Bankcard Association of Australia

Response to Reserve Bank's Consultation Document:

"Reform of Credit Card Schemes in Australia"

March 2002

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EXECUTIVE SUMMARY

Introduction

1. This submission by the Bankcard Association of Australia is in response to the notice, published in the Gazette of 14 December 2001, of the RBA's proposed application of three regulations to each of the "designated" schemes, Bankcard, MasterCard and Visa, under the *Payment Systems (Regulation) Act 1998* (the "**Act**").

2. Following the publication of the "Joint Study" on debit and credit cards by the RBA and ACCC in October 2000, Bankcard undertook an in-depth review of its scheme rules. On 6 March 2001, it advised the RBA in writing of its formal resolution to implement major rule changes. At subsequent discussions, the RBA made it clear that it did not accept the changes as adequate, but was unable or unwilling to provide specific feedback on the resolutions.

3. Bankcard considers that, in proceeding to designate the Bankcard Scheme on 12 April 2001, the RBA had not availed itself of the opportunity to agree voluntary reform of the Bankcard rules, and that its action was not in keeping with the "co-regulatory" and "last recourse" nature of its regulatory powers. Bankcard further considers that the RBA erred in designating each of the open schemes but none of the closed schemes. The RBA's reasons for this decision focused entirely on organisational (legal) differences between the schemes rather than on economic considerations.

Bankcard's Position on the Draft Regulations

4. The three regulations proposed by the RBA take the form of two draft "Standards" and a draft "Access Regime". The purpose of these regulations, and Bankcard's position on each, are as follows:

   Standard No. 1: *Establishes a formula for the setting of interchange fees, based on a restricted set of issuer costs, that would create more diversity of fees within each scheme and dramatically reduce the average fee level.*

   Bankcard considers that regulation of interchange fees is not an appropriate response to the perceived weaknesses in credit card markets. It further considers that the proposed formula is misconceived, is not based on robust principles and would create significant adverse consequences. These points are discussed in more detail below.

   Bankcard further considers that, if the RBA decides nonetheless to proceed with the regulation of interchange fees, it must do this under the "access regime" provisions (ie section 12) of the Act, because the payment of these fees constitutes one of the key conditions for participation in the Bankcard Scheme.

Standard No. 2: *Outlaws any restrictions or actions by scheme participants which prevent, or have the effect of preventing, merchants from recovering the cost of card acceptance from the scheme's card holders. Schemes are also required to have a rule which specifically prevents acquirers from restricting merchant cost recovery.*

Bankcard does not have any rules that would restrict merchants' ability to recover the cost of Bankcard card acceptance from Bankcard cardholders. However, the requirement in draft Standard No.2 that Bankcard introduce a new rule preventing members from restricting merchant cost recovery raises some important issues:

a) It would effectively impose on acquirers a condition of membership of the Bankcard Scheme. Hence, the regulation must be dealt with under the "access regime" provisions (ie section 12) of the Payment Systems (Regulation) Act.

b) It would prevent acquirers from insisting that merchants take reasonable steps to forewarn Bankcard cardholders of their surcharging policies. Bankcard considers that some redrafting of the regulation is required to enable Scheme participants to ensure adequate consumer protection.

c) It may prevent schemes and acquirers from including "anti-gouging" provisions in merchants' contracts to prevent excessive or discriminatory surcharging.

d) It would impose additional costs and complexity on contractual renegotiations between acquirers and merchants if acquirers had to conform to different rules for different schemes. Bankcard considers that uniformity in these arrangements is highly desirable.

Bankcard believes that these issues need to be carefully considered and stands ready to enter into discussion with the RBA to achieve a resolution without the need for the regulation to be imposed.

Access Regime: *Grants equal rights of participation in the designated schemes to a new class of organisation – the "specialist credit card service provider" – to be supervised by APRA under newly established prudential supervision arrangements. Bans schemes from preventing participants being an issuer, an acquirer, both an issuer and an acquirer or a merchant self-acquirer (subject to their capacity to meet their obligations) or to discriminate against participants on the basis of their activities.*

Bankcard draws comfort from the assurances contained in the Consultation Document that the arrangements for the proposed new class of specialist credit card service providers will be consistent with the logic underpinning Bankcard's membership rules. Bankcard is therefore prepared to work with APRA to help specify the concept and establish an appropriate framework for the prudential supervision of the proposed new class of specialist credit card service providers. Bankcard notes, however, that, until the details of the APRA standards for these new entities have been resolved, the concept remains undefined and the draft Access Regime is unspecified.

In its revised rule structure, Bankcard retained an "incentive fee" to ensure a balanced contribution from specialist acquirers towards the development of the Scheme. While Bankcard considers that this "incentive fee" remains justified, it is nonetheless prepared to enter into discussions with the RBA with a view to resolving the issue without the need for regulation.

The Need for Regulation of Interchange Fees

5. Bankcard considers that the case for regulation of interchange fees has not been made. Specifically, it is shown in Chapter 3 of the Submission that:

- The RBA has overstated the role of "issuer dominance" in the setting of interchange fees. All the evidence, including the data presented in the Joint Study, indicates that issuing is a highly competitive activity, with issuers earning below-normal profits at the margin. This competition prevents issuers from increasing their own profitability by raising interchange fees.

- The rapid growth in credit card usage relative to debit card usage does not indicate inefficiencies in the market. In the absence of restrictions on merchant pricing (which Bankcard does not impose), many merchants would choose not to "surcharge" for card use so as to avoid the costs (and customer confusion) involved in doing so. Provided the retail market is competitive, this behaviour of merchants enhances economic efficiency, despite promoting "overuse" of cards and causing a transfer of consumer surplus from cash payers to card users.

- The RBA has argued that, for many merchants, acceptance of credit cards has become a "condition of doing business" and that these merchants therefore have little resistance to merchant service fees. However, the RBA has then drawn the wrong conclusions. Situations involving "strategic imperatives" are commonplace in retailing but rarely a cause for regulatory concern. In relation to credit cards, the problem is fundamentally one of limited merchant choice. Regulation of interchange fees cannot solve this problem, and is likely to exacerbate it, thereby reducing economic efficiency.

- Credit card acceptance is strategically important for merchants because cardholders place a much higher value on the "non-payment" features of these cards than it costs merchants to accept them. (Otherwise, merchants' competitive strategies would be better served by providing consumer benefits directly.) This value would be significantly reduced under the RBA's proposed reduction in interchange fees. The RBA, however, does not acknowledge this point and does not take this welfare reduction into account in applying its public interest test, leading it to erroneous conclusions.
- The RBA has under-rated the potential for increased competition between credit cards and other payment instruments and between the designated schemes themselves. Analysis of the market indicates, for example, that:

  a) competition with store cards is part of the wider theatre of competition between smaller and larger retailers;

  b) the alleged weakness in competition with debit cards reflects, on a consistent application of the RBA's own logic, a fundamental distortion in the debit card system, which could be separately addressed by the RBA; and

  c) the designated credit card schemes are on the verge of entering a mature phase of development where competition for merchant acceptance is a key element.

  The proposed regulation of interchange fees would distort competition in each of these arenas.

6. Bankcard therefore concludes that the regulation of interchange fees would constitute an inappropriate regulatory action and would not be in the public interest. Bankcard further considers that, to the extent that there are weaknesses in the credit card markets, there is ample scope for these to be addressed by strengthening competitive forces. Such an approach would not only be consistent with the RBA's own public interest test, but would constitute the preferred approach under the national competition policy framework more generally.

Comments on Draft Standard No.1

7. Bankcard considers that there are serious weaknesses in the (implicit) assumptions on which the formula for setting interchange fees in the draft Standard is based. Specifically:

   - The RBA assumes that are no joint or common costs, which can only be allocated efficiently by reference to relative cardholder and merchant demands. This places the RBA at odds with mainstream economic thinking, including that of its own consultant economist.

- The RBA assumes that the only services provided by issuers that benefit merchants relate to the payments functionality of the cards. Since it is the "non-payment" functionality of credit cards that attracts cardholders and therefore gives credit card acceptance its strategic importance to merchants, the RBA is engaging, in effect, in "product definition" and risks tilting the competitive retail landscape in favour of large retailers.

- The RBA assumes that the existing allocations of functions in the designated schemes between issuers, acquirers and the central administration are unique. In reality, however, the allocation of functions differs between the schemes and can be altered to differing extents to offset the effect of interchange fee regulation.

8. The rationale given by the RBA for the calculation of interchange fees has not been consistently applied, leading to an apparently arbitrary selection of costs. Key payment-related costs, such as those associated with the traditional "buy-now-pay-later" feature of credit cards, have been excluded on the basis of "legalistic" rather than economic arguments.

9. Introduction of the proposed interchange fee regulations is likely to have a number of significant adverse consequences, including the following:

- The proposed formula would send the wrong price signals for innovation, with the result that innovation in the designated schemes could be seriously curtailed.

- The proposed formula is based exclusively on "debit card" type payment services. (For example, interchange fees would be no more than a few cents for a PIN-based credit card transaction.) Its imposition would ultimately lead to the demise of the open scheme credit card as a distinct product. Closed schemes would rapidly move to fill the vacuum, offering new card products with attractive inducements to financial institutions to bring over their cardholder and merchant bases. Retailers would then be faced with a new, more expensive "all or nothing choice".

- Offshore issuers could begin issuing to Australian cardholders but collect interchange fees at the higher cross-border rate. This would enable them to avoid the regulation at a cost to economic efficiency.

- Schemes could adopt one of a number of different forms of organisation where interchange fees no longer played any role but the economic effects of the scheme via its offerings to cardholders and merchants remained largely unchanged.

Concluding Remarks

10. The broad thrust of this submission has been twofold. The first is to state Bankcard's belief that the differences between its revised rules and the objectives of the RBA's draft Standard No.2 and draft Access Regime should be able to be resolved in discussion without the need to regulate. Bankcard has reiterated its willingness to actively engage in this process of resolution. The second is to make clear why Bankcard considers that draft Standard No.1 is misconceived and its application would be detrimental to the public interest. At the same time, Bankcard has sought to indicate broadly the elements of a more appropriate regulatory response to weaknesses in card markets.

11. Bankcard is concerned that the RBA feels it is under pressure to achieve a quick resolution of the perceived problems in the credit card markets. Bankcard's concern is that, in its haste to act, the RBA is not fully availing itself of the opportunity to consult, is not constructively utilising the expertise of the industry, and is making some fundamental errors in its thinking. There is a lot at stake in forcing changes to the credit card industry, and little to be gained by acting hastily. Bankcard considers that the RBA should, at the very least, pause and take stock of where it is heading and what it is trying to achieve.

12. Bankcard requests that, if the RBA is nevertheless determined to press ahead with draft Standard No.1, there should be adequate consultation on a number of technical issues including:

    a) the cost categories to be included in the formula for interchange fees;

    b) the approach to making the formula robust and logically consistent;

    c) the timetable for implementation; and

    d) whether some exemptions might be appropriate for Bankcard in view of its unique infrastructure configuration and relatively small market share.

1. BACKGROUND TO THE SUBMISSION

1.1. PURPOSE OF SUBMISSION

This submission by the Bankcard Association of Australia ("**Bankcard**") is in response to the invitation issued by the Reserve Bank of Australia ("**RBA**") to interested parties to provide comments on two draft "**Standards**" and a draft "**Access Regime**" (collectively the "**draft regulations**") set out in its "**Consultation Document**" issued in December 2001[1]. The RBA proposes to use its powers under the *Payment Systems (Regulation) Act 1998* (the "**Act**") to apply these draft regulations to the Bankcard, MasterCard and Visa credit card systems in Australia.

The issuing of the Consultation Document follows the "**Designation**"[2] under the Act, on 12 April 2001, of the target credit card systems. To support the Designation, the RBA relied on the work of the "**Joint Study**"[3] on debit and credit cards by the RBA and ACCC, published in October 2000.

1.2. BANKCARD'S COMMUNICATIONS WITH RBA

Following publication of the Joint Study, Bankcard undertook a review of its entry requirements and operating rules, and resolved to make major changes. The RBA was formally advised of the resolutions by letter on 6 March 2001, and discussions were held with the RBA on 6 March 2001 and 27 March 2001.

On 6 April 2001, the Chairman of Bankcard wrote to the Governor of the RBA expressing concern regarding the impending decision by the RBA to designate "the Australian credit card system" under the Act.[4] Specifically, Bankcard observed that the RBA had neither replied to, nor provided specific feedback on, Bankcard's letter advising changes to its rules.

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[1] REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA; I A consultation document; RESERVE BANK OF AUSTRALIA; December 2001. The invitation to comment appears on page 127 of that document. The two draft "Standards" and draft "Access Regime" appear on pages 57-60, 80-82 and 110-112 respectively.

[2] Before a payment system can be regulated under the Act, the RBA must first "designate" it and hold consultations with interested parties. These issues are discussed further in Chapter 2 of this submission.

[3] DEBIT AND CREDIT CARD SCHEMES IN AUSTRALIA; A STUDY OF INTERCHANGE FEES AND ACCESS; RESERVE BANK OF AUSTRALIA & AUSTRALIAN COMPETITION AND CONSUMER COMMISSION; OCTOBER 2000.

[4] REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA; III Submissions received (Volume 1); RESERVE BANK OF AUSTRALIA; December 2001; ref. I1.

On 10 April 2001, Bankcard again met with the RBA. At that meeting, the RBA reiterated its earlier position namely, that while it regarded the changes as a move in the right direction, the RBA did not regard the revised rules as being sufficiently liberal. Nevertheless, when again pressed by Bankcard to indicate how a further liberalisation of the rules might be achieved in practice, without endangering the safety of the Scheme, the RBA was unable or unwilling to provide any meaningful comments.

On 30 April 2001, following the formal designation of the “credit card system operated in Australia by the Bankcard Association”, the RBA, as part of its consultation processes, sent Bankcard a list of questions on credit cards. Bankcard’s response to these questions, together with a covering of a letter of 6 June 2001 are reproduced in the RBA’s compendium of submissions received.[5]

1.3. BANKCARD’S POSITION ON PROPOSED REGULATION

In essence, the proposed regulations are designed to:

Standard No. 1: Establish a formula for setting interchange fees;

Standard No. 2: Outlaw restrictions on merchant pricing (ie ban “**no surcharge**” rules); and

Access Regime: Grant rights of participation in the designated schemes to a new class of organisations supervised by APRA (under yet to be established prudential supervision arrangements).

Bankcard considers that, given its recent voluntary rule changes and its demonstrated willingness to consult with the RBA on the structure of its rules, it would not be appropriate for the RBA to impose the draft Access Regime or determine draft Standard No.2 in relation to the Bankcard scheme.

Bankcard further considers that draft Standard No.1 is fundamentally misconceived and should not be applied. Its determination by the RBA would fail to achieve its intention and would have significant adverse consequences.

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[5] *Ibid*, ref. I2.

1.4. PLAN OF SUBMISSION

The submission follows the following basic plan.

Chapter 2 begins with a review of the RBA's regulatory processes. This includes consideration of the RBA's powers, the scope of its designations, its consultative processes and its interpretation of legislative requirements. It also discusses the three draft regulations and Bankcard's position in relation to each one.

Chapter 3 examines the RBA's arguments for regulation of interchange fees in the open credit card schemes. In doing so, it attempts to set out logically the key issues that need to be taken into consideration before any decision on regulation of the industry is taken, and to identify a more appropriate regulatory response to weaknesses in card markets.

Chapter 4 provides specific comments on draft Standard No.1. It does this by considering the specification on three levels, namely the underlying principles, the application of those principles to the detailed specification and the consequences of the Standard being applied.

Chapter 5 concludes the Submission, briefly indicating Bankcard's view of what needs to be done in going forward.

