF so the customer has no basis for deciding if a surcharge is reasonable or not.

- Under the proposed reforms the merchant is not required to post his or her MSF so the customer has no basis for deciding if a surcharge is reasonable or not.

It is not clear why the RBA is proposing such drastic reforms based on assumptions that are not market tested or validated. There is no evidence that the assumed impacts will be realised.

The examples above demonstrate the impact of several key assumptions made by the RBA (surcharging and passing through to the consumer the reduction in interchange fees). More broadly, the RBA has made a broad set of assumptions and drawn a number of conclusions, many based solely on their opinions, that are arguable. These conclusions and assumptions with alternative views are provided in Table 3.4.

Table 3.4

RBA ASSUMPTIONS

Assumption/Conclusion		Effect
RBA	Merchants will pass through reductions in interchange to customers	Non–credit card users no longer subsidise credit card users to an extent This creates a public benefit
Alternative	Merchants do not alter current prices	Merchant profits increase by $500 million per year. No benefit to the public (except for equity holders in merchants)
RBA	Consumers will substitute open scheme credit card transactions to debit cards or cash	Consumers move to “lower cost” payment instruments and therefore (in the RBA’s opinion) payment systems are more efficient
Alternative	Consumers will substitute open scheme credit card transactions to closed scheme credit or charge cards	Consumers move to less efficient closed party schemes. Merchants are forced (due to force of numbers) to accept these higher cost instruments Merchants pay greater MSFs Cardholders retain same benefits as currently exist (e.g. loyalty points, interest free period etc) The payments system is, overall, less efficient
RBA	Merchants on aggregate do not benefit from issuer activities outside transaction processing and fraud activities	Merchants are paying just for services that they use
Alternative	Merchants do benefit from other credit card activities	Merchants are having a “free ride” at the expense of credit cardholders.
RBA	Aggregate consumption is not affected by the existence of credit cards	By decreasing credit card usage levels, the RBA will not decrease aggregate spending Individual merchant sales are unaffected
Alternative	Aggregate consumption increases due to the existence of credit cards	Spending will decrease if credit card usage is reduced Merchants will suffer from reduced national spending levels

Lack of workable transitional arrangements

Standard No 1 states that

> “The interchange fees of the Scheme must be calculated and published in accordance with this Standard within [3] months after this Standard comes into force”.

In the case of Europe, the European Commission imposed agreement for certain types of credit and deferred debit cards is to reduce interchange fees over 5 years and the reduction is only estimated to be one–fifth more than would have incurred without the ruling.[31]. This gradual and prudent implementation approach is significantly different than the approximately three–quarter reduction in the interchange fee the RBA proposes within three months after the proposed reforms come into effect. The time frame proposed by the

[31] Notice Pursuant to Article 19(3) of Council Regulation No 17 (8 November 2001).

RBA to implement so great a change in interchange fees is, to say the least, not prudent, for both sound technical and commercial reasons.

As a first step there is a need to conduct detailed cost studies for each of the schemes to determine the exact level of costs associated with the interchange standard. This will likely entail discussions with the RBA to clarify detailed costs to be included, the preparation of an accounting manual as a guide for the issuers to collect costs, the actual collection of the costs by the issuers, discussions with the issuers to review as needed of their work to ensure cross scheme and cross issuer consistency, compilation of the data, review of the aggregate data with the issuers and the RBA, preparation and issuance of appropriate notices and agreement of all relevant parties on the interchange fee level. It is unlikely that this can be accomplished in three months.

The proposed changes to interchange fees involve not only a change in fee levels but also the creation of additional fee categories to reflect the RBA's desire to have interchange fees that reflect the nature of data capture (electronic and non–electronic) and conditions of the payment guarantee (e.g. cardholder present or not). To implement these changes requires system changes in order to properly identify each transaction with the specific interchange fee for which it is eligible. In addition, the RBA was silent on the structure of the interchange fee in regard to whether it should continue to be an *ad valorem* fee (i.e. a percentage of the transaction value as it is currently structured) or whether is should be comprised of a fixed amount per transaction and an *ad valorem* component. Changing the structure of the fee would add to system change requirements and feasible and reasonable implementation timing.

