15 March 2002

Proposed Credit Card Regulation

ANZ Banking Group Ltd

response to

RBA Consultation Document

Reform of Credit Card Schemes in Australia, December 2001

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ANZ

Overview

This submission by the ANZ Banking Group responds to proposals by the Reserve Bank of Australia (RBA) to regulate the three 'open' credit card associations (or 'schemes') ie Bankcard, MasterCard and Visa in respect of entry of new players, merchant pricing for credit card sales and 'interchange' fees paid within the schemes.

Allowing New Players to Enter

ANZ supports making it as easy as possible for new players to participate in the three open credit card schemes, so long as: the safety of the schemes is protected; and there is a 'level playing field' among *all* players in the credit card market (including the 'closed schemes' and store cards). ANZ strongly agrees with the RBA's proposed prohibition of fees or loadings that discriminate between scheme members according to whether they focus on issuing or acquiring, as it believes these are anti-competitive.

Allowing Merchants to Surcharge Credit Card Payers

ANZ has no objection to requiring the open credit card schemes to allow merchants to surcharge their customers who pay by credit card, as long as this is applied equally to *all* credit card schemes (including closed scheme and store cards).

ANZ sees a need, however, for *consumer protections* to: limit any surcharging to the merchant fee, and prevent gouging; ensure merchants issuing their own cards do not discriminate against others; and ensure merchants pass on savings from lower merchant fees to all of their customers.

No Justification for Price Control

In ANZ's view, once access to the open schemes is made as freely available as possible, consistent with prudential standards, and merchants are free to surcharge, then any competitive constraints that may have been perceived to exist will certainly have been removed, and as a result: *there is no logical case for any regulatory intervention in interchange fee setting.*

The RBA's interchange fee proposal would set aside the key feature of the credit card as a way for merchants to accept payment: it offers much more than a debit card or cash, combining a 'buy now, pay later' benefit for the customer with a 'sell now, be paid now' benefit for the merchant.

The contrast with the European Union's recently announced moderate and phased reforms is striking. The European changes allow five years for interchange fees on credit cards to come down to levels at most a little lower than where Australia's are today. The RBA proposals will force a vastly bigger change in a matter of months. They do not allow a sufficiently long transition period for such a change.

Conclusion

ANZ supports reform of the credit card market. ANZ supports reforms that liberalise entry, increase transparency, and promote competition, while ensuring safety and a 'level playing field'. However, ANZ strongly urges the RBA to consider the risks of implementing its proposed intervention in interchange fee regulation set out in the Consultation Document and adopt more moderate proposals, with a phased implementation.

ANZ understands that after receiving written inputs in response to the Consultation Document, the RBA will consult with interested parties ahead of making final decisions on what regulations will apply. ANZ wishes to be part of that process, to work constructively towards an outcome that is in the public interest and minimises disruptive consequences.

Summary of Submission

This Submission

This submission by the ANZ Banking Group responds to proposals by the Reserve Bank of Australia (RBA) to regulate the three 'open' credit card associations or schemes (Bankcard, MasterCard and Visa). The RBA released a *Consultation Document* (CD) in December 2001 proposing:

- an 'Access Regime' designed to make it easier for new players to participate;
- a 'Standard' governing scheme rules about how merchants may charge customers paying by credit card; and
- a 'Standard' governing the setting of 'interchange fees' paid by the merchant's credit card service provider ('acquirer') to the issuer of the customer's credit card.

The proposals rely on the RBA's powers under the *Payment Systems (Regulation) Act* (PSRA).

Allowing New Players to Enter

ANZ supports making it as easy as possible for new players to participate in the three schemes, so long as:

- the safety of the schemes is protected; and
- there is a 'level playing field' among *all* players in the credit card market (including the closed schemes, AMEX and Diners Club, and store cards).

ANZ agrees with the RBA's proposed Access Regime on that basis.

The proposed Access Regime provides that:

- new players, which need not be financial institutions, be able to issue cards or acquire merchants' card transactions by setting up a 'specialist credit card service provider' (SCCSP) prudentially supervised by the Australian Prudential Regulation Authority (APRA); and that
- terms of participation be transparent and non–discriminatory. ANZ strongly supports the proposal that scheme rules be required to allow any member either to issue or acquire, or both, in any combination, without any penalties or loadings — including allowing self–acquiring — subject to the ability to meet all obligations as a scheme member. ANZ believes that where significant such penalties or loadings currently exist (eg the punitive 'Acceptance Development Fee' that one scheme applies to members focused mainly on acquiring), they are anti-competitive.

However ANZ notes that this reform will be more symbolic than dramatically improving competition since competition is already fierce in credit cards. Avenues for players other than authorised deposit–taking institutions (ADIs) to participate in issuing or acquiring are already liberal in Australia. The easiest avenue is to be a 'co–brand' partner of any of the 285 Australian ADIs that are eligible. Also the option to join Bankcard as a *full* member, by obtaining a guarantee to meeting scheme obligations from *any* institution supervised by APRA *or* by its recognised overseas counterparts, will be more practical for many entrants than setting up, as a separate entity, an APRA–supervised SCCSP under the RBA Access Regime.

ANZ does not see any public interest reason for mandating membership in the sense of governance (voting) rights etc, as distinct from being able to access the systems as a full user, and considers that the final form of the Access Regime should reflect this. Finally, ANZ is concerned that the other proposed regulations, particularly the Standard on interchange fees, will undermine the intent of the Access Regime ie work against any improvements in competition that it would otherwise bring about.

Allowing Merchants to Surcharge Credit Card Payers

ANZ believes that the no-surcharge rule has been an important contributor to the growth of the open card schemes, growth that has brought network benefits to both merchants and consumers. However, ANZ has no objection to requiring the open credit card schemes to allow merchants to surcharge their customers who pay by credit card, as long as this applies equally to *all* credit card schemes (including American Express and Diner Club). ANZ sees a need for *consumer protections* to:

- limit any surcharging to the merchant fee, and prevent gouging;
- ensure merchants issuing their own cards do not discriminate against others; and
- ensure merchants pass on savings from lower merchant fees to all of their customers.

ANZ has no objection to proposed *Standard No. 2* (S2), prohibiting credit card schemes from requiring merchants not to surcharge customers who pay with credit cards — so long as the standard applies to *all* credit card schemes, including the 'closed' schemes (notably AMEX and Diners). In fact, noting that at least one of the latter closed schemes has third–party issuers, ANZ argues that *all* credit card schemes should be subject to the *full* set of regulations ultimately determined in this process.

Dramatic effects are again unlikely from S2, experience overseas suggesting that, at least where there is enough competition, most merchants will not surcharge credit card payers if scheme rules against surcharging are dropped. In Australia the open credit card schemes already have only a weak form of 'non–discrimination' rule: merchants are allowed effectively to surcharge credit card payers by discounting for other forms of payment (eg cash, cheque or debit card). Also a few merchants explicitly surcharge, and this is rarely policed.

ANZ is however concerned that S2 lacks important consumer protections to limit surcharging to no more than the merchant fee, and to prevent gouging — especially in areas where merchants have market power (eg in rural and regional Australia). Regulation must also prevent discrimination by merchants between users of their own store linked cards and other cards. Also measures are needed to ensure that merchants pass on to all of their customers reductions in merchant fees.