2. THE RESERVE BANK'S PROCESSES

2.1. INTRODUCTION

The RBA has taken two major steps towards the regulation of the "credit card systems operated in Australia by Bankcard, MasterCard and Visa": It has "designated" each of these systems and it has released its "Consultation Document". In the Consultation Document, it sets out two draft Standards and a draft Access Regime, stating its intention to apply these to all three of the designated schemes.

In the sections below, the RBA's general powers to regulate payment systems and the requirements it must meet in doing so are first examined. Then follows a consideration of how those powers have been applied in relation to the designation of the open schemes in general, and to Bankcard in particular. Finally, consideration is given to the appropriateness of the RBA's intention to apply its draft Access Regime and Standards to the Bankcard Scheme.

2.2. THE RBA'S REGULATORY POWERS

2.2.1 Legislative Basis

The RBA derives its powers for regulation of payment systems from the *Payment Systems (Regulation) Act 1998.* To bring its two draft standards and draft Access Regime into force the RBA will rely on the powers provided in the Act under:

- **section 12** ("**Imposition of Access Regime**"); and
- **section 18** ("**Reserve Bank may make standards for designated systems**").

The Act requires that a "payment system", which is defined very broadly as:

> *"a funds transfer system that facilitates the circulation of money, and includes any instruments and procedures that relate to the system,"*

must be "designated" under **section 11** ("**Reserve Bank may designate payment systems**") before these powers can be applied. The "credit card system operated in Australia by Bankcard" was designated on 12 April 2001.

The Act further requires that the powers under sections 12 and 18 cannot be invoked unless the RBA has first "consulted" with interested parties in accordance with **section 28** ("**Consultation obligations**"). Specifically, this section requires the RBA to:

> *"(a) cause a notice to be published in the Gazette:*
> *(i) advising of the proposed action; and*
> *(ii) summarising its purpose and effect; and*
> *(iii) inviting people to make submissions within a specified time to the Reserve Bank on the proposed action; and*
> *(b) consider any submissions that are received within that time limit."*

On 14 December 2001 the RBA published a notice in the Gazette, inviting comments "before the Standards and Access regime are finalised". The final date specified in the notice for lodgement of submissions was 15 March 2002.

Finally, the Act defines a "public interest test" in **section 8** ("**Meaning of *public interest***") to be applied before the powers under sections 11, 12 or 18 are invoked. Specifically, sections 11 (designation) and 18 (determining standards) can only be applied if the RBA considers that such action would be in the public interest. The RBA can only apply section 12 (imposition of an access regime) if the access regime it is imposing is "one that the Reserve Bank considers appropriate, having regard to … whether imposing the access regime would be in the public interest".

Relevant aspects of these legislative provisions are examined below.

2.2.2 Last-Recourse Nature of the Powers

In his Second Reading Speech to Parliament introducing the *Payment Systems (Regulation) Bill 1998*, the Treasurer stated:

> *"The development of access regimes and standards will be undertaken, as far as possible, in conjunction and consultation with the private sector. This approach ensures that formal regulation will only be imposed on the payments system to the minimum extent necessary to achieve the public interest."*

This statement indicates clearly that the legislation was intended to give the RBA "last recourse" regulatory powers. This "last recourse" concept is consistent with, and is supported by, a number of other statements made at the time. For example, the Explanatory Memorandum accompanying the Bill states that its "philosophy" was "co-regulatory".[6] The requirement in the Act itself for "consultation" also suggests that, even when these "last recourse" powers were to be invoked, the RBA should seek maximum input and co-operation from the industry.

As Bankcard's correspondence and meetings with the RBA show, however, the RBA failed to engage in discussions or meaningful exchange with Bankcard on Bankcard's attempts at self-reform, despite Bankcard's repeated requests that it do so[7].

2.2.3 Application of Section 12 (Imposition of Access Regime)

Section 12 of the Act allows the RBA to impose an "access regime" on the participants in a designated payment system. The word "access" in this context is given as meaning:

> *"the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable".*

"Participant" is defined as a "constitutional corporation" that:

- is an administrator of the system; or
- participates in the system in accordance with the rules governing the operation of the system.

[6] Payment Systems (Regulation) Bill 1998, Explanatory Memorandum (Circulated by authority of the Treasurer, the Honourable Peter Costello MP). Clause 4.1 states, *inter alia*, "The philosophy of the Bill is, however, co-regulatory. Industry will continue to operate by self-regulation in so far as such regulation promotes an efficient, competitive and stable payments system."

[7] A brief outline of the relevant communications between Bankcard and the RBA is provided in section 1.2 of this submission. A more detailed account of the discussions is provided in section 2.3.4 below.

Sub-section 12 (2) of the Act lays down provisions to ensure that, before imposing an access regime, the RBA has taken into account not only the public interest, but also private interests which might be affected and which are protected under the Australian Constitution. Specifically, sub-section 12 (2) states:

> *"The access regime imposed must be one that the Reserve Bank considers appropriate, having regard to:*
>
> *(a) whether imposing the access regime would be in the public interest; and*
> *(b) the interests of the current participants in the system; and*
> *(c) the interests of people who, in the future, may want access to the system; and*
> *(d) any other matters the Reserve Bank considers relevant."*

Sections 16 and 17 of the Act provide that a person who has been denied access to a designated payment system, and considers the denial to be a breach of a provision of an access regime, may seek to remedy this situation by applying to the RBA to use its enforcement powers or by applying to the Federal Court for an appropriate court order.

Taken together, these provisions indicate that an access regime is intended to cover the regulation of situations relating to:

1. pre-conditions for admittance of potential participants wishing to use the system;

2. the admittance process, including decisions to accept or reject applications for admittance; and

3. contractual arrangements governing participation in the system.

As stated in the Consultation Document, the RBA intends to impose an Access Regime under section 12 of the Act and determine two Standards under section 18 of the Act for each of the designated credit card schemes. Applying the foregoing criteria leads to the conclusion that all three of the proposed regulatory measures could be dealt with under section 12. This conclusion reflects the following reasoning:

- the draft Access Regime, which deals with both eligibility for participation and the terms of participation, clearly satisfies the criteria for the application of section 12;

- draft Standard No.1, which deals with the setting of interchange fees, is (indirectly) setting one of the terms set by the designated schemes for participation in the system; and

- draft Standard No.2, which lays down elements of the contractual arrangements between a scheme and its participants to prevents the imposition of "no surcharge" rules on merchants, is dealing directly with terms of participation in the system.

2.2.4 Application of Section 18 (Determination of Standards)

Section 18 of the Act enables the RBA to "determine or vary standards" for the participants in a designated payment system, if it considers this to be in the public interest and has first consulted with interested parties. The need to consult, however, is waived [under sub-section (5)] if the RBA considers that the need to determine the standard is urgent or it involves a variation "of a minor technical nature".

Section 18 permits the RBA to regulate the operations of a payment system in relation to matters that could not be regarded as access related. Such matters would include:

- prudential supervision, for example for the control of systemic risk;
- matters involving the safety of third parties; and
- issues of technical efficiency or the joint usage of infrastructure by different payment systems (through common standards and processes).

It would not be appropriate, however, to use section 18 to deal with regulations having a significant impact on the contractual arrangements between the participants in a system. Apart from the fact that section 12 provides an appropriate avenue for dealing with such matters, section 18 has no provisions to safeguard private interests. Therefore, to the extent that participants in a system believe that, as a result of regulations under section 18, they have suffered material loss from a change in their contractual rights, they could challenge the constitutional validity of the RBA's actions.

In section 2.2.3, we concluded that section 12 of the Act provides an appropriate legal avenue for the RBA to bring the two draft "Standards" into force, since these "Standards" go to the heart of the contractual arrangements between system participants (ie they are conditions of access). For precisely the same reason, it would be inappropriate for the RBA to "determine" these "Standards" under section 18 of the Act.

2.2.5 Public Interest Test

The public interest test is defined in section 8 of the Act as follows:

> *"In determining … if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:*
>
> *(a) being (in its opinion):*
> *(i) financially safe for use by participants; and*
> *(ii) efficient; and*
> *(iii) competitive; and*
> *(b) not (in its opinion) materially causing or contributing to increased risk in the financial system.*
>
> *The Reserve may have regard to other matters that it considers are relevant, but is not required to do so."*

In the Consultation Document, the RBA states[8]: "In applying this test, the Reserve Bank's approach is consistent with the broad objectives of competition policy in Australia." Specifically, the RBA notes that[9]:

> *"Broadly speaking, competition policy seeks to promote efficiency and enhance community welfare through the encouragement of effective competition and the protection of the competitive process. The Hilmer Report identified three dimensions of economic efficiency … :*

- ***allocative efficiency**, which is achieved when resources are allocated to there highest valued uses (ie those that produce the highest benefit relative to cost);*
- ***productive efficiency**, which is achieved where firms produce goods and services at minimum costs; and*
- ***dynamic efficiency**, which reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities."*

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[8] Consultation Document: Section 1.5: page 11.

[9] *Ibid.*

Immediately thereafter, the RBA states[10]:

> *"If it is to meet the broad objectives of competition policy, the payments system in Australia needs to give maximum rein to the workings of the price mechanism and the free movement of resources, provided the safety of the system is not compromised. For this reason, the Reserve Bank sees the following competition 'benchmarks' as underpinning the public interest test in the payments system:*
>
> - *relative prices charged by financial institutions to consumers who use payment instruments should reflect the relative costs of providing these instruments as well as demand conditions;*
> - *merchants should be free to set prices for customers that promote the competitiveness of their business;*
> - *prices of payment instruments should be transparent;*
> - *any restrictions on the entry of institutions to a payment system should be the minimum necessary for the safe operation of that system; and*
> - *competition within the market for a payment instrument, and between different payment instruments, should be open and effective."*

The RBA gives no justification for these "benchmark", nor any indication why it has chosen these ones in particular. Since they are to be the "yardstick" for the RBA's assessment of payment systems, they deserve closer examination.

1. *"relative prices charged by financial institutions to consumers who use payment instruments should reflect the relative costs of providing these instruments as well as demand conditions"*

No definitions of the terms used in this "benchmark" are given. This is a serious omission. For example, since any payment represents both a service to a consumer and a service to a merchant, how are the joint production costs involved to be handled? Without precise definitions of the terms used, the statement cannot even begin to serve as a "benchmark".

More importantly, the statement may be inconsistent with attaining allocative efficiency. Specifically, it is a well-known fact of economics that, in situations where common costs of production are involved, social welfare can often be improved by departing from the simplistic principle of "price reflecting cost". Indeed, welfare may be maximised under conditions where the "less costly" service commands the highest price. For this reason, the statement cannot serve as a "benchmark" for assessing payment systems, where common costs are legion.

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[10] *Ibid.* pages11-12.

2. "merchants should be free to set prices for customers that promote the competitiveness of their business"

Basic economic theory shows that, provided there is sufficient competition between merchants (and the merchants' suppliers) and information on the prices they charge for goods and services is readily available to potential customers before they incur significant costs towards making a purchase, the freedom of merchants to set prices and promote the competitiveness of their businesses promotes the attainment of the highest level of social welfare. However, if these conditions are absent, for example there are merchants with significant market power, the free rein of market forces may not be in the public interest.

3. "prices of payment instruments should be transparent"

The use of the term "transparent" in this context is unfortunate. As noted above, information on the prices of goods and services on offer needs to be readily available if market forces are to be relied upon to promote social welfare. However, the processes by which those prices were determined do not need to be transparent.

To see this, consider the example in which consumers are seeking to purchase goods in a market where those goods are supplied by many independent merchants in close proximity to each other. Provided consumers can readily ascertain the prices charged by individual merchants, they will make the purchases that represent, for them, the best value for money. Where the same good is available from two different merchants, and all the "quality factors" associated with the purchase (eg waiting time, product information provided) are the same, consumers will choose the merchant offering the good at the lowest price. Other merchants offering the same good will be forced to respond, either by reducing their prices, or by differentiating their quality factors to provide higher value to consumers, or both. Welfare is increased through this competitive process. However, it adds nothing to the process if it is revealed to consumers how the merchants set their prices, or whether they employ a formula for that purpose or simply use "gut feel". In short, transparency is irrelevant in the competitive process.

Where transparency is valuable is as a tool that regulators can use for monitoring developments in a market under surveillance. This form of transparency can simply take the form of mandatory reporting, in which case the regulator can obtain information that is confidential as far as the market is concerned. Or it may take the form of publicly disclosed information where the regulator is trying to encourage "whistle blowing" activity, the institution of private legal challenges and the like. Clearly, the institution of this kind of transparency, which infringes participants' rights to privacy, would need to have clear public benefits to be legitimately employed.

4. "any restrictions on the entry of institutions to a payment system should be the minimum necessary for the safe operation of that system"

This proposed "benchmark" ignores the private rights and aspirations of the payment system owner(s). Would it, for example, be appropriate to apply such a "benchmark" in relation to American Express or Diners Club? If not, why would it be any more appropriate to apply it to a so-called "open" scheme with restricted membership?

In proposing this benchmark, the RBA appears to have lost sight of what it is trying to achieve, namely competitive and efficient payment systems. What is required, therefore, is a benchmark to establish when payment systems are sufficiently competitive, so that further action to increase competition would have no material effect on their efficiency. Since payment systems involve functions that are competing in different markets (eg issuing and acquiring) any valid test would need to be able to be applied to these specific markets.

5. "competition within the market for a payment instrument, and between different payment instruments, should be open and effective"

As a statement of objectives there would be presumably little disagreement. However, a "benchmark" is, by definition, something that sets a standard against which other things can be measured. What is required, therefore, is something (the "benchmark") that can be used to gauge the degree and effectiveness of competition between payment instruments of the same type or of different types. Setting competition as an ideal is one thing, but it is not a "benchmark".

The foregoing illustrates that the RBA's so-called "competition benchmarks" are not appropriate for the task. Worse, some of them have no underpinning economic logic and are seriously misleading, especially as a starting point for consideration of arguments for and against regulation. For this reason, they cannot be regarded as consistent with the Public Interest Test.

A closer examination shows that these "benchmarks" are, in fact, little more than a (coded) statement of the elements of the draft regulations. The code is as follows: "Benchmark" 1 says interchange fees should be built up from costs: "Benchmark" 2 says "no surcharge" rules should be banned; "Benchmark" 3 says the interchange fee calculations should be made public; and "Benchmark" 4 says that membership rules should be widened. The odd one out is "Benchmark" 5. This states an objective that the RBA argues has not been attained by the market, so regulation in the form of "Benchmarks" 1-4 is justified.

The fact that these "benchmarks" are assumed from the outset with no underlying rationale gives the RBA's arguments a degree of circulatory. This is dangerous, particularly in view of the elementary errors contained in them. In short, these so-called "competition benchmarks" and the "logic" of the Consultation Document are so seriously flawed that any conclusions drawn from them could well prove to be contrary to the public interest.

This leaves the question of whether another series of "tests" for the public interest could be devised. The statement of the public interest test in the Act and the general tenets of National Competition Policy clearly imply that, in assessing whether it would be appropriate to impose an access regime or determine a standard for a designated payment system, the following series of tests should be applied:

1. Does the available evidence provide reasonable grounds for believing that there is a divergence between private and public interests that is giving rise to, or is likely to give rise to, a significant loss of economic efficiency?

2. Has the source of the problem been properly identified?

3. Can the situation be remedied by voluntary action taken by the private sector?

4. Can the proposed regulation reasonably be expected to lead to a significant improvement in at least one of the following factors:

    - systemic risk;
    - participant safety;
    - competition;
    - allocative efficiency;
    - productive efficiency; or
    - dynamic efficiency;

    sufficient to outweigh any adverse impact on the others?