- A change of this magnitude will also have commercial ramifications for the marketplace; for example, acquirers will need to renegotiate and/or reprice appropriate merchant contracts.

Appropriate phasing

In other markets it is typical to implement large changes to interchange fees incrementally to allow the market to absorb and react to those changes. This appears to be the case in Europe in regard to the European Commission ruling. Changes (increases or decreases) to interchange fees in excess of 5 or 10 basis points (0.05 per cent to 0.10 per cent) at one time are typically not made. Therefore, if the interchange standard is implemented and the amount of the reduction is approximately the amount suggested above, it would be commercially prudent (as well as prudent in the regulatory sense) to implement the changes over 5 years with annual changes in the order of 10 to 12 basis points (depending on the actual calculated interchange costs).

A well thought out implementation schedule would need to be developed that takes into account the need to (1) make the initial calculation of interchange costs under Standard No 1, (2) make required system and business process changes as required and (3) develop a phased approach that will allow the changes to be absorbed in as non–disruptive manner as possible. Where appropriate, ABA is willing to work with the banks and the RBA and develop a detailed industry implementation timetable and approach to whatever regulation is ultimately determined. ABA of course strongly argues for a much more moderate and reasoned approach than proposed in Standard No. 1.

ABA and the banks are concerned that the RBA has relied upon interchange cost data collected from the banks as part of the Joint Study that may be of limited value because of inconsistencies in the way the banks account for these costs and due to legitimate interpretational differences. ABA strongly submits that the RBA should conduct a detailed examination of these interchange costs in consultation with the open schemes and their members in order to ensure any regulation of interchange fees is introduced on the basis of complete and accurate data. ABA and its member banks are most willing to assist the RBA in this endeavour.

3.3 Effect on Competition in Issuing and Acquiring

Small and regional issuers will suffer, especially if interchange fees are set too low

The ABA provided a confidential submission to the RBA in regard to the impact on smaller issuers, compared to the industry, if interchange fees are reduced. Although the details of this submission are confidential, the overall conclusion was that smaller issuers would be more adversely impacted by a reduction in interchange fees than larger issuers. As a result, a reduction in interchange fees could drive them from the market, lessening the competitive dynamic of the issuing marketplace.

In response to the issue of small issuers, the RBA in its CD states that "the key point, however, is that the existence of economies of scale is not an argument for keeping interchange fees high to enable small issuers to remain in the market" (CD, p123). ABA takes no exception to this and in fact has stated that issuers that cannot achieve a cost structure consistent with their commercial opportunities will be appropriately required to exit the market. ABA does not argue that interchange fees should be above average costs in order to provide support for small issuers.

In fact, in many markets (including markets such as the US in which there are issuers with enormous scale economies) there are small issuers that are technically efficient for their size and that can compete effectively for the market segments for which they tailor and target their products. It would be no more logical to suggest that small issuers that do not have the size and concurrent scale economies as large issuers should leave the market than it would be to suggest small retailers should exit the market if their unit costs are higher than the largest retailers. The point is that there should not be arbitrary obstacles placed in the way of the small issuers to compete if they are technically efficient for the commercial opportunities they have.

The existence of the four party credit card schemes provides issuers with the ability to offer their customers a buy now, pay later payment product. Because they typically have higher cost structures, small issuers must be particularly creative in tailoring their product offerings to stand out from their competitors' offerings. For example small issuers often issue credit cards with lower cardholder fees (and fewer features). Fewer features do not include not providing their customers the ability to 'buy now, pay later' because it is a core feature of the product. If the small issuers did not offer the buy now, pay later feature, they would significantly diminish whatever parity they have with their competition — large bank/ issuers and providers of other payments services such as the closed schemes and store card providers.

Standard No 1 excludes the costs associated with funding the interest–free period even though it is a cost for a 'buy now, pay later' payment option that the merchant typically pays. The small issuers therefore have only one other source to recover those costs — the cardholder. And if they have been able to differentiate their product by offering low, no frills cardholder fees compared to the large issuers, the percentage increase in those fees will be greater for the smaller issuer than the larger issuer.[32] Thus by excluding an appropriate cost (the interest–free period) from interchange costs, the RBA has placed a burden on small issuers that is greater than for large issuers. This problem exists even if the smaller issuer is highly efficient for its size, achieves positive margins and has carved out a profitable business for itself.