No Justification for Price Control

In ANZ's view, once access to the open schemes is made as available as possible, consistent with prudential standards, and merchants are free to surcharge, then any competitive constraints that may have been perceived to exist will certainly have been removed, and as a result: *there is no logical case for any regulatory intervention in interchange fee setting.*

A range of authoritative experts agree with this — as the RBA has acknowledged. Their conclusion that interchange fees have no net effect on community welfare in fact *only* depends on merchants being free to pass on to cardholders their net costs (if any, after the benefits they receive) of accepting cards. While the levels of competition in credit card issuing and acquiring and retailing matter to consumers as issues in their own right, the conclusion about interchange fees still holds even if one or more of those markets (eg retailing) is not very competitive. That is, once merchants can surcharge, there are no logical grounds for regulatory control of the price of interchange services.

The RBA's Proposal for Price Controls on Interchange Fees

The RBA's proposal would set aside the key feature of the credit card as a way for merchants to accept payment (it offers much more than a debit card or cash), combining:

- a 'buy now, pay later' benefit for the customer, with
- a 'sell now, be paid now' benefit for the merchant.

Under the RBA's proposals, costs essential to delivering those defining features of the credit card would not be recoverable through interchange. The intervention is radical. It would reduce interchange fees by about three–quarters.

The RBA clearly does not intend that this be absorbed. It is *intended* that cardholders pay more and/or not be offered some credit card features like the interest free period, and to switch to using debit cards or cash.

ANZ supports making the setting of interchange fees more transparent and objective, based on the costs of providing to merchants the benefit of accepting credit card payments. The RBA essentially proposes in *Standard No. 1* (S1), to control interchange fees on a basis that totally excludes costs related to the key feature that makes credit cards different from other means of payment — both for the consumer and for the merchant. Credit cards were basically developed as 'outsourced store cards'. In fact they are an *improvement* on store credit, because the merchant can both offer that (so gaining sales) *and receive immediate guaranteed settlement*. Merchants do not have to wait for payment or pursue slow or reluctant payers. This allows:

- customers to 'buy now, pay later'; and
- merchants to 'sell now, be paid now'.

The RBA proposal denies any merchant share of those interlinked mutual benefits. It proposes to allow interchange fees to recover only a small part of the costs of the credit card — as if the merchant were being paid by debit card. S1 is a radical and potentially high risk and disruptive intervention which would:

- prevent the recovery of *any cost related to the key distinguishing feature* of credit cards, the combination of 'buy now, pay later' with 'sell now, be paid now';
- reduce, by about three–quarters, Australian interchange fees which (at around 0.95 per cent of a payment) are already among the lowest in the world;
- prevent the recovery from merchants, through interchange, of any of the *joint and common costs* of the credit card system itself, including allowing no recovery through interchange of any return on the capital invested in providing the basic system overall; and
- thereby remove from issuers' revenues amounting to $500m annually, roughly equivalent to the entire annual profit of Australian open credit card issuing businesses, on all of their activities (including extended credit).

It is clearly *intended* by the RBA that cardholders pay more and/or not be offered some present card features, and that they switch to using debit cards or cash — which ANZ notes are not substitute products.

Proposed Intervention Does Not Meet Basic Principles for Good Regulation

The RBA's proposed intervention does not satisfy basic rules of best–practice regulation. It is opinion-based rather than addressing a proven failure of market competition; it has not been shown to advance the public interest; and it is open–ended and includes no outcome criteria or review process.

Essentially the RBA's case for intervention is that cardholders are charged too little, and hence over–use credit cards (vis-à-vis debit cards etc); and that, via interchange, merchants are charged too much in relation to any benefit they receive. The RBA further asserts, without proof, that merchants generally derive *no* benefit *at all* by accepting credit cards, vis-à-vis accepting only debit cards, cash etc. Powerful commonsense evidence that they do benefit has been put to the RBA but not accepted.

As a matter of best–practice regulation, any proposed regulatory intervention should:

- address a demonstrated significant market failure;
- be the minimum necessary to address the failure and bring benefits exceeding its costs;
- set up, at the outset, criteria against which its outcome can be assessed; and
- be subject to a zero–based review after a defined period.

The proposed intervention as currently set out does not satisfy those basic principles. The RBA has also reversed the onus of proof, effectively requiring that market participants provide evidence that the market has *not* failed, while relying on its own 'opinion'.

The Core of the Reserve Bank's Argument

The RBA denies any overall merchant benefit (ie any increase in sales — and profits) from accepting credit cards: if one merchant benefits, it is at the expense of others; sales in total are not increased.

This is incorrect. Liberalised access to consumer credit *has* increased consumer spending in total; in fact, the RBA is risking some reversal of that economic boost. But this is the wrong test anyway — the value to the *individual* merchant should determine what they are asked to pay, as with any other commercial service.

The heart of the RBA's argument is that, while an individual merchant may gain sales by accepting credit cards, merchant sales in aggregate are not increased (or so it is asserted), and so there is said to be no aggregate merchant benefit.

This argument is incorrect on its own terms. The household savings ratio has fallen appreciably over the past two decades , especially over the 1990s ie consumers are spending more out of their in incomes. This has occurred just as more credit, including through credit cards, has become available to households, and there is evidence from studies that liberalisation of credit has been a causal factor. This association has previously been noted by the RBA itself.

But in any case this test treating merchants as an aggregate (ie as a monopolist or cartel) is *the wrong test*. It is the benefit to the *individual* merchant that matters here. No merchant is obliged to accept credit cards, and virtually every consumer also carries a debit card. Yet merchants *willingly* accept credit cards — especially merchants selling larger items, for which 'buy now, pay later' may be important to clinching a sale — especially when this feature comes linked to 'sell now, be paid now' (ie guaranteed immediate settlement). Like advertising (which some also argue does not increase total spending), payment options are a key part of the competitive dynamic among merchants. Should regulators prevent merchants from being charged for advertising?

The RBA's argument that other consumers cross–subsidise credit card payers does not hold up either. If merchants freely accept credit cards because the benefit to them exceeds the cost, the net result to their bottom line is a gain. There is no *net* extra cost to pass on to other customers.

Indeed merchants have offered various forms of credit for hundreds of years, in the form of on-account, lay-by and other forms of store credit — and more recently store credit cards. Given such extensive history, it is difficult to postulate any plausible interpretation other than that merchants obtain a positive net benefit from offering 'buy now, pay later' facilities to consumers while themselves enjoying 'sell now, be paid now', not having to pursue non-payers etc.

In 2001 the US District Court accepted evidence that department stores such as Target and Saks Fifth Avenue would lose significant sales if they were to stop accepting Visa and MasterCard, confirming the findings of earlier studies. [US v Visa USA and others 98 Civ 7076 p 20]

Arbitrary Restrictions on Cost Recovery

RBA price controls would require not charging merchants anything at all for something that:

- saves them the cost of providing 'old tech' lay–buy facilities etc;
- gives them immediate payment; and
- is critical to 'new tech' selling on–line, which reduces other costs.

Even on the RBA's 'debit card costs only' benchmark, there is no good principle on which to decree that only cardholders, and not merchants, should be charged for the whole basic (common) costs of a system that plainly delivers benefits to *both*.

Under Standard No. 1, the RBA would require interchange fees to recover only certain recurrent costs "related to the payment service received by merchants", a criterion which is very narrowly and arbitrarily defined — effectively taking the *debit card* as the benchmark.

This goes well beyond the previously issued *Joint Study*, which acknowledged the concept of the credit card as an *outsourced store card* — a product effectively allowing all merchants to offer short–term credit to customers while enjoying 'sell now, be paid now' themselves. In the past, only big merchants could offer such credit, without being paid right away. S1 would destroy the economics of the outsourced store card model, by preventing recovery of any of the costs of the 'buy now pay later' / 'sell now, be paid now' interlinked features — in particular, the cost of the interest free period. If still offered, the costs of the interest free period could only be charged to cardholders.