5. Is the proposed regulation the best available having regard to the desirability of:

- achieving the greatest improvement in economic efficiency?
- attacking the source of the problem rather than using indirect means? and
- improving competition rather than constraining behaviour?

As will be shown in this submission, the RBA's proposed regulations fall short of these requirements.

2.3. DESIGNATION OF THE OPEN CREDIT CARD SCHEMES

2.3.1 Scope of Designation

On 12 April 2001, the RBA formally designated the "credit card systems operated in Australia by Bankcard, MasterCard and Visa" using its powers under section 11 of the *Act*. In announcing the Designation, the RBA stated its reasons for not designating the three party card schemes in Australia, American Express and Diners Club:

> *"These schemes do not have collectively determined interchange fees, nor access rules which discriminate on the grounds of institutional status. They do, however, impose restrictions on merchant pricing. For this reason, the Reserve Bank confirmed that any decision it took about restrictions on merchant pricing in the public interest with respect to the designated credit card systems would also apply to the three party schemes."*

This decision by the RBA to designate all, and only, the open credit card schemes can be criticised – and, indeed, has been – on the grounds that it represents an attack on an organisational form rather than on an economic problem. In particular, it violates the principle of competitive neutrality, which is one of the cornerstones of the National Competition Policy, and hence, on the RBA's own reckoning, should not have been judged as consistent with the Public Interest Test.

The following sections examine this question more carefully, beginning with an overview of the key differences and similarities between the open and closed schemes.

2.3.2 Card-Based Payment Instruments

A variety of card-based payment facilities is available in Australia offering various combinations of features. However, the basic forms are, in principle, as follows:

(i) ***Debit Cards*** allow a cardholder to make payments by providing access to the cardholder's own funds held in a debit (or "current") account. A debit account may have an attached overdraft facility, which provides a revolving line of credit on terms and conditions agreed between the cardholder and the issuer. When a debit card payment is executed, funds are, in principle, drawn directly and immediately from the cardholder's own funds (or from the overdraft facility if the cardholder has insufficient own funds in the account) and a matching payment is made directly and immediately to the merchant.[11]

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[11] In practice, systems limitations may result in some delay but this is normally less that 24 hours.

(ii) ***Charge Cards*** allow a cardholder to purchase and take delivery of goods and services immediately but provide a "period of grace" before payment is due (ie they provide a buy-now-pay-later facility). In this respect they provide a payment service similar to that which is still common for invoiced delivery in wholesale markets or for billed delivery of utility services. At the end of the grace period, the cardholder is expected to have paid the amount owing in full. Provided this is done, there is typically no additional charge levied on the cardholder for the transaction. A charge card may also have an attached line of revolving credit, which is drawn on in the event that the cardholder does not pay the full amount owing by the due date. It is then usually known as a ***Credit Card***.

In short, the difference in payment functionality[12] between a debit card and a charge card is that the former involves a transfer of funds from the cardholder to the merchant which is (in principle) simultaneous with the consumer's commitment to pay, while the latter involves a delay between the consumer's commitment to pay and subsequent provision of the necessary funds. From a merchant's perspective, the immediate receipt of funds is a given for debit card payments but the timing of payments via charge cards depends on the nature of the arrangements with the provider of the charge card services.[13] Either may have an attached line of revolving credit.

Two conclusions can immediately be drawn:

1. The provision of revolving credit is separable from the payment functionality for both debit and charge cards. In particular, there is no *prima facie* justification for distinguishing between "credit card payment systems" and "charge card payment systems" as legitimate targets for regulation under the Act.

2. Debit cards and charge cards may be either proprietary, or provided through open or closed schemes. Where provision is through open scheme, interchange fees may be payable in either case. In particular, there is no *prima facie* justification for distinguishing between debit and charge card payment systems as legitimate targets for regulation under the Act, except where that distinction relates to the immediate or delayed nature of those payments.

These conclusions immediately highlight several anomalies in the RBA's designations of the open credit card systems.

[12] There may of course be other differences in practice relating to non-payment services.

[13] For example, the merchant could receive funds immediately or could receive funds at the end of the grace period.

First, the words "credit card payment system" used in the designations of Bankcard, MasterCard and Visa are clearly regarded by the RBA as excluding the Visa debit card product. The RBA has not clarified its reasons for this exclusion. All its arguments relating to interchange fees, system access and restrictions on merchant pricing apply equally to the debit and credit card products.

Second, the RBA has not clarified precisely how it distinguishes between the Visa debit card and credit card systems in a technical sense, since it could be argued that they are both part of the same "*funds transfer system that facilitates the circulation of money*". One must therefore presume that the distinction is based on the concept of immediate versus delayed payment. As will be discussed later, however, in setting the formula for interchange fees in draft Standard No.1, the RBA excludes consideration of the delayed payment aspect of credit cards on the grounds that they are "not related to payment network considerations".

Third, the same words – "credit card payment system" – are, presumably, intended to exclude charge cards. Bankcard is usually described as a credit card scheme, but there is nothing in Bankcard's constitution or rules that prevents members from operating their issued Bankcards as charge cards. Does this mean, for example, that, if the RBA determines Standard No.1, Bankcard could set two interchange fees – one for credit cards regulated by the Standard and one for charge cards which would be unregulated – and let its members decide which is more appropriate for their business?

2.3.3 Open Versus Closed Schemes

In applying the public interest test to card-based payment systems, the central issues to be addressed relate to the nature and extent of the economic impact of those systems on their end users (ie cardholders and merchants), since it is via these end users that the systems produce their effects on the wider economy. Any decision to regulate, say, the open card schemes but not the closed schemes, therefore, needs to rest on differences on those end-user impacts. However, as the quote at the beginning of section 2.3.1 reveals, the RBA's arguments for designating only the open schemes focused on their interchange fees and access rules.

In order to explore the legitimacy of the RBA's decision further, it is first worth noting some of the key similarities and difference between open and closed schemes. To avoid confusion, a closed scheme is defined in what follows as an organisation providing card payment services which has full control over the card issuing and acquiring functions ie control of product design and cardholder pricing is internal to the organisation, as is merchant selection and merchant service pricing. American Express and Diners' Club closely approximate this definition. In contrast, issuing and acquiring decisions are "outsourced" to "members" in an open system under "loose" arrangements that specify neither end-user pricing nor most of the end-user services. In an open system, the word "scheme" is often taken as synonymous with the central administrative organisation. For this reason, to ensure a proper point of comparison with closed schemes, the central administrative organisation of an open scheme together with its members in their role of providing scheme-related functions will be referred to below as the "collective".

There are some clear parallels between the closed schemes and open collectives operating in Australia:

- Both have a profit objective. Closed schemes have a profit objective in their own right and, while the central administrative bodies of the open schemes are non-profit organisations, the collective can be considered as having a profit objective in the sense of the combined profit objectives of its issuer and acquirer members.

- In their respective decision-making processes, both the closed scheme decision makers and the collective decision makers for an open scheme are likely to have regard for the same kinds of market considerations. For example, the market share of the scheme, its brand position and growth rate, its fraud experience and its overall profitability.

- When considering operating rules, decision makers in a closed scheme take account of the impact on the various internal divisions of the scheme. In the case of the open scheme, the impact on the collective members must be taken into account.

- When considering proposed innovations, the business case takes account of the likely effect on the scheme in the case of a closed scheme, but must take account of the effect on the collective in the case of an open scheme.

There are also major points of difference, including the following:

- Closed schemes can rely on their internal chains of command to ensure that decisions are carried out: open collectives must rely on the co-operation of their members.

- In closed schemes, revenues from cardholders and merchants are effectively "pooled" and used to cover costs as needed to carry out various functions: in an open scheme, special arrangements (such as interchange and membership fees) must be instituted to transfer funds between members and the central administrative organisation.

- In closed schemes there is effectively a single monopoly issuer and a single monopoly acquirer: in an open collective, the issuing and acquiring members compete with each other for market share.

- Closed schemes can set terms and conditions for their cardholders and merchants directly: open schemes set rules (including interchange fees) which (along with other factors such as market conditions and members' competitive positions in issuing and acquiring markets) influence the cardholder and merchant terms and conditions set by their members.

The RBA is, of course, technically correct in observing that closed schemes do not have collectively determined interchange fees: in fact they have no interchange fees at all. But this misses the point as far as the public interest test is concerned, since closed schemes have internal mechanisms to redistribute funds between functions. Moreover, those funds flows are determined by an internal decision-making process that is just as hidden from outside purview as the collective decision process in an open scheme. Further, the decision-makers in a closed scheme are all drawn from a single organisation (ie the closed scheme itself) and are therefore likely to have their interests more closely aligned than their counterparts in the decision-making bodies of an open collective. Finally, the fact that closed schemes can set cardholder fees and benefits and merchant service fees directly means that, all else equal, they are in a stronger position than their collective counterpart to exploit market conditions in their own interests. Therefore, considered against the public interest test, the RBA should be more concerned with the operation of closed systems than with open ones.

The RBA is also missing the point when it draws attention to the fact that the decision makers in an open collective are otherwise competitors as issuers and acquirers. In the worst possible situation (from a competition or an efficiency perspective) where all the members of a collective conspired to exercise market power by coordinating their issuing and acquiring activities, the situation would be no worse than is normal for a closed scheme, where the issuing and acquiring functions are, in effect, monopolised.

As far as access rules are concerned, the RBA may again be technically correct to claim that closed schemes do not have "access rules which discriminate on the grounds of institutional status", but it again misses the point. As a regulator interested in promoting competition through freeing up access, the RBA should be concerned just as much with *de facto* rules as with *de jure* ones. The "access rules" of the closed schemes operating in Australia are demonstrably almost totally exclusionary.

In summary, therefore, the RBA's arguments for excluding the closed schemes from the designation process clearly betray a preoccupation with matters of organisational form and appearance (eg the explicitly stated rules of open schemes) rather than with matters pertaining to economic efficiency, competition and the public interest.

2.3.4 Bankcard's Consultations with the RBA

On 6 March 2001, Bankcard formally advised the RBA in writing that it had resolved to make major changes to its membership rules. The key change to the rules was the introduction of explicit criteria for membership eligibility. These specify that applicants for membership must:

> *"comply with at least one of the following prudential requirements ("**Bankcard Prudential Requirements**"):*
>
> *(i) be an authorised deposit-taking institution ("**ADI**") in Australia supervised by the Australian Prudential Regulation Authority ("**APRA**"); or*
>
> *(ii) be a financial institution registered in another country to operate as an institution with similar rights and obligations as an ADI in Australia, and supervised by an official prudential regulator in that other country that is recognised by APRA; or*
>
> *(iii) be an entity whose liabilities in respect of the Bankcard Scheme are guaranteed by an ADI in Australia supervised by APRA (or by a financial institution registered in another country to operate as an institution with similar rights and obligations as an ADI in Australia, and supervised by an official prudential regulator in that other country that is recognised by APRA) under a guarantee that will survive the commercial failure of the entity."*

In discussions with the RBA on 6 March 2001 and 27 March 2001, Bankcard representatives explained that this formulation provided the widest possible eligibility for membership, consistent with the objectives of safety, transparency, objectivity and practicality. In this context, they noted that the requirement for an applicant to be an ADI, or be guaranteed by an ADI, had nothing to do with deposit-taking activities *per se*. Rather, it was simply a reflection of the fact that this was the only class of organisation in Australia which was appropriately supervised by APRA, and could therefore provide a reasonable assurance of safety to all participants in, and users of, the Bankcard Scheme. Bankcard representatives argued that a further widening of the Bankcard eligibility rules would only be possible if the regulators were prepared to extend the scope of prudential supervision.

Bankcard further explained that a key role of issuers and acquirers in the Scheme was to underwrite the obligations of the cardholders and merchants using the scheme – including obligations not directly related to payments, such as the guarantee of restitution in the event of merchant non-fulfillment or fraudulent activity. By requiring that, for non-ADI entities, there be a guarantee in place from an ADI which would survive the commercial failure of the entity, Bankcard had been able to lift the restriction on merchant self-acquiring, without increasing the risk to the Scheme and its users.

Bankcard noted, however, that it had retained a modest "incentive fee" to encourage all members to become issuers. This was not set at such a level that it would have a material impact on the commercial viability of a specialist acquirer or merchant self-acquirer, but would represent a contribution towards the activities of issuer members, such as promotion of the Scheme, from which acquirers derived some benefit.

Finally, Bankcard noted that its rules had never included any prohibition on merchant "surcharging" and the introduction of such a rule was not contemplated. For this reason, it considered the RBA's concern over "no surcharge" rules had no relevance in relation to Bankcard.

While the RBA indicated that it regarded the resolutions as a good step in the right direction, it was adamant that the changes did not go far enough. Nevertheless, Bankcard was unable to elicit from the RBA any practical feedback on how its membership rules could be further widened without endangering the safety of the Scheme, or compromising the transparency and objectivity of the selection process.

On 6 April 2001, the Chairman of Bankcard wrote to the Governor of the RBA expressing concern regarding the impending decision by the RBA to designate "the Australian credit card system" under the *Payment Systems (Regulation) Act 1998*[14]. In particular, Bankcard was concerned with the haste with which the RBA intended to act and the processes it intended to follow. The letter observed that the RBA:

- needed to allow adequate time for the parties concerned to prepare submissions on the appropriate scope and definition of the systems to be designated;

- had not exhausted the other means available to it to achieve its goals of increased efficiency and competitiveness before invoking its "last recourse" regulatory powers; and

[14] Letter published as ref. I1 in REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA; III Submissions received (Volume 1); RESERVE BANK OF AUSTRALIA; December 2001.

- had neither replied to, nor provided specific feedback on, Bankcard's letter advising changes to its rules:[15] nor had it indicated whether it agreed or disagreed with Bankcard's view that these changes addressed the concerns raised in the Joint Study.

Despite a subsequent meeting with the RBA, Bankcard was unable to gain any further insight into the nature of the RBA's dissatisfaction with Bankcard's resolutions.

Bankcard considers that the RBA's designation of Bankcard on 12 April 2001 was not consistent with the "co-regulatory" and "last resort" nature of its powers under the Act. Bankcard considers that designation should only have occurred after the RBA had made its objections to the resolutions clear and discussions between Bankcard and the RBA had reached the point where further material progress was unlikely.

2.4. THE DRAFT REGULATIONS

2.4.1 The General Nature of the Regulations

As outlined briefly in section 1.3 above, the Consultation Document sets out the RBA's proposed regulation of the open credit card systems in the form of two draft Standards and a draft Access Regime.

The RBA describes its proposed reforms as promoting "efficiency and competition in the Australian payments system."[16] The RBA further states[17]:

> *"The reform measures involve:*
>
> *(i) an objective, transparent and cost-based methodology for determining interchange fees;*
> *(ii) freedom for merchants to recover from cardholders the cost of accepting credit cards; and*
> *(iii) a more liberal access regime that allows for the entry of specialist credit card service providers, both issuers and acquirers, to be supervised by APRA."*

Finally, the RBA states[18]:

> *"The Reserve Bank's proposed standards and access regime will apply to the three designated credit card schemes, Bankcard, MasterCard and Visa."*

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[15] As at the date of lodgement of this submission, Bankcard had still not received any reply.

[16] Consultation Document; Executive Summary; paragraph 22.

[17] *Ibid.*

18 *Ibid*, paragraph 29.

However, the three schemes are subject to separate designations, and the RBA is obliged, in each case separately, to have regard to the last recourse nature of its powers, and to consider the public interest, before applying the regulations. The application of the draft regulations to the Bankcard Scheme is considered below.