As described earlier, there are a number of costs that should be included in eligible interchange costs that the RBA has not included. To the degree these costs should be recovered from the merchant but are not, the issuers will need to increase cardholder fees to mitigate the impact. ABA's prior submission to the RBA in regard to small issuers provided evidence that increases to cardholder charges has a greater impact on small issuers than large issuers.

In ABA's view, the exclusion of costs from interchange costs that should be included will place a disproportionate burden on small issuers. This is not a view that is founded in the belief that inefficient issuers should be supported by inappropriately high interchange fees. It is a view that many small issuers work very hard to be efficient for the target markets they serve and provide a competitive presence to the large issuers. They should not be disproportionately and adversely impacted by excluding from interchange cost those costs that are appropriate to include. Leading the list of those costs that have inappropriately been excluded are the costs of funding buy now, pay later transactions.

In summary, ABA supports the proposition that issuers should be technically efficient, and is not proposing that small issuers should be given special status merely because of their scale. However, by excluding legitimate cost categories, Standard No. 1 will particularly penalise small issuers, *even if they are operating at a high level of technical efficiency.* This could lead to them leaving the industry. This outcome would be contrary to the public interest criterion of the PSRA in two respects: competition in card issuing would be diminished, and suppliers would be forced out not because they are inefficient but because of inappropriate regulation.

Standard No. 1 undermines the Access Regime

Notwithstanding the Access Regime, new issuers other than major merchants are unlikely to be attracted to the industry, largely because interchange prices will be regulated too low, but also because of regulatory uncertainty. As some existing issuers may exit, it can be seen that Standard No. 1 is in fact likely to undermine any positive effects on competition arising from more liberal access.

According to paragraph 15 of Standard No. 1, the RBA reserves the right to reintervene whenever it "considers that changes in costs warrant an earlier recalculation of interchange fees". An initially arbitrary and then open–ended regulatory regime of this type will not inspire confidence or attract investment. Over the longer term, issuers will no longer have

[32] This assumes the cost of funds for all issuers is equal. If a small issuer has a higher cost of funds it further exacerbates the problem the issuer faces.

the incentive to improve their products e.g. through chip based technologies if the improvements benefit the merchant and there is no clear path to recover the development cost from the merchant.[33] Open scheme credit cards will certainly not grow; they will at best stagnate but probably shrink as both cardholders and merchants migrate to the more attractive, unregulated closed schemes, store cards and other payments products..

On the acquiring side, margins will not be squeezed in the same way as on the issuing side, but as the costs of setting up a Specialist Credit Card Service Provider will be significant, it seems likely that mainly major merchant self–acquirers will enter this way. International specialist service providers (such as GE Capital and First Data) are already present in Australia, but perceptions of regulatory risk will likely deter others given the RBA's reforms will lead to a declining open scheme cardholder base and shrinking transaction volumes.

3.4 Effect on Competition in Retailing

As discussed above, the most likely effect of Standard No. 1 — in combination with the Standard No. 2 and the Access Regime — will be to confer a tremendous competitive advantage to large retailers. Unlike small retailers, large retailers will be able to use reductions in MSFs to increase their margins. Moreover, large retailers will be able to offer their own store cards as part of the open scheme networks, and offer incentives, not able to be offered by small retailers, for consumers to shop at their stores, using their cards. Small retailers cannot affords to offer these types of products and will be disadvantaged. The large retailers will be able to do this by surcharging when cards other their own are used as payment in their stores, and by offering loyalty points when their cards are used, but only in their stores.

This will result in further concentration of the retail sector, and further vertical integration of retailing and payment systems. ABA submits that there will be no public interest in this outcome, quite the contrary in fact.

3.5 Overall Likely Outcomes

In summary, the outcomes likely from the implementation of Standard No. 1 will be as follows.

- Many consumers will move to unregulated buy now, pay later card schemes which will not achieve the RBA's objective of shifting purchase transactions to debit cards, just as bank customers moved to unregulated building societies etc prior to financial system liberalisation in the 1980s.
- Banks will lose revenues, profits and stop investing in cards, contrary to principle of dynamic efficiency (and just when they are on the verge of widespread investment in chip technologies etc).
- Visa and MasterCard may lose interest in Australia and leave for less hostile environments.