The denial of merchant benefit from credit cards looks quite implausible against the history of numerous cumbersome and costly alternatives that merchants have themselves resorted to: lay–buy, store accounts, 'pay nothing until February' offers and the like. Moreover, credit cards are now integral to e–commerce in a way that debit cards cannot be — and are thereby a key to big savings in merchants' own businesses (in distribution, collection etc).

Even against a 'debit card costs only' concept, the RBA's proposed range of recoverable 'eligible' costs is extremely narrow. In particular, *none* of the *joint and common costs* of running the systems would be able to be recovered through interchange, including a return on the capital invested in providing the system. (It is important to note that in the generally accepted economic concept of cost, a normal return on the capital used is recognised as part of cost, whether the capital is debt or equity.)

There is no principle of economics or public interest supporting such arbitrarily restricted cost recovery. On the contrary, in networks — like the open credit card systems — which have heavy *shared* costs, any allocation that charges each group of users at least the incremental cost of the service they receive, but no more than its stand alone cost, is consistent with economic efficiency. Within those bounds, who is charged what proportion should be a commercial matter, determined in market competition, *not* a matter for prescriptive regulation. ANZ strongly argues that it is critical that relevant costs include the cost of providing an interest free period. Competition should determine what interest periods are offered, not regulators.

Recent expert measurement of the costs of operating the open credit card networks in Australia has demonstrated that interchange fees plus cardholder fees are currently recovering *less* than the stand alone costs of the system (ie the full costs of their essential features only). Moreover, no more than normal returns are being earned in card issuing — indicating it is competitive.

Consequences for Consumers

Whomever the RBA proposals may benefit, clearly cardholders will be losers. The changes will hurt most the least well off cardholders — those who most need access to revolving credit, for whom the RBA's 'debit card' benchmark does not provide a suitable alternative.

Whether any other consumers may benefit is doubtful. The RBA claims that competition in retailing will mean that reduced merchant fees will be passed on. But major areas of retailing are dominated by a few players — and there are many situations of local market dominance, eg in rural and regional Australia.

It follows that if only a fraction of costs are allowed to be recovered from merchants, *cardholders must pay more* in fees, in particular for the interest free period — and/or see that feature curtailed.

This is a clearly intended consequence, which must affect less well–off people who most need to access revolving credit eg to replace a household appliance — 'revolvers', about 70 per cent of all cardholders. The reforms contain nothing to alter competition in *interest rates* — currently 65 issuers compete on those. For example, there are a number of 'plain vanilla' cards featuring low interest rates. In fact some issuers may exit the market.

'Transactors', who pay off their balance on statement, will be less affected. They will, for example, be able to migrate to the higher cost closed schemes (AMEX or Diners, whose profits flow overseas) or to new cards issued by big merchants who can cross–subsidise the interest free period within the price of the goods and services they provide. Does the RBA really intend this?

Given the very high concentration of the Australian retailing sector, it is doubtful that the key criterion for successful reform — savings demonstrably passed on to all consumers, and outweighing increased cardholder costs — will be met. The 'buy now, pay later' feature that allows smaller merchants to compete with big merchants (who can offer store cards) is probably most important in Department Store retailing, where the market leader controls half the market, and the top three nearly 80 per cent. A similar figure to the latter applies in supermarkets and groceries. Locally, especially in rural and regional Australia, there are many situations of outright dominance in retailing.

Market Consequences

The proposal to force a large (and sudden) cut in interchange fees will clearly undermine the intent of the proposed Access Regime, and lead to a *less competitive* credit card market.

- It is virtually certain that S1 would force the exit of a number of smaller issuers, while the closed schemes and, especially, store cards would receive a huge 'free kick' — being exempted from the proposed reforms in all or key respects. Stores issuing cards within the open schemes could, for example, surcharge all but their own cards.
- Investment in the consumer payment systems generally in Australia will be deterred by the regulatory risk these proposals pose.

The RBA argues that the reform as a whole will increase competition in the credit card market. ANZ believes, however, that S1 will undermine positive effects from the other elements of the package, especially the Access Regime, and *the net result will be to both diminish and distort competition*.

- ANZ believes that S1 will make it uneconomic for a number of present issuers to remain in the market, and that this will outweigh any entry by new players. ANZ has reason to expect that some smaller institutions will exit or outsource their credit card business.
- Major competitive advantages will be handed to large merchants able to establish their own SCCSPs and issue cards whose key features are tied to in–store use — at the expense of both other issuers and other merchants. They will be given a major 'free kick', especially if allowed to surcharge (ie discriminate against) others' cards.

Some major global (mainly US–headquartered) players are already in the Australian market, in issuing, acquiring or parts of those businesses. The signals sent by these reforms — that consumer payment systems in Australia may progressively come under regimes limiting returns to cost recovery, and with arbitrary rules imposed on whom costs can be recovered from, seem far more likely to deter than attract new overseas entrants. The contrast with the European Union's recently announced moderate and phased reforms is striking. The European changes allow five years for interchange fees to come down to levels at most a little lower than where Australia's are today. The RBA proposes a significantly bigger change in a matter of months.

Low Cost Player

The open schemes currently represent the 'low cost' player in the credit card industry, ensuring price competition among the many existing issuers and card products (well over 200) and economies of scale that these large schemes provide.

The RBA's proposed interchange fee reforms will see this position comprehensively removed and advantages put in the hands of fewer 'high cost' closed and store card schemes, which are not affected directly by the proposed reforms. They will enjoy a greatly improved *relative* position in terms of attracting both cardholders (especially well off 'transactors') and, in the case of the closed schemes, third party issuers. This will lead to a substantial net reduction in competition and negatively affect consumers and smaller merchants, particularly less well off consumers and merchants with little or no market power.

ANZ submits that this is not in the public interest.

Conclusion

ANZ supports reform of the credit card market. ANZ supports reforms that liberalise entry, increase transparency, and promote competition, while ensuring safety and a 'level playing field'.

However, ANZ strongly urges the RBA to consider the risks of implementing the radical experiment in interchange fee regulation set out in the Consultation Document, and to *limit* a revised proposal to requiring

- transparency and objectivity in setting interchange fees, and
- recovery in total of no more than the reasonable costs of providing a basic credit card product, recognised as an 'outsourced store card' in nature. At a minimum, additional cost elements that should be reflected in interchange fee calculations are: the cost of interest–free period, charge back processing, GST, appropriate third party services, the cost of capital and regulatory compliance costs.

Competition in the market should determine how those costs are allocated between merchants and cardholders.

Alternatively, as has been done in Europe, there could be a phased moderate reduction of interchange to a specified level, allowing the consequences to be assessed stage by stage.

ANZ understands that after receiving written inputs in response to the Consultation Document, the RBA will consult with interested parties ahead of making final decisions on what regulations will apply. ANZ wishes to be part of that process, to work constructively towards an outcome that is in the public interest and minimises disruptive consequences.

ANZ

ANZ Response

1. Introduction

In April 2001, the Reserve Bank of Australia (RBA) designated the three 'open' credit card schemes operating in Australia (Bankcard, MasterCard and Visa), pursuant to the *Payment Systems (Regulation) Act 1998*.

After a period of receiving input, the RBA published a *Consultation Document* (CD) in December 2001 setting out proposals for regulating these three schemes, comprising:

- an 'Access Regime' designed to facilitate entry to the three schemes by new players, especially ones which are not authorised deposit–taking institutions (ADIs);
- a 'Standard' governing scheme rules about how merchants may charge customers paying by credit card; and
- a 'Standard' governing the setting of 'interchange fees' paid by the merchant's credit card service provider ('acquirer') to the issuer of the customer's credit card.