2.4.2 Draft Access Regime

The key clauses in the draft Access Regime are the following:

> ***"Eligibility for participation***
>
> 6. *Any person supervised by the Australian Prudential Regulation Authority (APRA) as an authorised deposit-taking institution or as a specialist credit card service provider must be eligible to participate in a Scheme in Australia.*
>
> 7. *The rules of a Scheme must not discriminate between authorised deposit taking institutions and specialist credit card service providers supervised by APRA in relation to the rights, obligations and entitlements of such participants in the Scheme.*
>
> ***Terms of participation***
>
> 8. *The rules of a Scheme must not prevent a participant from being:*
>
>   *(i) an issuer; or*
>
>   *(ii) an acquirer; or*
>
>   *(iii) both an issuer and an acquirer.*
>
> 9. *The rules of a Scheme must not impose on a participant in a Scheme any fees, charges, loadings or any form of penalty as a consequence of, or which are related in any way to, a difference in the value or number of transactions in which that participant is the acquirer in comparison to the value or number of transactions that involve the use of credit cards issued by that participant.*
>
> 10. *The rules of a Scheme must not prohibit a participant from being a self acquirer if the participant can establish to the reasonable satisfaction of the Scheme Administrator or, if none, to a majority of the participants in the Scheme that it has the capacity to meet the obligations of an acquirer as a self acquirer. The rules of a Scheme may allow the decision on the capacity of a self acquirer to meet its obligations to be reviewed by the Scheme Administrator or, if none, by the participants in the Scheme upon the giving of reasonable notice to that self acquirer."*

As noted in section 2.3.4 above, Bankcard's rules were derived from the principle that, to ensure a proper underwriting of the obligations of end-users of the Bankcard system (ie cardholders and merchants) the underwriter must be of sufficient substance and be sufficiently quarantined from the end user to be able to survive the commercial failure of the end user. This compares with the RBA's description of the proposed arrangements for the APRA supervision of the new class of "specialist credit card service providers":[19]

> *"Deposit-taking institutions authorised and supervised by APRA are eligible for membership of all three credit card schemes operating in Australia. The Reserve Bank has concluded that restrictions on the basis of institutional status – that members be deposit-taking institutions – are excessive; ADIs in Australia have traditionally undertaken a wide range of banking business of which participating in four party credit card schemes has usually been a small part. At the same time, the Reserve Bank acknowledges that reliance on APRA's prudential supervision of members has lent some objectivity to, and reduced the costs of, membership procedures in credit card schemes.*
>
> *To preserve these benefits, and to assist in promoting competition in credit card schemes, the APRA Board has agreed in principle that APRA will authorise and supervise specialist credit card issuers and acquirers. To this end, a regulation will need to be enacted under the Banking Act 1959 to deem credit card issuing and acquiring to be "banking business"; this matter is being progressed with the Treasury. Any specialist institutions wishing to undertake the "banking business" of issuing credit cards and/or acquiring credit card transactions in four party credit card schemes will need to obtain an authority from APRA and be subject to its ongoing supervision. As an assurance to the credit card schemes and the community generally that such institutions have the necessary competence and financial standing, they will need to:*
>
> - *be established as special purpose vehicles with a separate corporate identity;*
> - *be separately capitalised. The adequacy of start-up capital will be assessed on a case-by-case basis having regard to the scale of operations proposed;*
> - *demonstrate to APRA that they are of financial substance and able to meet their settlement obligations;*
> - *have in place appropriate risk management policies, particularly controls for monitoring credit risk, IT risk and liquidity risk; and*
> - *meet prudential standards, as determined by APRA, in relation to credit quality and liquidity management that are no less strict than would apply to an ADI's credit card business."*

[19] Consultation Document, pages 108-109.

On the basis of this assurance, Bankcard is prepared to work with APRA to help specify the concept and establish an appropriate technical framework for prudential supervision of the new specialist entities. Bankcard notes, however, that until the details of the APRA standards for the supervision of these new entities have been resolved, the concept remains undefined and the draft Access Regime remains unspecified. In particular, the RBA's proposed action in relation to regulating access are not defined and it is not possible for Bankcard to form a considered opinion on the proposal. Nor is it possible for the RBA to impose the draft Access Regime or otherwise bring the regulation into effect.

There is another key point of difference between Bankcard's rules and the draft Access Regime, namely Bankcard's "incentive fee" conflicts with the requirements of clause 9 of the draft regulation. Bankcard considers that its "incentive fee" remains justified, in particular because one of the risks facing open schemes is the damage that members (particularly major ones) can cause if they refuse to co-operate (or threaten to leave the scheme) unless their wishes prevail. The "incentive fee" is a mechanism to encourage members to develop and maintain a balanced view of the Scheme as a whole (ie. the collective) rather than to disrupt its workings by pursuing sectional interests. Bankcard is nonetheless prepared to enter into discussions with the RBA with the aim of resolving the differences of view on this issue.

Before concluding this section it is perhaps worth remarking on a further requirement of the draft Access Regime contained in clause 11, namely the requirement that each of the schemes must publish their rules for eligibility for participation, and the terms of participation in the scheme on a website. Bankcard considers that for the RBA to mandate a particular medium for publication of scheme rules is extraordinary. In view of the insecure nature of the medium chosen, Bankcard would be unable to warrant the accuracy of the material published. The requirement is also unnecessary given that a copy of the relevant rules can be immediately dispatched via more conventional means on request. Bankcard considers that such a requirement should be withdrawn.

2.4.3 Draft Standard No.2

The key clauses in this draft Standard are as follows:

> *"**Merchant pricing***
>
> *7. The rules of a Scheme must not include any rule that requires a participant in the Scheme to prohibit, or that has the effect of prohibiting, a merchant in Australia from recovering from a credit cardholder the cost to the merchant of accepting a credit card issued by a participant in the Scheme.*

8. The rules of a Scheme must include a rule that prohibits acquirers in the Scheme from imposing any term or condition in a contract, arrangement or understanding with a merchant in Australia which prevents, or has the effect of preventing, a merchant from recovering from a credit cardholder the cost to the merchant of accepting a credit card issued by a participant in the Scheme.

9. A participant in a Scheme must not prevent a merchant in Australia from recovering from a credit cardholder the cost to the merchant of accepting a credit card issued by a participant in the Scheme.

Transparency

10. The Scheme Administrator or, if none, each acquirer in the Scheme must ensure that each merchant in Australia that accepts a credit card issued by a participant in the Scheme is advised in writing of the provisions of this Standard."

The expression "cost to the merchant of accepting a credit card issued by a participant in the Scheme" is not defined. From an economic efficiency perspective, the "cost" should be the "marginal opportunity cost" of card acceptance, ie. assuming the advertised price is the cash price, the "cost" to the merchant of card acceptance is the difference between the additional cost of processing a card transaction and the additional cost of taking the payment in cash. However, it is not clear whether this is what the RBA intends. Nor is it clear whether clauses 7, 8 and 9 would allow the scheme or its members to take some form of restraining action (eg. through "anti-gouging" or "anti-discrimination" provisions in their contracts with merchants) if merchants attempted to apply surcharges for card transaction that would more than recover the cost of card acceptance or be aimed at disadvantaging a particular class of cardholder.

Given the range and variety of services that acquirers can provide to merchants, as well as the prevalence of joint scheme and debit card acquiring, attempts to disentangle the costs of the individual payment instruments would probably be too difficult in practice and the "formalistic" approach, such as the specification of "recovering the cost" in the draft Standard would founder on that account. If the notion of cost recovery is to be retained, the RBA needs to establish, as part of the regulation, a process for determining how that cost is to be calculated.

There is nothing in Bankcard's rules that would prevent a merchant from applying a different price in respect of a transaction made by a Bankcard card from the price applying to the transaction if other means of payment are employed. However, the requirement in draft Standard No.2 that Bankcard introduce a new rule preventing members from restricting merchant cost recovery raises two important issues:[20]

1. It would prevent acquirers from insisting that merchants take reasonable steps to forewarn Bankcard cardholders of their surcharging policies. Bankcard considers that some redrafting of the regulation is required to enable Scheme participants to ensure adequate consumer protection.

2. It would impose additional costs and complexity on contractual renegotiations between acquirers and merchants if acquirers had to conform to different rules for different schemes. Bankcard considers that uniformity in these arrangements is highly desirable.

Bankcard considers that the issues raised by clauses 8 and 9 of the draft regulation, particularly those relating to consumer protection, need to be carefully considered before the regulation is applied. Bankcard is willing to enter into discussion with the RBA on these issues with a view to achieving a resolution without the need for the regulation to be imposed.

2.4.4 Draft Standard No.1

The crucial clauses in this proposed regulation are as follows:

> *"**Methodology***
>
> *7. 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:*
>
> *(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*

[20] The fact that this requirement would effectively impose a further condition of membership of the Bankcard Scheme, and so must be dealt with under section 12 of the Act, has already been noted in section 2.2.4 above.

(iii) issuers' costs incurred in providing authorisation of credit card transactions,

*(collectively the "**eligible costs**").*

8. 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."

As indicated in the introductory chapter, Bankcard considers the approach represented by this draft Standard to be fundamentally misconceived. That misconception has a number of interlocking elements:

- the view that the specification of a formula for the setting of interchange fees is the most appropriate regulatory action is based on a misconception of the economics of credit card systems;
- the implicit assumption in the draft Standard that the only legitimate services that credit cards provide to merchants are "payment services" is based on a misconception of the "credit card product": implementation of the Standard would effectively cast the RBA in the role of redefining the product and of being the arbiter of the products allowed into the market; and
- the implicit assumptions that costs can be uniquely divided between cardholders and merchants reflects a misunderstanding of the nature of card-based payment services.

It is important that these issues are carefully addressed. This is the purpose of the next two chapters.

3. THE NEED FOR REGULATORY ACTION

3.1. INTRODUCTION

This section presents a summary of the RBA's main arguments for the need to regulate the designated card schemes and analyses the key elements. This leads to the conclusion that the RBA has failed to diagnose the situation correctly and is consequently focusing on the wrong problem.

The RBA's starting point is the Joint Study. On pages 6-7 of the Consultation Document, the RBA describes the conclusions of that Study as follows:

> *"The Joint Study concluded that in card networks, competition is not working as it should. In the case of the credit card schemes, the Joint Study found that:*
>
> - *interchange fees are not reviewed regularly by scheme members on the basis of any formal methodologies;*
> - *interchange fees are higher than can be justified by costs, and scheme members lack clear incentives to bring these fees into line with costs;*
> - *the "no surcharge" rule suppresses price signals that guide the efficient allocation of resources; and*
> - *restrictions by credit card schemes on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed."*

The RBA has not resiled from these "findings" despite the many contrary arguments presented in submissions. Rather, the "findings" are amplified and extended by the RBA in the Consultation Document.

3.2. RBA'S ARGUMENTS FOR REGULATION

In summary, the main arguments put forward by the RBA in the Consultation Document supporting the need to regulate the designated schemes are as follows:

1. Holders of credit cards are confronted with distorted price signals when deciding which payment instrument they should use to make a payment. This leads them to choose their credit cards, as their preferred payment instrument, in situations where it is economically inefficient for them to do so. As a result, there is excessive growth in a relatively costly and inefficient payment instrument (namely credit cards). The cost of this inefficiency is passed on to the general community in the form of higher prices for goods and services.

2. This situation arises because:

- interchange fees (paid by acquirers to issuers) for the designated schemes are at a level which is significantly above costs – this enables issuers to provide services and incentives to credit card holders at “subsidised” prices; and

- the cost of the interchange fees is passed on to merchants accepting the cards by their acquirers, but the “no surcharge” rules imposed on these merchants prevents them from recovering the cost of card use specifically from card holders. Consequently, merchants are forced to recover these costs by raising the general level of their prices.

3. Market forces are too weak to correct this situation because:

- the designated schemes are dominated by issuers who have an interest in promoting their own profits through the maintenance of high interchange fees. This issuer dominance is maintained by:

  - “net issuer” rules, which penalise members whose issuing activity is insufficient relative to their acquiring activity;

  - membership eligibility rules, which effectively restrict membership to deposit taking institutions; and

  - rules prohibiting self-acquiring except in limited circumstances;

- merchant resistance is weak due to the fact that acceptance of credit cards has become a “condition of doing business” (ie merchants cannot individually opt out because of the competitive disadvantage they would suffer as a result);

- there is little competition between the open schemes due to their overlapping membership and governance – in particular, the four major banks are represented on each of the open schemes, they do not actively promote the cards of one scheme over another, and competition between the schemes is limited to advertising undertaken by the schemes themselves;

- there is limited competition between the designated schemes and the closed schemes because of the latter’s relatively small market share and niche focus;

- there is limited competition between credit cards and debit cards because interchange fee pricing structures provides issuers with the incentive to promote credit cards at their expense; and

- there is limited scope for new credit card networks to arise because network effects provide strong competitive advantages to large established schemes.

This leads the RBA to conclude:[21]

> *"In the Reserve Bank's opinion, the current arrangements for the collective setting of interchange fees, were they to persist, would not be in the public interest."*

The arguments set out above are generic ones for the designated schemes as a whole. In the Consultation Document, it is not always clear whether the arguments are intended to apply to each of the schemes individually. As indicated in section 2.4.1 above, Bankcard considers that it would not be appropriate to regulate it on the basis of generic arguments. Rather, Bankcard's individual circumstances need to be considered before any decision to regulate Bankcard is taken.

In Bankcard's case, therefore, arguments for the need to regulate must be considered in the context of Bankcard's own rules. Specifically, Bankcard has liberal entry requirements and does not apply "no surcharge" rules. This means that, looking to the future, the alleged economic inefficiencies (outlined in point 1 above) must be attributable in Bankcard's case to the setting of interchange fees alone, and the alleged misalignment of these fees will not be attributable to the restrictions in scheme rules listed in the arrow points in point 3 above.

3.3. ANALYSIS OF THE ARGUMENTS

3.3.1. Issuer Power

The RBA refers to the ability of issuers to use their collective power in setting and maintaining interchange fees at a high level in several places in the Consultation Document. For example, on page 41 of that document, the RBA describes the fee-setting arrangements in the designated schemes as follows:

> *"The longstanding arrangements are characterised by secrecy, rigidity and lack of any objective and clearly articulated methodology. Such arrangements, in the pursuit of maximum credit card usage and scheme members' profits, run the serious risk of leading to overprovision of credit card services and inefficiently high merchant service fees."*

The fact that scheme members set interchange fees as part of the scheme joint venture arrangements is well known. That they should seek to maximise profits for the scheme as a whole should not be surprising[22]. However, from an efficiency perspective, it is important to distinguish between profits earned as a result of higher volumes of service, and those earned as a result of super-normal profitability (ie rate of return on capital).

[21] *Ibid*, page 41.

[22] In section 2.3.3 above, the similarity between closed schemes and open "collectives" in this respect was noted.

The RBA clearly thinks that issuer profitability is excessive. On page 84 of the Consultation Document, it presents data from the Joint Study with the statement that:

> *"indicative figuring by the Reserve Bank – based on the main risks against which capital would be held – suggested that the margins in credit card issuing and acquiring were well above what would be required to provide a competitive rate of return."*

As shown below, this claim fails to stand up to scrutiny.

The key question to be addressed is whether the issuers in the designated schemes have the power to drive up their profits above normal levels. What is the evidence for the RBA's hypothesis of issuers power?

Let us first consider the claim that issuer profits were shown by the Joint Study to be excessive. The original analysis in the Joint Study was erroneous, as the RBA itself now admits[23], so the RBA presents an alternative argument. Unfortunately, however, this argument relies on some "indicative figuring" which is not disclosed. The RBA presents instead a table[24] containing a few figures from the Joint Study and a calculated figure (39.4%) described as the "mark-up on direct costs". Why this figure is presented is not clear, for it has no economic significance in itself. Unfortunately, the analysis is again lacking – that the RBA could get the analysis wrong in the Joint Study is remarkable: that it can fail to get it right a second time, after the error has been pointed out, is extraordinary.