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[33] Two examples of where increased investment is currently required to enhance the security of the payments system are the PIN at point of sale project and Visa's 3D secure regime for Internet payments. In both cases, the issuers (not the merchants) are being asked to fund the developments.

- Large merchants, already enjoying considerable market power in their industry, will be big winners, at the expense of consumers and small merchants.

- Small issuers, including those who operate at a high level of technical efficiency, could be forced out of the industry,

- Consumers, especially low–income consumers, will be losers as: they will pay more for cards and find less competition among issuers

ABA submits that each of these outcomes is contrary to the public interest.

Chapter 4

Assessment of Rationale for Standard No. 2

4.1 RBA Arguments for abolishing the 'No Surcharge' Rule

The arguments put forward by the RBA in proposing Standard No. 2 relate essentially to the promotion of *allocative efficiency* i.e. scheme rules which prevent merchants from setting prices to cardholders in order to recover MSFs distort the relative prices of different payment instruments and are therefore not conducive to efficiency in payments systems.

In forming this judgement, the RBA has rejected arguments put forward by the ABA and others that these pricing restrictions can be justified to preserve the network benefits of credit card systems.

4.2 Assessment

ABA believes that the RBA has dismissed too quickly the network arguments in favour of the no surcharge rules. However, and more importantly, ABA submits that the lifting of these restrictions by regulatory fiat will have little practical effect. The major exception may lie in the behaviour of the large retailers who may adopt policies of selective surcharging. i.e. they will not surcharge consumers who pay with the retailers' own cards, but will surcharge consumers who pay with other cards. As discussed earlier, in combination with other factors, this will strengthen the competitive position of large retailers vis–à–vis small retailers, and the competitive position of store cards vis–à–vis other cards.

This point aside, the effect of abolishing the no surcharge rule is likely to be miniscule. Bankcard does not have a no surcharge rule and Visa and MasterCard have one of the weakest forms of the rule, with merchants free to offer discounts for non credit card payments (unlike other countries). With interchange fees and hence MSFs cut by nearly three–quarters, there will be rather less to surcharge. In all likelihood, the transactions costs of surcharging for merchants, especially small merchants, will be in excess of the benefits to them of doing so. This has been the general experience in those few other countries where such rules have been prohibited.

4.3 ABA Position

ABA notes that Standard No. 2 is a matter for the Schemes, but in any case believes that it will have little practical effect. ABA reiterates that the most important implication of Standard No. 2 is not the ability it gives to merchants to surcharge. Rather, in combination with the Access Regime, Standard No. 2 logically removes completely any grounds for regulating interchange fees. Once merchants are free to set retail prices in a competitive market, there is no argument for regulating the price of an intermediate service i.e. interchange fees. If the interchange fees or MSFs are set at above competitive levels, merchants would be free to purchase their acquiring services from anyone in the market, entry to which is liberalised by the Access Regime.

In the interests of preserving competitive neutrality, ABA submits that Standard No. 2 should be widened to include the closed schemes. If restrictions on merchant pricing imposed by open credit card schemes “suppress price signals to end–users about the costs of the credit card network” and hence are undesirable, as claimed in the Consultation Document (p 62), then the equivalent restrictions imposed by the closed schemes are equally undesirable. Furthermore, in those instances where a merchant does surcharge when accepting a credit card, consumers should be protected by regulations that limit the surcharge to no more than the cost to the merchant of accepting that card.

Chapter 5

Assessment of Rationale for Access Regime

5.1 RBA arguments for the Access Regime

The RBA argues that the current restrictions on access to the open card schemes create entry barriers, sustain super–normal profits and are more restrictive than required for the safety of those schemes. Hence, it is argued, competition is limited by these rules. The RBA therefore concludes that a more liberal access regime is warranted.

The RBA proposes an Access Regime by which specialist credit card issuers can enter the market (i.e. become Scheme members) provided a number of prudential conditions are satisfied.