This submission is a response by ANZ Banking Group Limited (ANZ) to those proposals.

> ANZ understands that after receiving written inputs in response to the CD, the RBA will consult with interested parties ahead of making final decisions on what regulations will apply. ANZ wishes to be part of that process, to work constructively towards an outcome that is in the public interest and minimises disruptive consequences.

2. Access to the Open Credit Card Systems

2.1 Principles

ANZ agrees (with qualification) with the proposed *Access Regime* (AR)[1] for the designated credit card schemes (Bankcard, MasterCard and Visa), and in particular with the underlying principles espoused in Section 4.7 of the RBA *Consultation Document*. There the RBA says that reform is intended to promote competition and efficiency without compromising safety, by ensuring that rules about who may be a member of these schemes:

> " • do not inhibit competition more than is necessary to protect the financial soundness of the schemes;
>
> • are clearly targeted at the risks incurred by credit card issuers and acquirers; and
>
> • do not discriminate between members whose business is focused on issuing or acquiring. "[2]

However ANZ disagrees with the RBA's assessment of current conditions of access by prospective players to the credit card market (see section 2.2). ANZ also notes that the RBA's proposed solution for liberalising access, ie to require an entrant to set up a kind of specialised quasi–bank to be supervised by APRA, is really only a practical option for bigger players — notably major merchants. The existing policy of the one open credit card scheme which is governed by Australian banks only, ie Bankcard, is in ANZ's view already more liberal than the proposed Access Regime (a point which is taken up further below).

ANZ sees no public interest case for requiring schemes to confer governance (voting) rights etc on new entrants — as distinct from allowing them to access the systems as full users. Access regulation in other sectors is confined to the latter, minimising infringement on property rights.

[1] CD, p 110.

[2] CD, p 108.

2.2 The RBA's Assessment of Current Access Conditions

The RBA asserts[3] that existing "restrictions on the basis of institutional status — that members be deposit–taking institutions [supervised by APRA] — are excessive". This is a questionable conclusion:

- First, there are around 285 authorised deposit–taking institutions (ADIs) in Australia. While it may only be practical for an organisation of some size, it is relatively straightforward to establish an ADI to undertake particular aspects of banking business; and, for example, it does not necessarily have to take deposits from the general public, but can be specialised.
- Second, all three designated open credit card schemes make some provision for players that are not ADIs in Australia to become members. These may be institutions supervised by eg the US or other recognised overseas prudential authorities (as is GE Capital) or in some cases may be non–banks admitted with guarantees or collateral ensuring their ability to meet obligations.
- Third, Bankcard explicitly allows non–ADIs to join as *full* members on the basis of a guarantee of ability to meet scheme liabilities, which can be obtained from any ADI or equivalent institution (typically a bank) supervised by APRA or by an APRA–recognised overseas prudential supervisor. This is a very straightforward and practical entry option even for smaller prospective players. Particularly for intending specialist acquirers, including self–acquirers, it should also be low cost — notably where goods are sold for immediate delivery (so that outstanding obligations should never be large).

There are in fact 65 competing issuers of credit cards in Australia, and many more 'co–brand' partners effectively participating. An example of such participation is ANZ's collaboration with two partners in the successful Qantas Telstra Visa (QTV) card, but such arrangements often involve much smaller organisations as partners.

On the acquiring side, there are 9 full service acquirers in Australia and a range of other participants competing in various segments of that side of the business — including merchants themselves and big international specialist players (like First Data).

- The RBA's assertions (CD, p 99) that co–brand partners are at a disadvantage, and that members "can extract an 'economic rent' from co–branders" are simply unfounded. The co–brand partner often has *better* access to customers and information about them than the formal issuer, and there is no evidence of 'rents' being extracted by the issuer members in these arrangements.
- The same is true on the acquiring side: there are far too many ADIs available for a prospective entrant to partner with for any 'rent' to be extracted, and the prospective participants are often major organisations in their own right, well able to secure favourable terms. As noted above, Bankcard allows *self–acquiring*, including by non–ADI members, and the other schemes also deal with it flexibly while ensuring scheme integrity. Barriers to either full or effective participation are, in short, already low.

The RBA also suggests (CD, p 99) that participants seeking to use the established credit card systems are disadvantaged by having "no input into scheme governance" and hence should not merely be able to *use* the systems freely on reasonable terms, but to have access as *full members*, including having governance (voting) rights. This goes far beyond what is contemplated under regulated access regimes in other sectors. To *mandate* it — notwithstanding that schemes like Bankcard may do it *voluntarily* — appears to be an excessive infringement on property rights, particularly where brand values and infrastructure have been built up over time through significant investment.

[3] CD, p 108.

2.3 The Proposed Access Regime

The RBA's proposed Access Regime will probably only suit the biggest players, such as major merchants, since it seems to involve essentially the same hurdles as establishing an ADI. In fact it will work in practice by legislative amendment defining the relevant credit card service provision activities as 'banking business' in terms of the *Banking Act 1959*:

- Entrants will have to set up separate *specialist credit card service provider* (SCCSP) businesses prudentially supervised by APRA.
- Terms of participation are to be transparent and non–discriminatory — something that ANZ and other banks have long supported and which is already reflected in Bankcard's policies.
- ANZ strongly supports the RBA's proposals that scheme rules must allow any member to issue or acquire, or both, in any mix, without penalties or loadings. This is already so in Visa, and only a very small and not unreasonable loading applies to predominant acquirers in Bankcard. MasterCard, however, maintains in Australia an 'Acceptance Development Fee' applied at punitive levels to members whose focus in that scheme is mainly acquiring. (This fee applies at certain threshold levels of acquiring volume relative to total volume, on a 'sudden death' basis; the fee then imposed is so high as to remove more than the acquirer's total profit margin on the whole of their acquiring business.) ANZ believes that where significant penalties or loadings of this type exist they are anti-competitive.

2.4 What Will Be Achieved?

At the end of the day, the proposed Access Regime will be largely symbolic rather than dramatically improving competition in the credit card market, which is already fierce on both sides — issuing and acquiring. On the issuing side, there are well over 200 competing card products, 65 active players and another 220 ADIs eligible to join the schemes. On the acquiring side, competition among full service players has steadily driven down merchant fees over the past decade; and specialist providers of terminals, communications, processing etc further lift the level of competition.

Notwithstanding the lack of any evidence presented in the CD that present access arrangements have any material anti–competitive effect, ANZ nevertheless agrees with the proposed Access Regime. This is, not least, because it would remove any logical grounds for any further assertion that access to the credit card market, and in particular to the three particular schemes which the RBA has selected to designate, is not as liberal as it can be consistent with safety.

ANZ's agreement to the proposed Access Regime is provided so long as:

- the safety of the schemes is protected; and
- there is a 'level playing field' among *all* players in the credit card market (including the closed schemes, AMEX and Diners Club, and store linked cards).

By a 'level playing field' ANZ means that:

- all schemes or other issuers of credit cards should disclose their 'eligible costs' as these come to be defined in the final form of Standard No. 1, so that these are transparent to both merchants (in relation to merchant fees) and cardholders (in relation to cardholder fees);
- all players should be subject to the same regulations in respect of merchant pricing (ie surcharging); and
- issuers of cards that are also merchants should not be permitted to discriminate between their own cards and others in their surcharging policies.