The correct comparison could easily have been done by the RBA. It is shown in Table 1 on the next page. The figures used in this table are all taken from the Joint Study. In particular, the figure included for capital costs was described in the Joint Study as follows:[25]

> *"Taking as a proxy for* (credit card issuing) *risks the value of credit card lending outstanding, and using average capital ratios for the banking sector, some very preliminary figures would suggest a margin over costs in the order of $0.30 a transaction would provide a competitive rate of return on capital for credit card issuing."*

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[23] On page 86 of the Consultation Document, the RBA states: "The Reserve Bank acknowledges that expenditure on loyalty programs affects issuers' accounting profits." The RBA then goes on to claim that in an "economic sense" loyalty programs "affect the price at which credit card services are provided to cardholders but are not a cost that is integral to the provision of these services." The RBA's reference to "accounting profits" in contrast to "economic" considerations is clearly devoid of substance, however, for there is no economic sense in which issuers retain the revenues they expend on loyalty programs – a reduction in price to cardholders is simply another way in which issuer profits are reduced.

[24] Table 4.1 on page 84 of the Consultation Document.

[25] Joint Study, page 46.

TABLE 1: Credit Card Issuer Revenues and Costs per Transaction 1999[26]

Revenues	($)		Costs	($)
Annual fees	0.33		**Operations**[27]	1.25
Interest margin	1.36		Interest-free period	0.26
Interchange fees	0.95		Fraud	0.07
Other	0.05		Credit losses	0.35
			Subtotal	**1.93**
			Loyalty program[28]	0.46
			Capital[29]	0.30
Total	**2.69**		***Total***	**2.69**

The fact that average costs and revenues for issuing are equal when all costs are included and a reasonable allowance for a return on capital is added shows that, on average, the industry is making normal profits. To the extent that some issuers are making above average returns, there must therefore be issuers making below average returns. This implies that, at the margin, the industry is making below-normal profits. Therefore, the RBA's conclusion that the industry enjoys super-normal profits is false, and can be seen as such on the basis of the RBA's own data.

A lack of super-normal profits is, in fact, characteristic of an industry experiencing strong competition. Is this conclusion supported by other evidence?

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[26] Figures shown are annual industry averages.

[27] Figures shown in Table 5.1 of the Joint Study for individual components do not add to the total shown. Since the main reason for this appears to be the interaction between differences in classifications employed by individual reporting banks and the RBA's process of excluding outliers, the figure shown for operations has been obtained by subtracting the component costs shown for the interest-free period, fraud and credit losses from the total issuing cost per transaction shown in the table. This accords with the RBA's stated belief that the totals in Table 5.1 of the Joint Study are accurate, and its own use of the separate figures for the component costs in Table 5.2 appearing on page 47 of the Joint Study.

[28] The figure for the average per transaction loyalty program cost is reported on page 44 of the Joint Study.

[29] The figure of 30c per transaction is suggested on page 46 of the Joint Study.

Given below-normal profits at the margin, did issuers use their alleged power to raise interchange fees? Or, again, did issuers use their alleged power in the early 1990s to raise interchange fees at a time when the industry was experiencing substantial losses? The fact is that, in the history of credit cards in Australia, interchange fees have not been raised except on one occasion – and that occasion corresponded with the introduction of the GST. Moreover, that GST-related rise was advised to, and sanctioned by, the ACCC at the time, under its commission from the Government to ensure that only GST induced price rises were permitted. Further, contrary to the assertions[30] of the RBA in its Consultation Document, interchange fees on the majority of electronic transactions were reduced in the early nineties. Rather than bring down the so-called "standard" rate, the reduction of interchange fees on "electronic" transactions was effected in recognition of the lower costs associated with these transactions, and to encourage the rapid adoption of electronic technology by acquirers and merchants.

The RBA has also pointed to the extent of concentration in the issuer market as indicative of a lack of competition. The RBA notes that the four major banks account, as issuers, for 87% of transactions undertaken on bank-issued cards. This figure, however, overstates the degree of concentration for two reasons. Firstly, non-bank issuers are ignored. Secondly, co-branded arrangements where a bank is the "official issuer" are treated as being the same as cards actually issued by the bank itself. Co-branding partners frequently have a considerable, if not the dominant, influence over the issuing arrangements, particularly when a large co-branding partner is involved. It also ignores the fact that the market performance of such arrangements often differs markedly from the performance of the cards issued by the bank in its own right and competes with these. For example, the Qantas-Telstra-Visa card now holds one of the top-ranking positions in terms of market share in Australia.

In any case, market concentration alone does not indicate a lack of competition. It is more important to examine the dynamic behaviour of the market. The myriad of card features and issuer co-branding arrangements evident in the market today, the continued appearance of new varieties, the significant shifts in market shares that have occurred between issuers and between schemes over the last decade, and the continuing high cardholder churn rates point to an intensely competitive market.[31]

In summary, the RBA's claims regarding the profitability of issuing do not stand up to scrutiny. The available evidence, including evidence collected by the RBA itself for the Joint Study, indicates that issuing is a highly competitive activity.

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[30] For example, on page 34 of the Consultation Document, the RBA states: "Australia has not enjoyed reductions in interchange fees as the credit card networks have grown in scale and per unit costs declined". This statement is false.

[31] According to the independent financial services research group, CANNEX Australia, there are at least 50 financial institutions in Australia issuing open scheme cards. In addition, there are a number of other co-branding arrangements eg Qantas, Woolworths supported by a major bank.

The fact that issuing for the open schemes is competitive has the following important consequences:

1. Issuers do not earn super-normal profits if interchange fees are raised – the higher interchange fee revenue is, instead, quickly bid away by issuers offering enhanced card features (eg in "rewards" programs) in an effort to attract and retain cardholders.

2. Issuer profitability is not reduced by a reduction in interchange fees (although there may be short-term costs associated with the transition to a new interchange fee level).

3. Since issuers do not gain or lose from changes in interchange fees, except to the extent that the volume of card usage is affected, their main interest in interchange fees is in promoting the success of the scheme as a whole. Acquirers also have a similar interest in promoting the overall success of the scheme, since their success is also linked to the volume of transactions. The alleged "issuer dominance" of the open schemes should not therefore be of major regulatory concern.[32]

4. For any given level of merchant contribution (via interchange fees) cardholders receive the most efficient mix of card benefits and fees. Hence, any change in interchange fees ultimately translates into a change in the nature of the card "product" available on the market.

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[32] The RBA appears to view negotiations between issuers and acquirers as a process of conflict, with issuers wanting higher interchange fees to increase their profits and acquirers wanting lower interchange fees to increase theirs. In addition, the RBA appears to regard issuers as advocates for cardholder interests and acquirers as advocates for merchant interests. For example, the RBA states on pages 39-40 of the Consultation Document:

> *"The interests of merchants and cardholders both need to be taken into account in assessing the effects on economic efficiency of the negotiating process on interchange fees which the international card schemes have described. If issuing is more strongly represented in this process than acquiring, there is likely to be insufficient account taken of merchants' interests; the opposite would apply if acquiring is more strongly represented."*

This view misses the point that the fortunes of issuers and acquirers are tied together in that both gain if transaction volumes can be increased, and both lose if they decrease; and neither side can affect their margins by tampering with interchange fees because these margins are determined by the level of competition in the respective issuing and acquiring markets. To achieve maximum transaction volumes, therefore, both issuers and acquirers are concerned with the interests of both cardholders and merchants so that they can ensure, as far as possible, that the interchange strikes a reasonable balance between these two sets of interests. So, although issuers and acquirers bring different information to the negotiating table, they share a common goal. A corollary of this is that, to the extent that scheme members appreciate the interests of the parties on both sides of a card transaction, the more likely they are to make accurate judgements on the best setting of interchange fees. It is therefore in a scheme's interests to encourage its members to be both issuers and acquirers.

3.3.2. Neutrality of Interchange Fees

The neutrality argument for interchange fees asserts that economic efficiency is not affected by the level of interchange fees if merchants are able to set separate prices, without cost, for purchases according to whether they are made by cash of by card. This result is independent of the nature of competition within either the issuing market, the acquiring market or the retail market. The importance of this "neutrality" result is that, if accepted, it would imply that interchange fees should not be an object of regulatory attention.

In the RBA's "**Commissioned Report**"[33], Professor Katz summarises the neutrality proposition as follows:

> *"If there is a unique equilibrium in each of the merchant, acquiring, and issuing markets for a given interchange fee, then there is a unique set of equilibrium consumption and output levels and it is invariant with respect to the level of the interchange fee."*

The neutrality argument works intuitively as follows. In each of the three markets – issuing, acquiring and retailing – the participants are seeking to maximise their profits. As a starting point, assume interchange fees have been set and these markets have reached a stable equilibrium position. Suppose, now, the interchange fee is raised by some given amount. We need to consider what happens.

If the increase in the interchange fee were fully passed on to cardholders and merchants via changes in their (net) transaction fees, a cardholder would enjoy, for any given transaction, a fee reduction (or benefit increase) exactly matching the fee increase experienced by the merchant. If the merchant's fee increase were then passed on to the cardholder (eg via an increased surcharge on the transaction for card use), the cardholder would be left facing exactly the same effective price for the transaction as before.[34] Thus, consumers would have no reason to change their behaviour, and all parties would be facing the same net cost, benefits, transactions and profits as before.

[33] REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA; II Commissioned report; RESERVE BANK OF AUSTRALIA; August 2001, page 18.

[34] Moreover, since merchants fully pass on the increase in their transaction fees to cardholders, there is no effect on transactions executed by cash-paying customers.

Would this new situation be a new equilibrium? The answer is "yes". Cardholders, facing an unchanged pricing structure would not change their behaviour, while issuers, acquirers and merchants, facing the same volume of transactions generating the same net revenues as before, would be still be unable to take any action (such as changing prices, services or other benefits) to improve their profits.[35] In short, the new situation would again be an equilibrium position. The fact that volumes, incomes and effective prices are all unchanged means that this new equilibrium generates precisely the same level of economic welfare as before.

Would the economy move to this new equilibrium? The same forces which drove the economy to its initial equilibrium would act to drive the economy to its new equilibrium.[36] In his summary, Katz[37] draws attention to the additional role that expectations would play: since everyone would *expect* a pass-through of cost increases they would act on that expectation while issuers would enhance cardholders' net benefits to avoid a loss of transactions.

The neutrality argument holds, therefore, under extremely general conditions, provided that merchants can pass on their costs of card acceptance directly to cardholders, without incurring significant additional costs in doing so. While this assumption may be very close to the truth for many merchants, it may not be true in practice in some segments of the retail market. This issue is therefore the subject of further examination in the section below.

[35] The assumption that the markets were in equilibrium under the initial interchange fee means that all opportunities for participants to increase their profits had been exhausted.

[36] Katz's assumption of the uniqueness of the (initial) equilibrium position is not essential, but it avoids the problem of analysing the situation when a change in the interchange fee large enough to cause the economy to migrate to a different equilibrium. The existence of multiple equilibria, in any case, creates difficulties for welfare analysis.

[37] Commissioned Report, page 18.

3.3.3. Merchant Differential Pricing

The question to be examined is: given no prohibition on merchant "surcharging" (or discounting) for card transactions, what determines merchants' behaviour in setting price differentials for card use, and how does this effect economic efficiency?

The key issues can be demonstrated by considering some transitions within a simple model. To simplify the exposition the following assumptions, all of which have been argued by the RBA, are made:

- The overall level of sales in the economy is fixed (ie benefits from increased sales are ignored);
- The costs involved in performing a card transaction are higher than the costs involved in execution an equivalent cash transaction: and
- The market for retail goods and services is competitive.

The aim is to examine the model under different sets of conditions. These conditions are chosen to facilitate comparison of the relative efficiencies. By choosing a chain of different conditions with, say, increasing economic efficiency at each step, we can be sure that the final conditions are more efficient than the starting ones. Providing the end conditions are realistic, it does not matter whether the intermediate conditions are realistic or not – the intermediate steps are no more than an analytic tool.

We begin with the economy in a state where cards do not exist and transactions take place using cash for payment. Into this economy we introduce a card system, subject to a "decree" that the price paid by a cardholder in making a purchase from a merchant using a card will be equal to that merchant's cash price plus an amount that just covers the merchant's net additional costs in offering card payments. These additional cost would include the merchant service fee paid to the merchant's transactions acquirer, the costs of installed equipment and staff training, the costs of dealing with customer confusion and complaints regarding the merchant's differential pricing for card-based transactions, the cost of IT systems required to facilitate differential pricing, and so on. Merchants are free to accept cards if they choose, and consumers are free to obtain cards if they wish and use them to pay merchants who accept the cards, provided they are willing to pay the higher price charged by merchants for card use.

The effect of introducing card transactions in this way is similar to introducing a new product into the market at its incremental price. Merchants are free to "supply" card services as they wish and consumers are free to "buy" card services. The pricing decree for credit card services would ensure that the introduction of cards represented a gain in economic efficiency. This appears to be the kind of model the RBA has in mind and is seeking to promote through its proposed regulations. Moreover, under these conditions, as the previous section showed, if the card scheme is open, economic efficiency is not affected by the level of interchange fees set by the scheme.

Now suppose we remove the decree. Two things happen. Some merchants will decide to maintain differential pricing but may change the pricing gap between card and cash purchases.[38] Provided this is done under competitive conditions, we can be confident that this increases economic efficiency.

Other merchants will decide to abandon differential pricing, setting instead common prices for card and cash transactions. Their reason for doing this would be to avoid the costs of maintaining differential pricing. This cost avoidance behaviour, when undertaken under competitive conditions, also leads to an increase in social welfare. At the same time, however, it also leads to a transfer of income from cash payers to cardholders, an "under pricing" of credit card services and an "over usage" of credit cards.

It is worth considering both of these propositions a little more to gain a better intuitive understanding of what is implied. This can be done with the aid of a simple numerical - model at the "aggregate sales" level.

Suppose the additional cost to a merchant of executing an average card based transaction of $100 (ie the cash price) is $2, including the merchant service fee, and that the cost to the merchant of maintaining differential pricing amounts to an additional $1 on the transaction. Suppose further that, in deciding whether to pay by cash or card, consumers weigh up the convenience value and other card benefits against the price differential for card use. For the sake of simplicity we assume a linear demand schedule for card services:

- at a price differential of $3 only 20% of consumers choose to use their card;
- at $2 differential, 30% use their card;
- at $1 differential, 40% use their card; and
- at no differential, 50% use their card.

Under the decree, consumers face a cash price of $100 on the average transaction and a price of $103 for the same bundle of goods and services if they pay by card. 20% of consumers choose to pay by card while the remainder pay by cash.

[38] Their motive for this might be that consumers, in choosing to become a card payer, or remain a cash payer, may have separated themselves into two groups with different price sensitivities. Where fixed costs of production are involved, application of a higher price to the less sensitive group and a lower price to the more sensitive group increases both merchant competitiveness and economic efficiency.