5.2 Assessment

In its submission of July 2001, ABA supported the principle that entities should have maximum opportunity to participate in credit card acquiring and/or issuing, subject to satisfactory prudential controls. ABA thus supports the principles of the Access Regime, provided that is results in a market environment that is truly competitively neutral (a ‘level playing field’). However, ABA notes that the Access Regime is a matter primarily for the Schemes, and that the Schemes have legitimate interests in defending their intellectual property, which may conflict with the Access Regime, as formulated. In particular, it is of concern that by contrast with access regulation as applied in other sectors — which governs terms of use but does not provide third party users with equity or governance i.e. voting rights — the RBA is proposing that schemes provide access in terms of membership, not merely use.

ABA does not agree with the RBA that margins on credit card issuing and acquiring are excessive.

ABA has previously noted its support for the new entry conditions for Bankcard, which are in fact more liberal than those proposed by the RBA. Unlike the proposed RBA rules, Bankcard’s rules do not require members to set up separately capitalised entities (effectively, specialised bank–like entities) that are supervised by APRA. Bankcard requires just that they be supervised by APRA or a prudential regulator overseas recognised by APRA, or have their Scheme liabilities guaranteed by any such supervised institution.

Chapter 6

The Exercise of Powers by the RBA

If the RBA proceeds to determine the Standards and impose the Access Regime as proposed in the CD it will have acted beyond its powers, in disregard of the considerations and process directed by the PSRA and upon the basis of erroneous and unreasonable assumptions.

6.1 Beyond Power

The regulatory intervention proposed would be beyond power in at least two significant respects. First, Standard No. 1 imposes rules and procedures for the capping of the level of interchange pricing in the guise of the exercise of a power to determine standards. While the PSRA describes this power in simple terms, without defining the word standard or putting express limitations upon the subject matter of a standard, the normal English meaning of the word standard as a qualitative norm would not encompass such an action. Further, this usual meaning is reinforced by usage of the term in examples such as the phrases “Australian Standards” and industry standards and the use of the term in other legislation such as the prudential legislation of the financial services industry and consumer and employee protection legislation. This is consistent with the reference in the Treasurer’s PSR Bill Second Reading speech to “technical standards” which contrasts starkly with the reference to the access regime power, which is described as “the imposition of rules of access for participants on commercial terms”.

Secondly, the proposed Access Regime confers entitlements beyond those defined to be access under the PSRA. In addition, the proposed rights are not conferred ‘in relation to a payment system’. Payment system is defined in the PSRA to be a funds transfer system that facilitates the circulation of money. The Explanatory Memorandum to the PSR Bill refers to the intended regulation as covering “the rules for participation in clearing streams” and describes the consequences in the regulatory impact statement as including that “Banks would face greater competition in clearing systems”. However, the proposed Access Regime makes no attempt to identify and define the funds transfer aspects of the system to which a right of use is being conferred. Instead the subject matter of the regime is the conferral of all rights, obligations and entitlements of a participant in each of the three designated credit card Schemes. This is despite the very narrow definition in Standard No. 1 of the credit card services for which interchange fees may be charged as limited to processing, authorising and settling credit card transactions and bearing the costs of fraud. Included in the rights conferred by the Access Regime in respect of each Scheme would be rights to use intellectual property and rights of governance — rights which extend well beyond rights as a user of a funds transfer system.

If the proposed Access Regime were to be within the power conferred by the PSRA it would enable the imposition of regimes beyond those adapted to and appropriate to the statutory objective and a serious question would arise as to whether such legislation is an acquisition on other than just terms.

6.2 Disregard of Relevant Considerations

The proposed regulations and their rationale as set out in the CD evidence a failure to take into account at least the following key relevant considerations:

- having appropriate regard to the interests of the current participants in the system and the continuing efficiency and financial safety of each designated system. One example of the consequence of these failures as represented in the narrow characterisation of the costs included in Standard No. 1 is that there is no allowance for a return on capital invested in the system. This is likely to have the effect of disincenting investment in new technologies or enhanced functions of the system (as discussed in Chapter 3). Whether the regulation of interchange is proposed to be made under the access regime power or the standards power, the protection of investment in the system and its fostering for efficiency gains in the future is highly relevant.

- an analysis as to whether the desired regulatory public policy objectives are achieved by the combination of some of the proposed regulations (eg Standard No. 2 and the Access Regime) without the imposition of additional regulation (as discussed in Chapters 4 and 5).