3. Allowing Merchants to Surcharge Credit Card Payers

3.1 Even Handed Regulation?

ANZ believes that the no-surcharge rule has been an important contributor to the growth of the open card schemes, growth that has brought network benefits to both merchants and consumers. That is, cardholders have had more and more outlets made available to them that accept credit cards for payment. Merchants have been able to choose to accept credit cards in the knowledge that a large and growing customer base will be equipped with them — and be readier to 'buy now' as a result. Had cardholders faced surcharges, this growth would have been stunted.

However, ANZ has no objection to the RBA's proposed *Standard No. 2* (S2),[4] prohibiting credit card schemes from requiring merchants not to surcharge customers who pay with credit cards — so long as it includes *consumer protections* and this regulation applies to *all* credit card schemes, including the 'closed' schemes, principally American Express (AMEX) and Diners Club (Diners).

Particularly since at least AMEX has third–party issuers in Australia, ANZ cannot see the logic of excluding the 'closed' schemes from the coverage of both the proposed Access Regime (discussed above) and the proposed Standard No. 1 (discussed below) as well as Standard No. 2 — on obvious grounds of competitive neutrality.

In ANZ's view, any benefit from, and general acceptance of, the proposed Standard No. 2 will also depend on protections being included to prevent gouging of consumers by retailers and other merchants in situations of market power, whether in national consumer segments or in particular geographical areas, notably rural and regional Australia.

Equally measures will be required to ensure that merchants pass on to all their customers the reductions in merchant fees that S2 will bring about. Furthermore, protections will be required to prevent merchants who issue their own cards from unfairly discriminating against other credit cards.

3.2 The RBA's Assessment

'No surcharge' rules — requiring merchants who choose to accept credit cards not to discriminate against customers who use them — have a reasonable rationale, already put by various parties to the RBA and rejected. Again, however, regulatory intervention in this area (as in respect of access) must be seen as largely symbolic:

- The European Commission comprehensively studied the effect of these non–discrimination rules and concluded that they are not anti–competitive.
- In those few countries where such rules are prohibited, few merchants surcharge anyway — since, contrary to the RBA's assertions, many merchants behave as if they do derive significant benefit from attracting customers who have the extra ability to pay that the credit card provides (with its key 'buy now, pay later' feature, combined with 'sell now, be paid now').
- The three open schemes in Australia already have only a weak form of non–discrimination rule, in any case. In some countries, the rule requires that merchants charge credit card payers *the same* as those paying by other means. In Australia, merchants are effectively allowed to surcharge credit card payers by discounting for payment by other means (eg cash, cheque or debit card). A few merchants (eg in the service sector) actually explicitly surcharge credit card payers, and this is rarely policed by the schemes. Generally — as in other countries — merchants in Australia freely *choose* not to surcharge, either directly or indirectly.

ANZ sees the possibility that in particular areas where they have market power — eg in rural and regional centres — some merchants may take advantage of S2 as an officially sanctioned pretext for gouging customers, notwithstanding that merchants will enjoy much lower merchant service fees (MSFs) if the proposed Standard No. 1 (canvassed below) is implemented.

[4] CD, p 80.

ANZ believes that Standard No. 2 should be re–formulated, at least to limit surcharging to the level of the MSF, whereas it is open–ended as presently proposed. ANZ also believes that price surveillance may be required to expose exploitation by merchants and to protect consumers from gouging. Importantly, price surveillance will also be required to ensure that merchants pass on to all their customers the windfall reductions of some $500 million in merchant fees flowing from the RBA's proposed intervention.

ANZ supports this standard, despite the fact that there is little evidence of the need for it — and a clear case for adding effective consumer protections to it — not least because once it is in place, along with the proposed Access Regime, there will no longer be any logical case for regulating interchange fees in credit card systems. A range of authoritative experts agree with this, including several quoted in the CD (but not agreed with by the RBA).[5]

4. The RBA's Case for Intervention in Interchange Pricing

4.1 All Agree on Transparency and Objectivity

ANZ accepts that the setting of interchange fees in open credit card systems should be more transparent and objective — based on the costs of providing to merchants the benefits of giving their customers the option to pay by credit card. Australian banks, including ANZ, in early 2001 formally offered the Australian Competition and Consumer Commission (ACCC) arrangements which would achieve this. Subsequently the banks submitted to the RBA a further developed proposal which fully met all relevant criteria, and was fully consistent with widely accepted economic and public policy principles.

4.2 Radical Intervention

The proposed *Standard No. 1* (S1),[6] however, is a quite radical intervention likely to have disruptive consequences — an experiment which goes far beyond anything warranted either by competitive conditions in the credit card market or by any obvious economic or public policy principles or logic.

It would:

- prevent the recovery of *any part of the cost of providing the key distinguishing feature* of credit cards, the combination of 'buy now, pay later' for the cardholder with 'sell now, be paid now' for the merchant. That is, the cost of the interest free period (from purchase date to the date allowed for paying on statement) would be entirely excluded;
- slash, by about three–quarters, Australian interchange fees which (at around 0.95 per cent of a payment) are already among the lowest in the world;
- prevent the recovery from merchants, through the interchange fee, of any of the *joint and common costs* of the credit card system — for example, excluding any return on the capital invested in providing the system; and
- thereby remove from issuers' revenues amounting to $500 million annually.

[5] See CD, p 31.

[6] CD, p 57.

4.3 What is the RBA's Case?

Essentially the RBA's case for intervention is that cardholders are charged too little, and hence over–use credit cards (vis-à-vis debit cards etc); and that, via interchange, merchants are charged too much in relation to any benefit they receive. The RBA not only asserts that others have failed to demonstrate (to its satisfaction) quantifiable benefits to merchants. It goes so far as to assert definite and precise 'knowledge' of its own: ie that merchants (as a group) derive *no* benefit *at all* by accepting credit cards, vis-à-vis accepting only debit cards, cash etc.

This position is, avowedly, based on the RBA's "opinion" rather than on any proof — let alone proof meeting the standard that would normally be expected to be required to demonstrate a need for such radical intervention. (The Consultation Document explicitly states in more than 20 places that what is being asserted is based on the RBA's "opinion".)

In the previously released Joint Study, the RBA acknowledged the essential nature of the innovation in payments that the credit card delivers. It combines the consumer benefit of being able to *buy now and arrange payment later* with the merchant benefit of being able to *sell now and receive guaranteed payment now* for items that they would not otherwise sell until later — if at all. For the smaller merchant it is not merely an 'outsourced store card', but better than that.

4.4 What Criteria should be met before Regulators Intervene?

As a matter of best–practice regulation, any proposed regulatory intervention should:

- demonstrate on the basis of objective evidence (and not assertion or opinion) a significant failure of market competition;
- be the minimum necessary to address the failure;
- bring about benefits exceeding its costs;
- set up, at the outset, clear criteria against which its outcome (ie its actual results, both benefits and costs) can later be assessed; and
- be subject to a zero–based review after a defined period — ie a review which includes an independent assessment of whether the intervention has succeeded in achieving its intended outcome or not, and whether it continues to be warranted at all.

As currently set out, the proposed intervention (S1) does not meet those principles and thus is not in the public interest, as the PSRA requires.

The RBA has also reversed the onus of proof, effectively requiring that participants in the credit card market (specifically, in the three schemes that it has chosen to designate) prove that the market has *not* failed. A key element in the RBA case is the unfortunate, but inevitable fact that little hard *quantitative* evidence of merchant benefit from accepting credit cards has come forward. This is understandable, of course — since it requires posing a hypothetical 'counterfactual' situation in which there are no credit cards (only cash, cheques, debit cards etc). Powerful commonsense evidence has nevertheless been put to the RBA to the effect that merchants do benefit significantly, but has been ignored.