Merchants, under competitive pressure, decide to narrow and finally abandon the price differential. They reach a final position (according to the demand schedule above) where 50% of their customers choose to pay by card while the remaining 50% choose to pay by cash. Merchants now strike a common average price for the transaction of $101. What has happened to economic efficiency? The 50% of customers who decided to remain as cash payers have each lost $1 of their consumer surplus (ie they now pay $101 instead of $100). The 20% of consumers who were initially card users have each gained $2 ie they now pay $101 rather than $103). Each of the original cash payers who converted to card usage (the remaining 30% of consumers) has gained the benefit of card services but has had to pay $1 more than before. What is the average value these consumers place on these card services? Given the assumption of a linear demand curve (and a shrinkage of the card price differential from $3 to zero) this value can easily be calculated: it is on average $1.50. Putting these figures together yields an average gain per consumer of 5c.[39]

The model highlights some simple results. First, over usage of cards can be dramatic but remain consistent with economic efficiency.[40] Moreover, the model illustrated that a transfer of income away from cash payers towards card payers may be more efficient than without it. This is because the cost savings from merchants' abandoning price differentials may outweigh the deadweight losses associated with "distorted" price signals. In short, the evidence of card "over use" and "cross subsidisation" presented by the RBA cannot be regarded as evidence for economic inefficiency at all. In a competitive retail market, merchants will take decisions leading to those outcomes in the interests of their own competitive positions, generating these results as a by-product, and increasing economic efficiency in the process.

3.3.4. Merchant Resistance

In the Joint Study the authors note:[41]

> *"It may be true, for an individual merchant, that acceptance of a credit card increases its sales because it can attract customers from other merchants that do not accept cards. But as credit card networks become more widespread, accepting a credit card becomes a condition of doing business rather than a means of gaining an advantage over competitors."*

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[39] The calculation is as follows: 50%*(-$1) + 20%*$2 + 30%*($1.50 - $1) = -50c + 40c + 15c = 5c.

[40] In the model there was a 150% over usage based on assumptions that do not appear to be too far from reality.

[41] Joint Study, page 28.

This statement indicates that merchants' credit card acceptance forms part of their individual "competitive strategy of attracting sales from, or not losing sales to, rival merchants"[42]. It also attests to the efficacy of the strategy. The RBA regards this as a problem because the strategic nature of credit card acceptance is seen as severely limiting merchants' ability to resist merchant service fees.

It is worth noting that competitive strategies to attract customers are commonplace for merchants. A clothing store, for example, might find that the "conditions of doing business" include the provision of an array of merchandise on display, trained staff to answer questions and provide assistance, change rooms for potential customers to try on items for sale, a pleasant décor including carpets, lighting and furniture, a convenient pick-up window in the car park and so on. In a competitive market none of this causes any problems from an efficiency perspective, even though not all customers use the services provided but may still pay the same prices for their purchases as customers that do use them[43]. The decisions of merchants, taken in their own competitive self-interests, ultimately enhance the welfare of their customers, since it is precisely the customers' expressions of their preferences that drive merchants' competitive advantage.

Efficiency issues arise, however, in the case where the suppliers of a strategic item enjoy market power. If, to continue the previous example, there were only one supplier of change rooms, that supplier could set an above-normal price (ie a price that would yield monopoly profits) and thus appropriate some of the competitive advantage each merchant derives from having them installed. Although the entry of the monopoly supplier into the market would increase social welfare (assuming that clothing retailing is competitive and the monopoly supplier will provide change rooms to all merchants that are willing to pay), welfare could be sub-optimal for two reasons. First, at the margin, some merchants may decide that the price for change rooms is too high and they will battle on in business without them or cease business altogether. Second, those that install change rooms need to charge higher prices for items of clothing than would have been necessary under competitive supply conditions, leading some consumers to decide not to buy when they would otherwise have regarded it as being in their interests to do so.

It is instructive to consider what actions a regulator might take in this situation to increase economic efficiency. Consider the following arguments:

[42] Consultation Document, Executive Summary, paragraph 3.

[43] The reasons why customers paying the same price for different levels of service and resource utilisation does not represent a sub-optimal level of economic efficiency was outlined in section 3.3.3 above in relation to credit cards. Precisely the same economic considerations apply in both cases.

1. *Change rooms should be banned (or "redefined" or their prevalence scaled down). They do not add to the aggregate level of sales but only serve to increase the price of clothing as merchants compete with each other for customer patronage. If they were banned, the price of clothing would fall and economic efficiency would be increased.*

This argument is misconceived. It assumes that, because change room services are not separately "sold", they are not an integral part of the merchant's business, and can be cut away without loss. It ignores the fact that change rooms are a strategic item for merchants because of the high value that consumers place on their services. That value must exceed the cost to merchants of providing change room services. Otherwise, merchants could enhance their businesses by creating superior benefits to consumers out of the money saved by not installing them. Hence, banning change rooms would reduce social welfare – it would destroy more consumer value than it would save in costs.

An alternative way of reaching the same conclusion is to appeal to the fundamental result in economics that competitive markets are efficient. Since change rooms seem likely to be adopted by merchants in competitive clothing markets, the argument that merchants are not making the correct decisions in the circumstances they face is tantamount to a denial of that result.

2. *The price charged by the monopoly supplier of change rooms should be regulated. This will reduce the cost to merchants and will be reflected in lower prices to consumers, thus increasing economic efficiency.*

The problem with this approach is that the supplier may respond by producing inferior "quality" change rooms to maintain profit margins. Since, prior to regulation, a self-serving monopolist is likely to have been producing change room of close to optimal quality (ie the point at which the strategic benefits to merchants of an improvement in quality would match the increase in cost required to produce them), any reduction in quality is likely to detract from economic efficiency.

This drawback could be avoided if the regulator was prepared to specify the "product features" of change rooms (at the level prevailing in the market) as well as the price. However, efficiency could still be sub-optimal for two reasons:

- Merchants could face a "choice problem". Merchants may not all need, for example, the standard model change rooms specified by the regulator to enhance their business: for some, a cheaper version, and for others, a deluxe model, had they been available, would have been more cost effective. But purchase of the standard model may be better than nothing, so merchants make do with their "all or nothing" choice.

- The regulations may be dynamically inefficient. As the markets evolve, the optimal characteristics of change rooms may vary. However, there is no obvious mechanism to guide appropriate changes to the regulator's product specifications.

3. Additional suppliers of change rooms should be encouraged to enter the market.

If this is feasible, and the cost of encouraging new entrants is minimal, it is clearly the preferable solution. Competition would put pressure on supplier margins, promote innovation and ameliorate the problem of merchant choice.

Insights from the above example can be applied to the credit card market. If this market were supplied by a single closed scheme, that scheme could exploit the weakness in merchant resistance to maximise its own profits.[44] Specifically, it would do this most effectively by tailoring merchant fees to the individual merchant, so as to appropriate as much of the merchant's strategic benefit as possible, without causing the merchant to withdraw from the scheme. Regulatory action could be taken to limit merchant service fees, but this is likely to induce the scheme to reduce net cardholder benefits, thereby reducing the value of the card to cardholders, reducing the efficacy of card acceptance as a strategic tool for merchants and reducing economic efficiency. If the regulator were simultaneously prepared to specify the card product features (at their current market levels), the monopoly profits of the closed scheme could be reduced. Allocative efficiency would be thereby enhanced at the expense of dynamic efficiency. The problem of limited merchant choice would, of course, still remain.

A different result emerges in the case of the designated schemes. Here, as we saw in section 3.3.1 above, issuing is competitive and issuers cannot exercise their market power to generate super-normal profits. As discussed in that section, regulatory action to reduce interchange fees would simply force a reduction in net cardholder benefits without affecting issuer profitability. Thus, regulatory action with respect to interchange fees would solve neither a "monopoly" problem nor a "merchant choice" problem. Rather, it would simply result in a different credit card "product" being offered on the market, presumably with weaker strategic characteristics from a merchant's point of view (reflecting the reduced net cardholder benefits). As in the example above, provided the retail markets are sufficiently competitive, that corresponds to a reduction in economic efficiency.

This is an important conclusion. As with the example of clothing stores given above, it indicates clearly the superiority of a regulatory approach focused on creating competition in relevant markets and on increasing the real choice available to merchants in making their credit card acceptance decisions.

Before concluding this section, there remains a further question that should be addressed namely: why is credit card acceptance a strategic decision for merchants? Or, to put that another way, why has credit card acceptance become "a condition of doing business"? What features of credit cards are important in this regard?

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[44] The case of a single card scheme in which issuers have market power has been studied extensively by Rochet & Tirole in Jean-Charles Rochet & Jean Tirole; Cooperation among Competitors: Some Economics of Payment Card Associations; 30 October 2001; mimeo.

Virtually every credit card holder also holds a debit card. In fact, cardholders' debit and credit card facilities are frequently combined on a single piece of plastic, through so-called "linked" accounts. Debit cards provide essentially the same "pure payments" convenience at any EFTPOS-enabled merchant, making them virtually perfect substitutes in this regard. Nevertheless, the shift toward credit card usage, which is of concern to the RBA, is evident at these merchants.

One possibility is that debit cards do not typically have attached lines of revolving credit. If this were the problem, it could be easily and directly addresses by the RBA by encouraging debit card issuers to provide attached overdraft facilities. This would create relevant merchant choice, without the need to regulate interchange fees.

It is more likely, however, that the great attractiveness of credit cards to consumers, which makes them strategically important to merchants, lies in their other "non payment" attributes. These are precisely the features of credit cards that cause the RBA most concern, namely the guaranteed reimbursement for merchant non-fulfillment, the provision of an interest-free period until payment is due, and the various attached "loyalty" programs that are offered "free", or at "subsidised" prices to credit card holders. These features did not appear by accident: they have been carefully modeled on the proprietary enhancements that merchants have offered consumers to attract their patronage.

Some immediate observations can be made based on the above considerations:

1. Credit cards are more than a payment instrument with an attached line of revolving credit. They offer "non-payment" cardholder benefits which are so highly valued by cardholders that credit card acceptance has become a strategic business consideration for many merchants.

2. Mandatory reductions in credit card interchange fees amount, in effect, to an enforced scaling back of these features.[45] This is a misconceived regulatory approach, which leads to a reduction in economic efficiency. The RBA advocates this approach because it refuses to view cardholder "non payment" benefits as legitimate or take their reduction into account in its welfare considerations.

3. The RBA does not appear to be concerned by the emergence of free "non payment" benefits to cardholders in proprietary card schemes (eg store cards) even when the stores offering them have substantial market share. However, it is concerned when merchant acceptance of such cards is made widely available through open schemes, although apparently not if they are closed schemes. There is no logic in this.

[45] Because of issuer competition. See section 3.3.1.

3.3.5. Open Scheme Cards and Store Cards

In their Joint Study, the RBA and ACCC remark on what they appear to regard as a curious phenomenon:[46]

> *"The interest-free period … offers benefits to both merchants and cardholders. For small merchants who have never provided credit to their customers, participation in a credit card scheme allows them to offer a credit facility. Credit card schemes also allow other merchants to substitute credit funded by financial institutions for credit they were providing themselves. Even so, large merchants in Australia typically retain their store cards, which offer a credit facility. The continued existence of store cards suggests that large merchants consider the benefits of offering their own card, particularly in generating loyalty to the store, to outweigh any additional costs of providing credit themselves. Substituting credit provided by a financial institution which is a member of a credit card scheme for these store-based credit programs is therefore not an unambiguous benefit for these merchants."*

In this quotation, the authors hint at the nub of the issue, namely that competition between credit cards and store cards is, in reality, an element of the more general competitive process between large and small retailers. Large retailers offer store cards because it gives them a competitive advantage and small retailers accept credit cards because it allows them to respond to this competitive challenge.

Historically, both closed scheme and open scheme credit and charge cards evolved from store cards. Originally, charge accounts, and later "retail" or "store" cards, were developed by large merchants as a means of retaining the custom of selected clients. In the 1950s, Diners Club introduced an innovation, namely a card that was accepted at a variety of restaurants, rather than at a single store. Because the handling of fraud and credit typically requires know-how and involves economies of scale, it was not long before smaller merchants were collectively contracting out the provision of card services to financial institutions in an effort to compete with the store cards of their larger rivals. Both MasterCard and Visa evolved from this process.

Let us examine this competitive process in a little more detail. In principle, store cards could carry a surcharge that enabled the stores to recover the cost of providing the facility from the cardholders themselves. As discussed in the section 3.3.3 above, there is no question that offering a new store card facility under these circumstances would increase social welfare. However, unlike the situation discussed in section 3.3.3, there may be a marked divergence between the private effects on a retailer's profits and economic welfare if the retailer chooses not to differentiate prices according to the method of payment.

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[46] Joint Study, pages 47-48.

Specifically, if by offering a store cards at no additional cost to the cardholder, more consumers are induced to patronise the retailer's store, the offer will make good commercial sense if the net incremental revenue from the additional customers exceeds the cost of providing the store card. However, in choosing to offer a store card in this way, the retailer is exercising a degree of market power. That power is afforded by the exclusive access the retailer has to the store card: the store, in effect, has a monopoly on the supply of services from these cards to the market.

Other large retailers may choose to respond by offering their own store cards. This puts similar, but not necessarily identical, card products into the market and provides a degree of competition. However, the only practical avenue available to small merchants to respond is by collectively offering acceptance of a widely available card with comparable features.

What is important to these smaller merchants is not what features the card offers, why these features are offered or how they have been negotiated between the consumer and the card issuer, but whether they act as an effective counter to the features offered by competing store cards. By accepting such cards, smaller merchants are restoring competitive balance in the retail market, and enhancing economic efficiency in the process. With competition restored, decisions on whether to apply differential pricing for card use are likely to be consistent with enhancing economic efficiency, as discussed in section 3.3.3.

It is this role of credit cards, ie their role in providing a counterweight to store cards, that puts them into competition with these store cards. If a credit card scheme cannot offer card features which, in consumers' estimation, have a value similar or superior to that offered by store cards, its acceptance in the market is likely to be significantly curtailed.

The foregoing has two main consequences namely:

1. the utility of credit card acceptance for smaller merchants derives importantly from its usefulness as a competitive response to store cards;

2. since competition between issuers ensures that open scheme cards are issued with the most efficient mix of cardholder benefits and fees for any given level of interchange fees, the level of interchange fees is the key determinant the effectiveness of these cards in providing smaller merchant with a strategic response to store cards; and

3. the features of credit cards need to evolve over time in response to the features offered by store cards.

3.3.6. Inter-System Competition

Card payment systems may compete with each other for market share, but ultimately this means competing for cardholders and merchants.

Issuers also compete for market share. Since the issuers for the open schemes are operating in a competitive market, they are, as a general rule, indifferent to which card the customer takes (since they earn on average only normal profits from their issuing activities) so they offer customers a choice and make sales at minimum cost. This means that schemes must compete by offering superior card services such as wider merchant acceptance, including overseas (ie network benefits) superior brand attractiveness (eg through special promotions or relationships with important organisations or events) superior information services (eg a travel assistance hotline) or cardholder support services (eg for lost or stolen cards). They could also provide higher interchange fees to issuers to enable them to offer cardholders more attractive issuer card benefits.

Similarly schemes can compete for merchants by offering, for example, superior network benefits such as access to a larger, wealthier or more transactions-motivated cardholder base, enhanced information services and so on. They could also ensure lower merchant service fees by reducing interchange fees.

The different elements of inter-scheme competition can be found to different extents in the market. As a general observation, competition for cardholders has been vigorous (at both the scheme and the issuer level), and significant shifts in the market shares of the three designated schemes have occurred over the last decade as a result of that competition. However, although competition for merchant acceptance has been vigorous at the acquirer level,[47] it appears to have been far less effective at the scheme level, and the open schemes have maintained almost identical merchant acceptance bases.

A comment by Rochet and Tirole[48] on the general dynamics of inter-scheme competition provides an important insight into this state of affairs, and the following analysis builds on that insight. There are several factors to consider:

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[47] There have been marked shifts in acquirers' shares of merchants over the last decade and merchant churn rates among the major acquirers remains high. Moreover, a significant proportion of merchants have an acquiring relationship with a financial institution other than its main bank. This points to a high level of competition between acquirers. However, acquirers are typically indifferent to merchants' choice of card acceptance, and the high level of overlap in schemes' merchant acceptance bases suggests that competition for merchant acceptance at the scheme level has been less effective.