- that access is required to be on a commercial basis that is fair and reasonable. The Explanatory Memorandum concludes “This means that access rights are not imposed on non–commercial terms that do not take appropriate account of the costs and interests of the current participants in a payment system.”

- failing to recognise and evaluate the anti-competitive effects of requiring participants to disclose publicly information as to costs and transaction volumes which would give access to competing banks, competing schemes and competing closed credit card and store card providers to competitively sensitive information.

- misapprehending the relevant components in the definition of the public interest including failing to have regard to the importance of the designated payment systems remaining competitive with the closed credit card schemes and store cards. Imposition of deep regulatory intervention upon the Schemes when these competitive products (and others) are wholly unregulated either as to price, the financial returns to issuers of those products or whether a merchant may charge a surcharge, would competitively disadvantage the schemes and the current participants in them.

6.3 Mandated Process

Pursuant to sections 12, 18 and 28 of the PSRA the RBA is obliged to consult before taking action to impose an access regime or determine a standard. The procedure to be followed under sections 28 (consultation obligations) and 29 (notification obligations) is:

- RBA to advise of the proposed action;

- RBA to take reasonable steps to ensure that participants in the payment system concerned are informed of the action;
- Invite submissions within a specified time;
- Consider any submission received within that time limit; and
- Notify participants of the finalised action.

The consequence of the time limit upon submissions and its interaction with the notification and advice obligations, is that the RBA's advice and information as to its proposed action must sufficiently disclose with certainty the proposed actions so that properly informed submissions may form the basis of the RBA's consultation process. If there is material ambiguity or uncertainty or non–disclosure in the advice as notified, the consultation obligation will not be fulfilled.

The notice of the proposed action and the information in the CD are defective in at least the following respects:

- There is considerable uncertainty as to the heads of cost that are allowed to be recovered under Standard No. 1 due to:
  - the qualifying language in paragraph 7(i) that purports to exclude from the cost calculation costs that would be incurred if the issuer was also the acquirer in the transactions. It is not clear whether this is intended to be an exclusion of on–us costs or to be some elliptical incorporation of an incremental cost concept;
  - the failure to define "costs" allowing fundamental uncertainty as to questions such as whether the concept is that of economic cost ie opportunity cost including cost of capital or accounting cost;
  - the classification of transactions for which costs are to be collected and an interchange fee calculated into 4 categories, electronic or non–electronic and with and without a payment guarantee. This classification does not accord with the current understanding of transactions conducted using credit cards.
- The Access Regime proposes a new class of eligible participant, a Specialist Credit Card Service Provider. The CD states that APRA is to define the prudential requirements for such a provider and that regulations are to be made pursuant to the Banking Act to deem credit card provision as "banking business" to allow the licensing of such providers. It is unclear whether such legislative powers may be enacted and in what terms. It is also unclear on what basis APRA will approve and supervise such new participants. Members of the ABA have been led to understand that once such an entity is approved a Scheme may form its own view on a non-discriminatory basis, that admission of the entity should be refused as it would endanger the financial safety of its Scheme. However, this is not clear in the terms of the draft Access Regime.

- There is no certainty from the CD that the RBA will designate the closed card schemes for the purposes of Standard No. 2 and therefore it is not possible to assess the competitive implications of the application of this regulation. The CD only states that the RBA will consult with the three party schemes on why the standard should not apply to them.

Without clarification and better disclosure of the proposed action including in the respects as outlined above, consultation as required under the PSRA cannot take place. The Treasurer's Second Reading speech placed significant emphasis on the consultation requirement. He stated "This approach ensures that formal regulation will be imposed on the payments system only to the minimum extent necessary to achieve the public interest."

6.4 Erroneous and Unreasonable Assumptions

The RBA bases its reasoning supporting the proposed regulations to a significant extent upon a number of erroneous and unreasonable assumptions including:

- That a basis for imposing Standard No. 1 upon the open credit card schemes (and no regulation of return to providers of credit cards under the closed 3 party schemes) is that the open credit card schemes collectively determine interchange fees and that the ACCC reached the conclusion that the arrangements were in breach of the price–fixing provisions of the Trade Practices Act (TPA). This is a significantly flawed basis for such fundamental action and distinctions because:

  – It is wrong as a matter of fact. The ACCC stated that it formed the view that the arrangements were likely to breach the TPA but only a Court may determine that a contravention of the TPA has occurred and no such determination has occurred. Further, the Schemes and their members have contrary views.