5. The Core of the RBA's Argument

5.1 Do Credit Cards Increase Consumer Spending and Merchant Sales?

If merchants benefit, it must essentially be by making sales that they would not otherwise make and/or would not make until later. The heart of the RBA's argument is that, while an individual merchant may gain sales by accepting credit cards, there is a 'fallacy of composition', ie merchant sales *in aggregate* are not increased, and hence there is said to be no aggregate merchant benefit.

This argument is incorrect on its own terms. The household saving ratio has fallen appreciably over the past two decades , especially over the 1990s i.e. consumers are spending more out of their in incomes. This has occurred just as more credit, including through credit cards, has become available to households, and there is evidence that the liberalisation of credit has been a causal factor. The association has been noted previously by the RBA itself.[7]

There is in fact extensive literature around the world on the link between financial deregulation — in particular easier access to credit by households — and a lower household saving ratio ie higher consumer spending relative to income, from about the 1980s onwards.[8] As observed at the 2000 RBA Conference on *The Australian Economy in the 1990s*, "prior to financial deregulation, households needed to establish a saving history in order to get a loan …".[9] The paper on saving behaviour contributed to that conference by RBA staff discussed the link between the falling saving ratio and increased access to credit by households.[10] This link was discussed extensively in a prior article, entitled "Consumer Credit and Household Finances", published in the RBA's *Bulletin*, June 1999 issue.[11] The article presented data showing that:

- Household use of credit in Australia has risen rapidly over the 1990s. Access to revolving credit has risen most rapidly, predominantly credit card lending.
- Household use of credit is nevertheless not excessive in Australia. It is "currently still in the middle of the international field".

The RBA gives a number of reasons in the article for the increased use of credit cards by both 'transactors' (who tend to pay-out their statement balance) and 'revolvers' (who access extended credit). These include features of value to both, including the fact that while credit card interest rates are higher than interest rates on secured loans, "the margin [on credit card loans] in Australia is at the low end of the [international] range"[12] for this type of unsecured lending.

Overall, as the RBA points out, households' debt servicing burden declined over the 1990s (as a percentage of income) — again, hardly consistent with assertions in the CD that Australians are over–using credit cards, or credit in general.

In other words, the RBA itself has helped demonstrate elsewhere what is in fact a win–win for consumers and merchants: aggregate consumer spending out of incomes is permanently higher due to increased access to credit, in which use of credit cards has been an important factor, particularly over the 1990s when it increased far more rapidly than use of other forms of credit.

5.2 What Matters is the Benefit to the Individual Merchant

But in any case this test, treating merchants as an aggregate (ie as a single monopolist or cartel) is *the wrong test* for merchant benefit. It is the benefit to the *individual* merchant that matters here. No merchant is obliged to accept credit cards, and virtually every consumer also carries a debit card. Yet *merchants willingly accept credit cards* — particularly merchants selling larger items, for which 'buy now, pay later' may be very important to clinching a sale, especially when that customer feature is integrally combined with immediate guaranteed payment to the merchant (ie to sell the items to a consumer requiring credit, the merchant does not have to accept deferred settlement, but enjoys 'sell now, be paid now').

Like advertising, payment options for customers are a key part of the competitive dynamic among merchants. Few, if any, people would argue that advertising costs should not be charged to

[7] Marianne Gizycki and Philip Lowe, "The Australian Financial System in the 1990s", in Reserve Bank of Australia Conference Volume, *The Australian Economy in the 1990s*, D. Gruen and S. Shrestha, eds, July 2000.

[8] One of the few overseas studies to quantify the effect found that in the UK, financial deregulation (similar in the consumer areas to Australia's) lowered the saving ratio by around 2.25 per cent. See T. Bayoumi, "Financial Deregulation and Household Saving", Bank of England Working Paper No. 5, 1992.

[9] *Ibid.* p 314.

[10] M. Edey and L. Gower, "National Saving: Trends and Policy", RBA *op. cit.* p 277, at p 282.

[11] P 11.

[12] *Ibid.* p 15.

merchants, even if were true that sales were not increased in aggregate by advertising. This is because advertising provides benefits to individual merchants. The same is true of the cost of credit card payments.

As Gerry Harvey of Harvey Norman put it in a Nine Network interview in June 2001, "If we don't provide credit, our sales will drop."

This obvious, commonsense observation has been demonstrated in studies and accepted by authorities elsewhere. In 2001, for example, the US District Court accepted evidence that department stores such as Target and Saks Fifth Avenue would lose significant sales if they were to stop accepting Visa and MasterCard, confirming findings of earlier US studies.
[United States v Visa USA and others 98 Civ 7076 p 20]

5.3 This Merchant Benefit is Clearly Positive

The fact that merchants *voluntarily* accept credit cards for payment even though they incur higher merchant fees than if they accepted debit cards only (which, as just noted, virtually every customer also carries) is persuasive evidence against the RBA's argument.

- If merchants see no value in the combination of 'buy now, pay later' with 'sell now, be paid now' that credit cards uniquely offer, why do they willingly choose to accept them? No–one forces them to do so.
- The RBA previously, in the *Joint Study* published in 2000 in conjunction with the ACCC, canvassed the concept of the credit card as an 'outsourced store card' — ie a vehicle for all merchants, not just dominant major merchants, to offer customers efficiently a 'buy now, pay later' option, with the merchant being paid efficiently. As there conceded, that concept would appear to justify counting at least a substantial part of the cost of the interest free period as benefiting the merchant. In the past, a merchant had to offer a store account, time payment or lay–by etc — and bear the whole of the interest cost. To achieve immediate settlement, the merchant would have had to factor the debts — an option often impractical for even large merchants. The RBA has now recanted the *Joint Study* analysis of these merchant alternatives.

Presumably the RBA does not intend, by denying any inclusion of the benefit of the combined consumer 'buy now, pay later' and merchant 'sell now, be paid now' feature in the proposed 'eligible' interchange costs, that the open schemes move to a deferred settlement regime under which the merchant is no longer paid on the same day as the sale occurs.

- The RBA analysis is anachronistic in other respects. Not only does the credit card save the merchant the cost of 'old tech' lay–by etc, but it is a key enabler of new means of commerce notably online selling — which could not work without it and which can potentially deliver the merchant substantial savings in eg staff, premises, collection costs etc. It is not only online selling that only credit cards can effectively facilitate. There is no real substitute for the credit card in guaranteeing a hotel room, for example.

Moreover, if the RBA's analysis is correct and merchants do not benefit and should not bear costs beyond what would be incurred in a debit card transaction, then it applies also to closed scheme cards. There is no justification for leaving them out of the scope of the proposed intervention should it proceed. All cards, including closed and store cards, should compete on a level playing field.

5.4 Do Other Consumers Subsidise Credit Card Payers?

The RBA's argument that other consumers cross–subsidise credit card payers does not hold up. If merchants freely accept credit cards they presumably do so because the benefit to them exceeds the cost, ie they gain extra sales and margins on these extra sales that at least equal the extra cost of the merchant fees (over and above the costs of other forms of payment). Otherwise they would not do it. Therefore the bottom line effect of doing so is neutral or a net *gain*, certainly not a net cost. Therefore it is not obvious that *any* net cost is passed on to, or is borne by, other consumers — ie those paying by means other than credit cards. The RBA certainly has not demonstrated that any net cost exists or that any net amount is so passed on.

5.5 A Case for Radical Intervention?

The above discussion leads to the same conclusion as stated earlier: that once merchants can freely surcharge (under S2), and there is liberal entry to the credit card business (under the AR), there logically is *no case* for *any* intervention in open credit card interchange fee setting, let alone one so radical — and especially with all other payments distortions left in place.