[48] Rochet and Tirole, pages 21-22.

1. Because of the relatively high fixed costs associated with credit card acceptance by merchants and the possibilities for joint acceptance of the cards of different schemes using the same infrastructure, merchants are more likely to accept the cards for a number of schemes, all else equal, rather than settle for just one scheme. In short, the economics of card acceptance creates a positive correlation between merchant acceptance decisions.

2. In contrast, because consumers face budget constraints, a decision to become a cardholder for one scheme makes it less likely, all else equal, that a consumer will become a cardholder for another scheme. In short, the economics of cardholder decisions introduces a negative correlation into consumer decisions to hold cards.

3. Ignoring the correlation noted in the first point, if cardholders hold at most one card, merchants' decisions on accepting cards from different schemes are independent. This is because each acceptance decision gives a merchant access to a separate group of consumers (ie those holding the particular scheme's cards) and the merchant can weigh up independently the benefits of that access. The more overlap between the cardholders of different schemes, the more the schemes are put into competition with each other for merchant acceptance. For example, if the cardholders of two schemes were identical, a merchant could reject acceptance of one, knowing that its cardholders are carrying the cards of the competing scheme in their wallets.

4. Ignoring the correlation noted in point 2 above, if the sets of merchants accepting the cards of different schemes are disjoint, consumer decisions on card selection are independent. In the contrary case where schemes enjoy identical merchant acceptance, the schemes are put into competition for consumer selection, since consumers can select one card without sacrificing access to merchants.

Bringing these factors together, it can be seen that vigorous competition by schemes for cardholders, together with closely matching merchant acceptance patterns, represents a likely stage of development for schemes that have comparable access to the market through their issuers and acquirers, closely matching card attributes, and similar levels of interchange fees. However, as the schemes mature, and overlapping cardholding occurs with increasing regularity, the door is opened to competition between the schemes for merchant acceptance.

The incidence of cardholders in Australia with cards from more than one scheme is rising. In the Consultation Document, the RBA claims that there are now 15 million credit cards on issue, held by around 60% of persons aged 18 or above. This implies that the average number of cards held by cardholders is around 1.7. Moreover, the strong growth in credit cards on issue suggests that this number is rising rapidly.

This development sets the scene for the emergence of vigorous inter-scheme competition for merchant acceptance. And this competition will create choice – since there are no monopoly profits in issuing to be bid away in the process of competition, competition will only occur through the differentiation of the different scheme offerings.

Regulation of interchange fees, however, is likely to stifle the development of that competition before it emerges.

3.3.7. Competition Between Debit and Credit Cards

An important corollary of the discussion in the previous section is that the stage is already set for competition for merchant acceptance between credit and debit cards, as virtually all credit card holders also carry a debit card – the two separate accounts frequently being accessed via the same piece of plastic. A key question for the RBA, therefore, is what would be required to strengthen this competition.

According to the RBA:[49]

> *"The preference of card issuers to promote the use of credit cards over debit cards is not difficult to understand. At the simplest level, card issuers receive interchange fees each time a credit cardholder make a purchase … but they pay interchange fees … whenever a debit card is used. The Joint Study showed that issuers incur higher costs in providing credit card services compared with debit cards … but nonetheless earn more net revenue when their customers use credit cards rather than debit cards."*

Since credit cards generate, at best, only normal returns for issuers, the alleged issuer preference for issuing this payment instrument must reflect a fundamental mis-pricing of the debit card product. Hence, rather than pointing to the need to regulate credit card interchange fees, the RBA's argument, if accepted, would point to the need for action to improve the profitability of debit cards, which fail to generate normal profits for issuers. The RBA appears to implicitly acknowledge this when it states:[50]

> *"Debit cards are also a potentially strong competitor for credit cards. … However, debit cards are not actively promoted … Moreover, the pricing structure for debit cards, which is determined by the four major banks (sic), discourages consumers from using these cards in preference to credit cards. … Competition between payment instruments has also been undermined by the limited promotion in Australia of the debit cards of the international card schemes which, unlike proprietary debit cards, have world-wide acceptance."*

However, the RBA fails to draw the appropriate conclusion from its own arguments, namely that it should direct attention towards correcting the pricing anomalies associated with debit cards rather than seeking to regulate credit card interchange fees.

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[49] Consultation Document, page 39.

[50] *Ibid*, page 38.

4. COMMENTS ON DRAFT STANDARD NO.1

4.1. INTRODUCTION

In Chapter 3 we saw that much of the evidence for the need to regulate interchange fees has been misinterpreted and that such regulation would not only be an inappropriate response to weaknesses in the credit card markets, but that more appropriate responses are available. In the current Chapter we consider the actual specification of the draft Standard (ie Standard No.1) that the RBA intends to apply to the regulation of these fees.

The commentary is divided into three parts. In the first part, the theoretical underpinnings of the general approach adopted by the RBA are considered. In the second, the rationale for the chosen formula is examined. Finally, the likely consequences of the application of the formula are presented.

4.2. BASIS OF THE STANDARD

4.2.1. Rationale for the Approach

The RBA summarises its position regarding the setting of interchange fees as follows:[51]

> *"In the absence of a vigorous and competitive environment, the Reserve Bank believes that the public interest requires a transparent and objective methodology for the setting of credit card interchange fees in Australia, and that the fee-setting process be open to public scrutiny. This would give cardholders, merchants and the community confidence in the integrity of arrangements by which a crucial wholesale price in credit card schemes is determined. In the Reserve Bank's view, any methodology for determining an interchange fee should be consistent with a set of principles that would promote more efficient and transparent pricing of credit card services to both merchants and cardholders. These principles would require any methodology to:*
>
> *(i) provide a cost-based justification for the level of interchange fees that is transparent to merchants, cardholders and the community in general;*
> *(ii) be based on the credit card payment services which are provided to merchants, and for which credit card issuers recover costs through interchange fees;*
> *(iii) exclude from its calculations costs that are not related to payment network considerations, and are therefore not relevant to interchange fee calculations;*

[51] Consultation Document, pages 42-43.

(iv) provide for different interchange fees for different types of transactions and / or differences in the credit card payment services provided to merchants;
(v) have the data independently verified; and
(vi) be subject to regular reviews."

Since no definitions are provided, it is not at all clear what some of the expressions used in the above statement are intended to mean. The expressions "credit card payment services provided to merchants" and "costs that are not related to payment network considerations" are two such examples. This makes it difficult to provide meaningful comments on the RBA's principles. Nevertheless, it does seem to be possible to draw out some of the key assumptions the RBA is making in putting these principles forward.

The RBA's assumptions (in italics) are as follows:

1. *The services provided to cardholders and merchants are separable (ie they are not jointly produced) and all costs incurred within a scheme can be uniquely assigned to, or allocated between, merchant and cardholder services.*

If some services to cardholders and merchants were jointly produced (ie the process producing a service for say, cardholders, automatically produced a corresponding service for merchants) or were separately produced using common infrastructure, the question arises as to how the associated costs of production should be allocated between the beneficiaries. The efficient allocation of joint costs is the allocation that balances the demand for these services on both sides. The efficient allocation of common costs must be based on the relative price sensitivities of cardholders and merchants. However, as the RBA is proposing to set efficient interchange fees without considering demand conditions, one must presume that it denies the possibility of joint or common costs.

This issue is discussed further in the next section.

2. *The only services provided by issuers which benefit merchants relate to the payments functionality of credit cards.*

The RBA is explicitly denying that issuers provide non-payment services which benefit merchants. As discussed in section 3.3.4 above, credit cards are far more that just a payment instrument. In particular, in adopting its position, the RBA is denying that small merchants use (or, perhaps, should be allowed to use) credit card acceptance as a means of countering the store card strategies of major retailers.[52] Why the RBA should wish to alter the nature of products and strategies available to retail merchants and, in doing so, tilt the competitive landscape in favour of large retailers is not clear. This issue is considered further in sections 4.4.2 and 4.4.3 below.

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[52] As discussed in section 3.3.5, the key to this countervailing strategy by small merchants is to be able to offer cardholder net benefits comparable to the benefits provided by the store cards, and this requires funding of these benefits through the interchange fee.

3. *The existing division of functions between issuers, acquirers and the central administration of the scheme is uniquely determined.*

If, for example, non-payment functions could be arbitrarily rearranged, the costs of performing them could be shifted from cardholders to merchants or vice versa. If the cost allocation implied by one arrangement were efficient, then that implied by some rearrangement would not be. Since the RBA does not take this possibility into account, it must be implicitly assuming that the arrangement of functions is unique. This issue is discussed further in section 4.3.3 below.

4.2.2. Separation of Cardholder and Merchant Services

The RBA does not justify its position that costs can be separately and uniquely allocated either to cardholder or to merchant services. Moreover, its position on this runs counter to the weight of informed economic opinion, including apparently the RBA's own economic advisor. In the Commissioned Report, Professor Katz states:[53]

> *"… processes of basing interchange fees on allocations of cost components between merchants and consumers based on functionality do not conform with any of the economic analyses that have been cited in this matter. In all of the models, the optimal merchant service fees and consumer card services charges depend only on the* <u>*sum*</u> *of the marginal costs of providing service and the conditions of demand. To the extent that the formulas for optimal interchange fees depend on the individual components – issuer marginal costs and acquirer marginal costs – it is because those components affect the pricing decisions separately made by issuers and acquirers."*

To the penultimate sentence of this quote, Professor Katz appends the following footnote:[54]

> *"Cost allocations based on specific functionality could be economically sensible if specific services were sold to merchants and card users on an unbundled basis and the consumption of these services by one side of a card-based transaction had no effect on the welfare of the other side. The interchange fee, however, affects the prices charged for bundles of services associated with a card-based transaction which, as respondents have emphasised, affect both sides of the transaction."*

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[53] Commissioned Report, page 31.

[54] *Ibid*, footnote 96.

Professor Katz makes the further following comment on the matter:[55]

> *"As the economic analysis of credit and charge card markets demonstrates, however, card-based transactions may have costs and benefits for both sides of the market simultaneously, many costs are common, and efficient pricing must be based in part on demand conditions."*

Bankcard considers that, given the weight of informed economic opinion against it, the RBA should clearly justify its position before embarking on the regulation of interchange fees. In particular, it should explain carefully, with an appropriate rationale, how it proposes to treat joint and common costs in a manner consistent with maximising economic efficiency. If the RBA maintains the view that ignoring demand conditions can still yield an efficient interchange fee, it is incumbent on it (and consistent with the principle of regulatory transparency) to explain clearly why this is so.

4.3. SPECIFICATION OF THE FORMULA

4.3.1. Rationale for the formula

The RBA's claims that the formula in draft Standard No.1 is:[56]

> *"based on the credit card payment services which are provided to merchants, and for which card issuers recover costs through interchange fees. In the Reserve Bank's opinion, only two categories of issuers' costs are eligible for inclusion in the calculation. These are:*
>
> *(i) costs incurred for processing transactions received from other scheme members that would not be incurred if the issuer were also the acquirer. These are costs associated with operating the credit card payment network and include the costs of receiving, verifying, reconciling and settlement of transactions from other scheme members. The costs would be separately calculated for electronic and paper-based transactions; and*
>
> *(ii) costs for fraud and fraud prevention and authorisation incurred in providing any payment guarantees. The payment guarantee is a payment service provided by a credit card of which merchants are the main beneficiary. Again, costs will be separately calculated for electronic and paper-based transactions. However, where issuers can charge fraud costs back to the merchant, such as in "card not present" transactions, these costs would not be included in the interchange fee (nor presumably in a merchant service fee); to do so would be double counting."*

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[55] *Ibid*, pages 34-35.

[56] Consultation Document, pages 54-55.

This specification raises a number of issues, which are addressed below.

4.3.2. Payment Guarantee Services

As quoted above, the RBA regards merchants as the "main beneficiary" of the payment guarantee. Why the expression "sole beneficiary" is not used is not made clear. The RBA also claims that "in principle the payment guarantee could be 'unbundled' from other credit card payment services".[57] It is difficult to understand, therefore, why only some of the costs associated with providing payment guarantees are included in the draft formula.

Issuers incur a variety of costs in providing payment guarantees. For the provision of payment guarantees to constitute a viable business – as it would need to be if it were to be conducted on an "unbundled" basis – the guarantor must either collect the funds owing or write off the loss. This would involve the following costs:

- the cost of collecting repayments made by cardholders up to and on the due date, including the costs of advising cardholders of the amount due (ie the issuing of transaction statements), the costs of dealing with cardholder queries about those statements, the cost of receiving funds from cardholders in cash or drawn from another account, and the costs of maintaining records of the amounts paid and the amounts due, or, where such payment is not received, the cost of drawing the funds from cardholders' revolving line of credit;

- the costs of transaction authorisations;

- the cost of fraud prevention, detection and recovery, including the cost of issuing cards with embossing and magnetic stripes made to specified standards, the costs associated with the secure delivery of those cards to cardholders, the costs of reissuing cards over a fixed life-cycle, the costs of maintaining "hot lines" for the reporting of suspected fraud cases, the costs of dealing with reported card thefts, the costs of maintaining and operating intelligent systems and software for fraud detection purposes and the costs associated with running a fraud control unit; and

- the cost of fraud writeoffs where these are not recouped from other sources.

However, the RBA rules out many of these cost components as "unrelated to the payment services of a credit card or to payment network considerations" or as "not relevant to the payment services provided to merchants". This is inconsistent with the RBA's stated view that merchants are the main beneficiaries of the payments guarantee.

[57] *Ibid*, page 55.

4.3.3. Reallocation of Functions

As noted in section 2.3.3 above, to be consistent with the public interest test, the RBA's purpose in seeking to regulate interchange fees must be to influence the end prices and benefits provided by issuers and acquirers to cardholders and merchants. There are, however, other factors that would need to be considered: interchange fees are only one of the many scheme rules that have a bearing on end-user services and prices. One of the key factors is the allocation of functions between scheme participants.

The issue is perhaps best illustrated by some examples:

1. Funding the Interest Free Period

The provision of an interest-free period before payment is due is a long-standing feature of credit (and charge) cards. However, the RBA has rejected the inclusion in the interchange fee of any costs related to this feature on the grounds that the terms and conditions for it are set exclusively by individual card issuers, so "it is not related to payment network considerations".[58]

Under the current arrangements for the open schemes in Australia, issuers are responsible for funding and meeting the cost of the interest free period in the first instance. This responsibility could, however, be shifted to acquirers simply by altering the settlement arrangements.

Currently, acquirers submit "for value" records of transactions to issuers which are settled the next day. If, instead, settlement were delayed until the issuer received payment from the cardholder, or the funds were drawn down from the cardholder's line of revolving credit, issuers would be freed from the responsibility and costs of funding the interest free period. Acquirers could, in turn, delay payment to merchants either until they received funds from issuers or until a "standardised" due date for cardholder payment. Alternatively, merchants could make arrangements with acquirers to provide immediate value.

Whatever the arrangements agreed between merchants and acquirers, there is no question that merchants would be obliged to bear the cost of delayed payment under a delayed settlement regime. Moreover, the costs of arrangements for payments to merchants would no longer involve dealings between issuers and cardholders: they would be settled in negotiations for "advance payments" between acquirers and merchants. Applying the RBA's own "logic", consideration of these costs would be excluded from the calculation of interchange fees and "advance payments" would be implicitly regarded as a merchant benefit.

[58] *Ibid*, page 49.

This example illustrates several facts about open payment systems:

- they are genuine systems in the sense that their parts are inter-related;

- key elements of the payment services have a dual nature (eg delayed payment for cardholders and advance funding of merchants are two sides of the same coin); and

- issues such as who negotiates what with whom (ie the legalities of the situation) do not constitute a robust basis for determining the incidence of economic benefit.