  – The TPA excludes from its prohibition of price fixing the joint supply of goods or services provided in pursuance of a joint venture, such as each of the open credit card schemes. This is somewhat a similar principle to the Guidelines of the US Department of Justice concerning permissible collaboration between parties that are otherwise competitors. In the *Nabanco Case*[34] the US Supreme Court held that the interchange arrangements between the bank members of the Visa scheme did not violate US competition laws because the arrangements were integral to a pro–competitive joint venture.

  – This erroneous assumption of illegality is used to taint the open schemes by comparison to the closed schemes when the closed schemes by their vertically integrated proprietary structure introduce much less competition in the provision of payment services. The pro–competitive strengths of open credit card schemes are that they open the issuing and acquiring functions to competition. It is of no surprise that the closed schemes charge significantly higher merchant service fees — a fact the RBA acknowledges but (erroneously) chooses to dismiss as irrelevant.

[34] *National Bancard Corporation (NaBANCO) v Visa U.S.A.* 596 F. Supp. 1231.

- That a basis for access regulating the open schemes and not the closed is that the closed schemes do not have access rules which discriminate on the grounds of institutional status. This statement and ground for differential regulation is erroneous and unreasonable. The closed schemes have no access rules, they are vertically integrated with a single entity owning and controlling all functions. This is a further respect in which the open schemes are significantly pro–competitive compared to the closed schemes.

- In a number of significant respects the RBA casts the test for its satisfaction under the PSRA in the terms that the current participants must discharge an onus of proof that they should not be regulated. For example the CD states that:

  > "…if such regulations [Scheme Rules] suppress or distort the normal market mechanisms, the onus must be on those institutions imposing the regulations to demonstrate that community welfare is not harmed." (CD, p 12)

  This is an erroneous construction of the PSRA. The RBA must be positively satisfied that regulation under the PSRA is appropriate having regard to the statutory criteria. In fact as noted above the Treasurer introduced the PSRA by stating that formal regulation would be imposed only to the minimum extent necessary.

- The RBA states that its proposed reform measures:

  > "will promote greater efficiency, transparency and competition in the Australian payments system, to the benefit of the community as a whole, *while leaving the basic structure of credit card schemes intact*." [Emphasis added] (CD, p ix)

  This is an erroneous assumption. By severely limiting the cost categories able to be recovered in the interchange fee the RBA has fundamentally compromised the structure of open credit card schemes. Most significantly the exclusion of any cost of funding the interest free period — (the "buy now, pay later" service for consumers and the "be paid now" service for merchants from which both groups benefit) excludes cost recovery from merchants for the service which distinguishes credit cards from debit cards. (as discussed in Chapter 3).

Chapter 7

Review Mechanisms

7.1 Need to apply Regulatory Best Practice

The RBA's proposals include no mechanism for testing in the future whether these regulations are needed at all. At the outset, the criteria for determining the success, or otherwise, of the regulatory regime should be explicit. These criteria should include an objective basis for assessing whether the benefits actually delivered by the regulations exceed their actual costs, and whether the regulations, if needed at all, continue to be the minimum necessary to achieve their objectives.

An independent review by the Productivity Commission, in no more than three years, should investigate whether Standards No 1 and 2 and the Access regime are still required, given developments in the payments system over that time.

Such reviews are now commonplace for regulated industries and are an integral component of regulatory best practice. The Productivity Commission has recently completed inquiries into the regulation of telecommunications and airports, amongst others.

7.2 Appropriate Benchmarks

This independent review should investigate whether the RBA's regulations have worked as intended, whether there have been any unforeseen consequences, and what would be the effect of removing these regulations. The burden of proof should fall with the RBA to demonstrate that the net benefits of its regulations have been positive. If positive net benefits cannot be demonstrated i.e. if it can be shown that the net benefits have been negative, *or* if there is no strong evidence either way, then the regulations should be removed at the conclusion of the review. In other words, the review should be 'zero–based', set against the objectives specified at the outset of the regulatory regime.