Pricing of open credit card scheme interchange services to acquirers and merchants in Australia is already at the low end of the range internationally, and would fall further under the proposals that have put forward voluntarily by the industry itself — which would see outcomes comparable to those to be achieved by the regulated moderate phase–down, of interchange fees on debit and credit cards combined, recently determined by the European Commission, to 0.7 per cent over five years. That implies a higher final figure than 0.7 per cent for credit card interchange, because debit card interchange is significantly lower. In fact, European interchange fee levels on credit cards may end up not very far from present Australian levels. The RBA's proposal to reduce the already low Australian credit card interchange fee by about three quarters — probably to under 0.3 per cent — within a matter of months is extraordinarily extreme by comparison, particularly when it is considered that this is a much smaller market. Disruptive consequences may be more dramatic than in a larger market.

6. Arbitrary Restrictions on Recoverable Costs

6.1 What Benchmark? Debit Card or Outsourced Store Card?

Under Standard No. 1, the RBA would require interchange fees to recover only costs "related to the payment service received by merchants", a criterion which is extremely narrowly defined — as noted, effectively taking the *debit card* as the benchmark, and allowing only a narrow subset of costs even on that benchmark.

- As also noted above, this goes well beyond the previously issued Joint Study, which canvassed the concept of the credit card as an *outsourced store card* — a product effectively allowing all merchants to offer the 'buy now, pay later' option that in the past only big merchants could offer. S1 would destroy the economics of that, by preventing recovery of any of the costs of the central 'buy now pay later' feature of credit cards — ie of any of the cost of the interest free period. If still offered, the cost of this feature could only be charged to cardholders, even though it is clear that merchants enjoy a major part of the benefit — via bigger, earlier sales coupled with immediate payment.

ANZ strongly argues that any regulated regime for interchange fees should permit recovery of the costs of an interest free period, to the extent not recovered in cardholder fees — but with the proportions recovered on either side left to competition to determine.

6.2 What System Costs should be Recoverable?

Even against the debit card benchmark, the proposed range of recoverable 'eligible' costs is extremely narrow. In particular *none* of the *joint and common costs* of running the system itself would be able to be recovered through interchange — neither any of the costs of staff, premises etc nor any return on the capital invested in building the system. These would be recoverable only from the cardholder — or be absorbed.

- There is no principle of economics or public interest supporting such an arbitrarily restricted allocation as between the merchant and the cardholder, and the RBA does not provide one. On the contrary, in networks — like the open credit card systems — which have heavy *shared* costs, any allocation that charges each group of users at least the *incremental* cost of the service they receive, but no more than its *stand alone* cost, is unambiguously consistent with

economic efficiency.[13] Within those bounds, who is charged what proportion should be a commercial matter, determined by competition, not a matter for prescriptive regulation.

- The industry has already expressed its willingness to be regulated to the extent that the *total* recovered by issuers from both interchange and cardholder fees combined does not exceed the efficient stand alone costs of the system, and to contemplate a significant phased reduction. There is no public policy case for intervention in *how* recovery of those costs is allocated, especially with merchants explicitly free (under S2) to pass on any or all of their merchant fees to their customers.[14] In that event, if a scheme set its interchange fee too high, merchants would likely pass some of it on. Consumers would spend less on that scheme's card and the scheme would be obliged by competition to lower the fee.
- At a minimum, additional cost elements that should be reflected in interchange fee calculations are:
  - the cost of the interest–free period;
  - the cost of charge back processing;
  - GST;
  - the cost of appropriate third party services;
  - the cost of capital; and
  - regulatory and compliance costs.

It is important to note here that what is meant by 'costs' here is costs in the *economic* sense, including a normal return on the capital employed, recognised as a true resource cost. This differs from the narrower accounting usage of the term 'cost'.

Recent expert measurement of the costs of operating the open credit card networks in Australia[15] has in fact demonstrated that interchange fees plus cardholder fees are currently recovering *less* than the stand alone costs of the system.

> ANZ notes that in other network industries subject to price regulation, regulatory practice gives great weight to maintaining incentives for further investment and innovation. In particular, the relevant regulators typically allow investors in systems to earn a return on their past investments. ANZ believes that denial of an opportunity to recover returns through interchange fees in the open credit card systems will send a very negative signal (and perceptions of regulatory risk) to prospective investors in the Australian payments system generally. It may well also see the exit of existing players from the consumer payments market — undermining the intent of the Access Regime.

The Australian credit card industry has been at the forefront of innovation eg in introducing chip cards to enhance functionality, improve security etc. The RBA's radical intervention is likely to severely inhibit such developments, to the disadvantage of the whole community.

7. Consequences for Consumers

7.1 Cardholders to Pay More

Over time, any service that is commercially provided must pay its way. Given that less than total stand-alone costs are being recovered now in the open credit card schemes, it follows that if less than bare *incremental* costs are allowed to be recovered from merchants, *cardholders must pay more* in annual or other fees, in particular for the interest free period — and/or see that feature

[13] Submissions in 2001 to the RBA's post–designation Inquiry by both ANZ and the Australian Bankers' Association (ABA) provided authoritative support for this position.

[14] Or indeed to charge them even more, given the lack of consumer protections in S2.

[15] Conducted under appropriate legal protocols for the banks participating in the ABA's submissions to the ACCC and the RBA in 2001.

curtailed. (The obverse possible consequence is that merchants, in addition to having customers less able to buy bigger ticket items, may see some deferral of settlement to them.)

It is clear that cardholders paying higher fees (and so, the RBA hopes, using cash or debit more) is an *intended* outcome of the proposed intervention.

7.2 How will Consumers be Affected?

The intervention must most affect less well–off people who most need to access revolving credit eg to replace a household appliance unexpectedly. They will end up paying more in fees.

- Approximately 70 per cent of credit card holders are 'revolvers', ie use the extended credit feature, and many of these have no good alternative to this form of credit.
- The reforms contain nothing to increase competition in the credit card interest rates that credit card users pay — currently 65 issuers compete on those. Eg there are a number of 'plain vanilla' open scheme cards now in the market featuring low interest rates which are tailored to revolvers. As the RBA's own research (cited above) shows, margins in Australia on this type of unsecured consumer lending are already low by international standards.
- In fact, if interchange fees are radically reduced under S1, it is very likely that some smaller issuers (and lenders) will exit the industry (see below) — narrowing the range of interest rate (and feature) offerings available.
- Better–off 'transactors', who tend to pay off their balance on statement, will be less affected. They will be able to migrate to the closed schemes (AMEX or Diners), or to new cards issued by big merchants who can cross–subsidise the 'buy now, pay later' interest free period within the price of the goods and services they provide and/or link particular card rewards and features to use in their stores.

Again, the RBA's public interest calculus is difficult to understand. The *best case* outcome is that consumers paying by cash or debit, closed scheme card or store card are either a little better off or not much worse off, while people who most need short term credit and have few alternatives, are somewhat disadvantaged. The alternative possible outcome is that those in the latter category are significantly disadvantaged. That is, the 'reform' would appear to be regressive in its social impact even in the best case.

7.3 Will Merchant Gains be Passed on to Consumers?

A key part of the RBA chain of reasoning is the following sequence:

(i) merchants as a group receive no benefit at all from accepting credit cards;

(ii) they may seem to do so voluntarily, but if they could only act in concert, they would not accept credit cards — an individual merchant accepts them only do because others do;

(iii) therefore the extra fees they pay (compared to what it would cost if they accepted only debit cards, cash etc) are costs to them, with no offsetting benefit;

(iv) they pass these costs on to non–credit card paying customers;

(v) if the 'excess' part of credit card costs (the part over and above what a 'debit card' type transaction would cost) were not allowed to be recovered via interchange, virtually all of the savings to merchants (some $500 million) would be passed on to those customers;

(vi) although credit card paying customers will pay more, everyone will be better off because those customers are being artificially encouraged to over–use credit cards.