Before concluding this section, it is worth observing that the provision of a payment guarantee does not, of itself, specify the timing of the payment (although a guarantee would normally specify a final date of payment, since an "open ended" guarantee would be no guarantee at all). In wholesale markets, the supply of goods is frequently provided on a delayed payment basis, on terms specified in the invoice (eg payment within 30 days). In retail markets, where the identity of the purchaser may not be known and the costs of following up purchasers for payment would be prohibitive, a requirement for immediate payment is more common. The issuing of cards to consumers largely solves the identity problem and makes the cost of follow up for collection of payments due more tractable. Thus, delayed payment arrangements with customers who are cardholders becomes a perfectly feasible option for merchants, as the existence of store cards testifies. If settlement between issuers and acquirers were delayed, the cards issued by the open schemes would become even closer store card substitutes.

The key point in all of this is that immediate (or next day) settlement can legitimately be regarded as constituting an additional payment service to merchants. Where the issuer pays for the service, it would then be reasonable for the issuer to expect some form of reimbursement from the merchant via interchange fees.

2. Marketing Campaigns

Marketing campaigns, like other promotional activity, are regarded by the RBA as "not integral" to the provision of payment services, and the costs of such activities are therefore not included in the draft formula for the calculation of interchange fees.

At present card marketing is undertaken partly by issuers and partly by the schemes themselves. If the scheme assumed full responsibility for marketing and levied fees on its members to cover the costs, acquirers would bear the marketing costs of the scheme to the extent that the levies fell on them. These costs would then form part of their overall costs needing to be recovered through merchant service fees.

> This examples highlight the fact that the division between issuers, acquirers and the scheme administration is, to a large extent, an arbitrary one. Moreover, the current arrangements differ in detail between the schemes. Hence, a single formula for the setting of interchange fees based on a selection of costs that is intended to apply to all the designated schemes would, in fact, have a differential impact on the different schemes, contrary to the principle of competitive neutrality. In addition schemes could vary that impact by varying the allocation of functions between scheme participants.

In summary, the above examples indicate that,if a robust and efficient "cost-based" formula for interchange fees is to be devised at all, it needs to be based on some principles for identifying and measuring the economic incidence of benefits arising from all of the card-based services and functions.

4.4. CONSEQUENCES OF APPLYING DRAFT STANDARD

4.4.1. Effect on Innovation

One of the most serious deficiencies of the formula in draft Standard No.1 is that it would send the wrong price signals for innovation. This is perhaps most easily seen by way of an example.

Example on Innovation

> *Suppose an open credit card system has a positive business case for the introduction of smart cards to reduce fraud. As noted in section 2.3.3 above, to be valid, such a business case must deal with the impact of the innovation on the whole collective. Suppose, in this example, that the business case shows that fraud costs falling on issuers will be significantly reduced by the introduction of microchip technology on cards and these savings will provide a handsome return on the total investment required by issuers, acquirers and merchants over the course of a number of years. Under the RBA's proposed cost-based interchange fee standard, however, the reduction in fraud costs experienced by issuers would be completely offset by corresponding reductions in the calculated interchange fees. Issuers would therefore be unwilling to agree to the necessary investments.*

This example highlights one of the dangers of introducing a formula for the calculation of interchange fees. On one hand, ad hoc methods could be used to find a way around the problem but each would involve some departure from the given formula. Moreover, as innovations accumulated over time, administrative complexities could multiply and the formula may become more honoured in the breach than in the observance (after all, all features of credit card systems were at one time an innovation). On the other hand, if the issue of innovation is not dealt with, the implementation of a formula-based interchange fee would fail the test of dynamic efficiency.

4.4.2. Reduced Choice in the Market

In section 3.3.1 above, it was shown that a reduction in interchange fees for the designated schemes would result in a change in the nature of the card "product", including a reduction in net cardholder benefits. Taking the actual specification of the proposed formula in draft Standard No.1 into account enables the consequence of regulation to be described more precisely.

Under the draft Standard, interchange fees for credit cards only encompass costs for services which issuers would also provide to acquirers in the case of debit card transactions. This would become even more apparent with the introduction of PIN-based credit card transaction, which would reduce fraud costs and enable authorisation and "for value" transactions to be processed simultaneously, as currently occurs under the APCA debit card arrangements. Faced with interchange fee revenues structured around a debit card transactions model, issuers are likely to make debit-card-type decisions under competitive pressure. These would include the following:

- The interest-free period would vanish. Although the cost of providing the interest-free period could be built into annual cardholder fees, this would ultimately prove unworkable because of the "moral hazard" issues involved. Cardholders would, in effect, be buying "insurance" against paying for the cost of funding the payment delay, when the extent of use of this facility was entirely under their own control. The alternative of making cardholders "pay" directly for the cost of an interest-free period is, of course, a contradiction in terms. The open scheme credit card would therefore lose its defining characteristic[59]: it would effectively be turned into a debit card (with attached overdraft).

- Issuers would promote the cards of the designated schemes (or their associated debit cards, Maestro and Visa Debit) as a replacement to their existing proprietary debit cards. This would have the effect of switching interchange fees on debit cards from negative to issuer to positive to issuer.

- The closed schemes, being still free to set end-user prices in any manner they choose, would move into the market space formerly occupied by the open schemes. As already noted, they could exploit merchants' desire to gain a strategic advantage over their rivals more effectively than the open schemes they would replace, and issue superior inducements to cardholders to adopt their cards. The closed schemes could rapidly further their strategies to sign up major financial institutions to act as agents in distributing their cards. Faced with a gap in the cardholder market and lucrative commissions, financial institutions would find it difficult to resist these offers and many, if not all, would swing their current cardholder bases over to the closed schemes.

[59] The distinction between credit and debit cards was discussed in section 2.3.2.

As these changes took effect, the card market could look broadly as follows:

- The closed schemes would still be operating in their current market space.[60]

- The closed schemes, assisted by the majority of financial institutions, would be operating (with specially designed offerings) in the market space currently occupied by the designated schemes, and would have largely taken over the cardholder base of the designated schemes. By extending their transaction capture arrangements with acquirers, they would also have largely taken over the current merchant base of the designated schemes. By directly acquiring these merchant, they would be able to apply fee discrimination to maximise the merchant revenue without discouraging merchants from leaving the system, and use this to provide superior rewards to cardholders.

- The designated schemes would be offering debit cards (with attached overdraft facilities) on the market (although they still may be called "credit cards"). These would in many respects be similar to the current Maestro and Visa Debit products. They would attract positive-to-issuer interchange fees, so merchant acceptance would be more expensive than is currently the case for APCA sponsored debit cards.

- The current APCA sponsored debit cards would have been largely replaced by their international scheme counterparts.

In short, the market structure would, in many respects, not have changed very much. However, in some respects it is likely to have changed a great deal. For example, issuing and acquiring would be far more concentrated, and the interchange fee and card fee structure of debit cards would be significantly different. Choice is also likely to have suffered, and the areas where it may increase (eg with debit cards) could have been achieved more efficiently by direct action by the RBA in those areas.

Given the changes that the proposed regulation of interchange fees could precipitate, the RBA should seriously consider alternative approaches to dealing with perceived weaknesses in the credit card markets.

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[60] The RBA argues (on page 119 of the Consultation Document) that the closed schemes would be forced to respond to the changed pricing of the open schemes because of the latter's dominant position in the market. This ignores the fact that regulation of interchange fees will change the nature of the open scheme product, thereby removing competition from the traditional credit card market. Debit cards already hold a strong position in the market for payment instruments but do not exert strong pressure on the pricing of the closed schemes. The regulation of interchange fees would add to competition in the debit card market but this is unlikely to exert any significant additional pressure on the closed schemes. The removal of the open credit card schemes from their traditional market space would, however, greatly reduce the competitive pressures on the closed schemes, who would rapidly move to exploit the vacuum created by the regulation.

4.4.3. The Position of Small Retailers

With the transformation of the credit cards of the open schemes into another debit card product and the occupation of their former market territory by the closed schemes, as outlined in the previous section, smaller retailers wishing to counter the store card strategies of their larger rivals would have little option but to sign up with the closed schemes. In effect, their current "all or nothing" choice would have been exacerbated.

If the closed schemes were unable or unwilling to occupy the market space vacated by the open schemes, or the RBA were to take action to prevent it, smaller merchants would be left without any effective counter at all to larger retailers' store card strategies. These larger retailers would, thereby, gain market power at the expense of their smaller rivals. As shown in section 3.3.5 above, there would be a welfare loss associated with this development, which would not be consistent with the public interest test.

4.4.4. Offshore Issuers

Consistent with the terms of the designation of the open schemes, viz "credit card systems operated in Australia", the draft formula for interchange fees is silent in relation to cross-border payments. This opens the possibility of an offshore issuer issuing cards in Australia (for example, through an onshore partner) and collecting interchange fees for transactions in Australia at cross-border rates.[61] The higher interchange fees collected on transactions using these cards, would allow such an offshore issuer to offer greater incentives to its cardholders than could be offered by Australian issuers.

Although higher interchange fees could be obtained using this approach under current interchange fee arrangements, the differences between cross-border and domestic interchange fees do not appear to be sufficiently large to justify the additional cost such an operation would incur. The larger differential applying after the introduction of the draft Standard, however, would provide a significant incentive for such an approach.

This kind of development would, of course, largely defeat the purpose of the regulation. Since higher costs would be involved in to provision of these "cross-border" card services, without any gain to cardholders or merchants, economic efficiency would be lower than before the regulation was applied. As an Australian credit card scheme, Bankcard would be placed at a severe disadvantage by this kind of development.

[61] While this may not be permitted under the current rules of the international schemes, regulation of domestic interchange fees could prompt any necessary rule changes.

4.4.5. Abolishing Interchange Fees

The instituting of draft Standard No.1 would prompt the designated schemes to seriously consider reconstituting themselves. There are a number of different organisational structures that could be adopted.

One possibility would be for a scheme to dispense with "members" in favour of "participants" with no decision-making power. Participants would undertake issuing and acquiring activities under contract with the scheme and be paid, or pay, separately negotiated commissions and / or licence fees to do so. There would be no interchange fees paid between the participants and the separately negotiated issuer and acquirer commissions and fees (which would presumably vary between different issuers and different acquirers according to their individual circumstances) would avoid any allegation of a breach of section 45A (the price fixing provisions) of the Trade Practices Act. The key role of the scheme would then be to promote its card products, to offer inducements to participants designed to best promote the interests of the scheme and to balance the incoming and outgoing revenues.

In the example above, the reorganisation of the scheme could be effected in such a way as to have little impact on cardholder benefits and fees or on merchant services and fees. It therefore demonstrates clearly why the RBA's selective designation and proposed regulation of the open credit card schemes (but not the closed or proprietary schemes) represents, in effect, an attack on a specific organisational form rather than a solution to a problem of perceived market failure. It also highlights clearly the superiority of a regulatory approach designed to strengthen competition and flexibility in relevant markets, rather than one which attempts to interfere directly with the operations of individual entities.

5. CONCLUDING REMARKS

In this submission, Bankcard has examined the RBA's regulatory processes and its proposed regulations for the designated credit card schemes. Bankcard considers that the RBA did not adopt adequate consultation procedures prior to designating the Bankcard Scheme and was wrong to dismiss Bankcard's attempts to find a voluntary solution acceptable to the RBA. Nevertheless, Bankcard considers that the opportunity to reach agreement with the RBA, at least in relation to draft Standard No.2 and the draft Access Regime, has not passed, and urges the RBA to engage with Bankcard in reaching a solution which Bankcard can voluntarily implement. To that end, Bankcard stands ready to participate with both APRA and the RBA in reaching a workable solution in relation to draft Standard No.2 and the draft Access Regime.

Bankcard is concerned, however, with the proposal embodied in draft Standard No.1. As argued in Chapter 3 of this submission, Bankcard considers that the case for regulation of interchange fees has not been made. The RBA's view appears to reflect a misunderstanding of the nature of the credit card product, how it generates value for cardholders and how credit card acceptance thereby becomes part of the strategic arsenal of merchants, particularly small merchants who cannot counter the store card strategies of their larger competitors except on a collective basis. This appears to have led the RBA to misinterpret the evidence of market failure. To the extent that there is any problem at all in the credit card markets, it would have to be related primarily to limitations on the choice of card products available for merchant acceptance. This is a problem that regulation of interchange fees cannot solve but can only make worse. To the extent that this is a significant problem therefore, the appropriate regulatory response would involve the strengthening of competitive forces in the relevant markets.

Regarding the specification of the formula for interchange fees in draft Standard No.1, Bankcard considers that it lacks proper theoretical underpinnings, that the selection of costs for inclusion is arbitrary and that the specification is not robust. Its application would produce a number of significant adverse economic consequences and would be likely to generate a number of changes to scheme structure designed to circumvent the regulation. Because of this, the regulation is unlikely to be successful.

Bankcard is concerned that the RBA is showing the signs of being an organisation under pressure. For example, in the Consultation Document the RBA states:[62]

> *"Several submissions to the Reserve Bank have argued that debit card interchange fees should be reformed at the same time as those for credit cards, so that consumers and merchants can face more efficient prices for both payment instruments. The Reserve Bank agrees that this is a desirable objective, but it has not been prepared to slow the timetable for reform of the credit card market."*

[62] Consultation Document, page 127.

This indicates that the RBA regards itself as working to some kind of regulatory timetable, and is not prepared to deviate from this timetable even when it considers that this would be desirable in other ways.

The reason for this pressure is not clear. It may reflect the fact that 8 months were allowed to lapse between the time of the designation and the Consultation Document's appearance or it may reflect the inevitable pressure on specialised regulators to be seen to "do something". Whatever the reason, it appears to be leading the RBA into making some fundamental errors in its thinking, particularly as, as Bankcard's direct experience can testify, it is not availing itself of the industry expertise that could assist it in achieving reforms in the credit card market.

Bankcard would urge the RBA to pause and take stock of where it is heading and what it is trying to achieve. The material provided in this submission is designed to help that process. In the end, there is a great deal at stake, not only the investment that has been made by the industry over the last few decades but also the interests of cardholders and the business strategies of retailers. And there are no prizes for getting it wrong. It is better to devote a little time now to reviewing and testing the assumptions than to act too hastily.

If, despite this, the RBA is determined to press ahead with the implementation of draft Standard No.1, Bankcard considers that it would be further compounding its mistake if regulations, designed to place similar controls on the merchant service fees charged by the closed schemes, were not simultaneously put into place. To ignore the closed schemes would represent a focus on organisational form rather than economic effect, and the main end result could simply be a reorganisation of the designated schemes.

Bankcard is aware that exemptions are frequently granted by regulators to organisation with a relatively small market share when they consider that the impact on the market of regulating the larger players will provide an effective constraint on their smaller competitors. Bankcard has noted in section 4.4.2 above that is not a valid argument in relation to the credit card market, since regulation itself would change the nature of the open scheme product, thereby reducing the extent of competition. Nevertheless, if this approach were to be adopted by the RBA, Bankcard considers that it should be exempted on the same grounds.

If the RBA decides to apply draft Standard No.1 to Bankcard, Bankcard requests that the Reserve Bank consult with it on a number of technical matters prior to the determination of the Standard. These issues would include:

a) the cost categories to be included in the formula for the determination of interchange fees. These would need to be tailored to Bankcard's specific circumstances;

b) the RBA's approach to making the formula robust and logically consistent;

c) the timetable for implementation. In particular, Bankcard is unlikely to be able to implement the Standard in the 3 months' timeframe envisaged. Bankcard has no central systems infrastructure, and implementation would require co-ordinated systems development by the member banks; and

d) appropriate exemptions for Bankcard, in view of its unique infrastructure configuration and relatively small market share.

15 March 2002.