Every link in this chain is weak. For example the last one ignores the fact that about 70 per cent of the users of credit cards need the revolving credit feature, and these are typically less–well–off people. However a critical link in the argument that the intervention will bring net public benefit is (v): the assumption that the windfall gain to merchants will be passed on. However given the high concentration of the Australian retailing sector, it seems very doubtful that this crucial criterion for successful reform will be met — that savings will be passed on to all consumers, and will in total at least outweigh the (intended) increases in cardholder costs.

As the Parliamentary Joint Select Committee on the Retailing Sector concluded in respect of the supermarket and grocery sector:

> "... 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 market power. This has placed significant pressures on small and independent retailers, leading to calls for legislative remedies ..."

> "The market share of the three major chains amounts to around 80 per cent of the dry/packaged goods market." [16]

That 80 per cent share relates to 1997–98 and would be higher now. It considerably exceeds the share of the largest three players in credit card issuing — where there has been no general clamour for legislative remedies to curtail dominant players such as that which has arisen in retailing.

Yet the RBA in the CD has chosen[17] to dismiss all evidence put to it of concentration in retailing, eg by pointing out that grocery items (only part of the supermarkets and groceries market examined by the Joint Committee) is only 34 per cent of retailing 'broadly defined'. This evades the issue, since credit cards are virtually irrelevant in some areas of retail sales, at both ends of the value spectrum (eg milk bars and motor vehicles). Concentration is highest in some of the most relevant sectors, notably *Department Stores* — arguably, the arena of consumer spending in which the 'buy now, pay later' option is *most* important to competition between smaller merchants and big ones.[18] In that arena, based on a recent IBISWorld report[19] analysing market concentration, the top three players hold 78 per cent of the market — again, a higher top three concentration ratio than in credit card issuing (or acquiring).

ANZ argues that the RBA's confidence in the level of competition in retailing is misplaced, and that there is every reason to fear that consumers who do not pay by credit card will not benefit materially from its radical intervention.

In this regard, what particularly concerned the Parliamentary Joint Committee is that the major players in the supermarket and groceries segment are often either dominant or even virtual monopolists in particular geographical areas — especially across rural and regional Australia.

In short, not only will people who pay by credit card be worse off than now — as intended — but it is problematic whether people who pay by other means will share in merchants' gains. It is especially problematic in areas of Australia (eg rural and regional Australia) where major merchants are locally dominant.

These concerns about whether consumers may be gouged (let alone see any passed on savings) are heightened when the likely commercial outfall of the proposals in the credit card market is considered (see below).

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[16] *Fair Market or Market Failure: A review of Australia's retailing sector*, Report by the Parliamentary Joint Select Committee on the Retailing Sector, August 1999. Available at http://www.aph.gov.au/.

[17] CD, p 126.

[18] Although it might be argued that a full supermarket trolley for a family can be a 'big ticket' item in respect of which a 'buy now, pay later' option may be important to some people on some occasions.

[19] IBISWorld Report G5210 — *Department Stores in Australia*, 1 June 2001.

8. Market Consequences

8.1 Will Competition Increase? Or Decrease?

The RBA argues that the reform as a whole will increase competition in the credit card market. ANZ believes, however that Standard No. 1 will undermine any positive competitive effects from the other elements of the package, and *the net result will be to both diminish and distort competition*.

- ANZ believes that S1 is very likely to make it uneconomic for a number of present issuers to remain in the market, and that this will outweigh any entry by new players. (ANZ has reason to expect that some smaller deposit–taking institutions will exit or outsource their credit card business.)
- Major competitive advantages will be handed to large merchants able to establish their own SCCSPs and issue cards with rewards and key features tied to in–store use — at the expense of both other issuers and other merchants.
- Clearly major retailers are well placed to benefit in this way. Smaller retailers will be less able to compete as the 'outsourced store cards' available to them to offer a 'buy now, pay later' option will be much restricted in key features.

8.2 Will Major Specialist Players Enter the Australian Market?

Some major global (mainly US–headquartered) players are already in the Australian credit card market, in issuing, acquiring or parts of those businesses. The signals sent by these reforms — that consumer payment systems in Australia may progressively come under regimes limiting returns to recurrent cost recovery, and with arbitrary rules imposed on whom costs can be recovered from, seem as likely to deter as to attract new overseas entrants. The contrast with the European Union's recently announced moderate and phased reforms will be striking when viewed from Europe or third countries, notably the United States.

Prospective investors in the Australian payments system are likely to attach a significantly higher risk premium to any potential investment in this market — or simply avoid this market altogether given the demonstration of a higher risk of opinion, rather than evidence, based regulatory intervention.

8.3 Low Cost Player

ANZ finds it unacceptable on both efficiency and competitive neutrality grounds that the RBA should target the open credit card schemes for radical intervention but exempt others in the same market. The fact is that the open schemes have been the 'low cost player' in the credit card market, particularly in Australia where their interchange fees are among the lowest in the world.

The open schemes in this market facilitate price competition among some 65 issuers and well over 200 card products. All participants in them benefit from the scale of these schemes. Their competitive influence restrains the pricing of higher cost closed scheme and store cards.

Under the RBA's proposed reforms, the closed schemes may experience some pressure, but r*elatively* they will be greatly advantaged. They will be able to attract well off transactors and, even more so than now therefore, will be able to maintain high merchant fees — because many merchants will still wish to attract their cardholders as customers despite those fees. If merchants willingly pay their fees now, why will merchants resist the combination of more 'well heeled' cardholders and fees not as high as now? These schemes will also attract more third party issuers, by being able to offer unregulated interchange fees higher than the open schemes will be able to offer.

Store cards too are intrinsically higher cost but will also be relatively advantaged — by being able to cross-subsidise key features, notably the interest free period (within the price of the goods and services provided), while discriminating against other cards. More liberal access to the open schemes will in fact allow major merchants to have the best of both worlds — adding the ability to

use the card elsewhere to what will still be basically a store card, with store linked benefits denied to competing cards.

Regulation of the low cost schemes while those other players are exempt will, in ANZ's view, lead to a substantial net reduction in competition. It will negatively affect both consumers and smaller merchants — particularly less well off consumers and smaller merchants with little (or no) market power.

ANZ has seen no evidence to support the contention that such uneven intervention would be in the public interest.

9. Conclusion

ANZ supports reform of the credit card market. ANZ supports reforms that liberalise entry, increase transparency, and promote competition, while ensuring safety and a 'level playing field'.

However, ANZ strongly urges the RBA to consider the extreme risks of implementing the radical experiment in interchange fee regulation set out in the Consultation Document, and to *limit* a revised and moderate proposal to requiring

- transparency and objectivity in setting interchange fees, and
- recovery in total of no more than the reasonable costs of providing a basic credit card product, recognised as an 'outsourced store card' in nature. At a minimum, additional cost elements that should be included in interchange fee calculations are: the cost of interest–free period, charge back processing, GST, appropriate third party services, the cost of capital and regulatory compliance costs.

Competition in the market should determine how those costs are allocated between merchants and cardholders.

Alternatively, as has been done in Europe, there could be a phased moderate reduction of interchange to a specified level, allowing the consequences to be assessed stage by stage.