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15 March 2002

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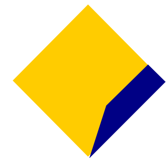


Dear Dr Veale

REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA – SUBMISSION IN RESPONSE TO CONSULTATION DOCUMENT DECEMBER 2001

I refer to the Reserve Bank of Australia's December 2001 document entitled "Reform of Credit Card Schemes in Australia – A Consultation Document" and the request for comments on the draft Standards and Access Regime. The Commonwealth Bank appreciates the opportunity to provide its comments in the attached Submission.

While more detailed comments are in the attached Submission, I draw your particular attention to the following three issues:

1. Maintaining the integrity of the credit card systems is of paramount importance to the Commonwealth Bank. The ability for participants to achieve appropriate returns on past and future investments is essential to ensure the on-going integrity and development of payments systems infrastructure in Australia. We believe that the proposals do not meet this hurdle, resulting in negative long term benefits to all participants (including cardholders);

2. The Commonwealth Bank believes that the range of 'eligible costs' included under draft Standard No. 1 is unjustifiably narrow, overlooking the fundamental characteristics of the credit card product to merchants and consumers and does not pass the public benefit test; and

3. Various key proposals (including prudential standards for access) are yet to be detailed. The Commonwealth Bank is consequently unable to make detailed responses until such time that they are available.

These and other related issues are explored in greater detail in the attached Submission.

We understand that the Reserve Bank intends to commence further consultation with interested parties after 15 March 2002 and before the Standards and Access Regime are finalised. The Commonwealth Bank is committed to ensure that Australia continues to enjoy a competitive and robust credit card payments market, providing appropriate benefits to all participants. We, therefore, look forward to the opportunity for further discussions on matters of principle, clarification, or detail.

Yours sincerely

N. L. A. Kennett

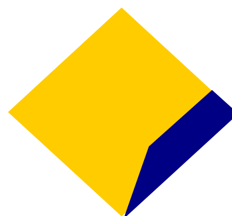
REFORM OF
CREDIT CARD SCHEMES
IN AUSTRALIA

A Consultation Document
(December 2001)

Submission to Reserve Bank of Australia

By

COMMONWEALTH BANK OF AUSTRALIA



15 March 2002

SUBMISSION TO RESERVE BANK OF AUSTRALIA

BY

COMMONWEALTH BANK OF AUSTRALIA

REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA

15 MARCH 2002

1.0 EXECUTIVE SUMMARY

The Reserve Bank of Australia's (Reserve Bank) Consultation Document on Reform of Credit Card Schemes in Australia (the Consultation Document) was published in December 2001. The Commonwealth Bank of Australia (the Bank) welcomes the opportunity to provide written comment on the Consultation Document's proposed draft standards and access regime prior to their finalisation.

The Bank continues to be of the view that the Australian credit card system operates at world's best practice, providing significant benefits to all participants. As a result, the Bank does not agree with the need for substantial reform, nor that the proposed regulatory intervention will enhance long term value or benefits to participants.

Overall, the Bank believes that the proposals set out in the Consultation Document do not result in net public benefits. Furthermore, the Joint Study data (after allowance for all issuers' costs) indicated that the credit card issuing market currently makes appropriate economic returns; the proposals will result in sizeable sub-economic returns to issuers, while providing the credit card systems to merchants at almost nil cost.

Within the context of the specific draft proposals, the Bank is of the view that:

- draft Standard No. 1 (Draft Standard for Designated Credit Card Schemes – the Setting of Wholesale ("Interchange") Fees) is fundamentally flawed as a result of the application of unjustifiably narrow "eligible costs" and the inappropriate application of Section 18 of the Payment Systems (Regulation) Act (PSRA), when Section 12 is the correct power to apply;

- draft Standard No. 2 (Draft Standard for Designated Credit Card Schemes – Merchant Pricing for Credit Card Purchases) is unnecessary but in any event, without comparable application to three party schemes, results in an uneven playing field; and

- the draft Access Regime for Designated Credit Card Schemes is incomplete and inappropriate to implement as the detail of the proposed prudential standards to apply to the proposed new category of participants is yet to be developed.

The Bank notes that the Reserve Bank states that the proposed reforms leave "the basic structure of credit card schemes intact". The Bank disagrees with this view. The proposed reforms amount to product regulation (with both direct and indirect changes to the product offerings to both cardholders and merchants).

In addition, the Reserve Bank has not considered the impact of its proposed reforms on incentives for participants to continue to invest in payments infrastructure in Australia.

Notwithstanding the Bank strongly disagreeing with the need for the proposed reforms, the Bank has made specific recommendations regarding the proposals and reform process.

The Bank understands that the Reserve Bank intends to announce shortly a three-month period for consultation with interested parties. The Bank looks forward to further consultation and discussion on our Submission prior to the Reserve Bank finalising its Standards and Access Regime.

2.0 INTRODUCTION

2.1 General

The Reserve Bank's Consultation Document on Reform of Credit Card Schemes in Australia (the Consultation Document) was published in December 2001. The Bank welcomes the opportunity to provide written comment on the Consultation Document's proposed draft standards and access regime prior to their finalisation. The Bank understands that the Reserve Bank intends to announce shortly a three-month period for consultation with interested parties. The Bank looks forward to further consultation and discussion on our Submission prior to the Reserve Bank finalising its standards and access regime.

Australia's current world class electronic payment networks contribute significantly to the efficient workings of the Australian economy. Bank submissions to the Reserve Bank in December 2000 and July 2001 (refer submissions M.1 and M.3) noted that:

> *"The Bank is keen to ensure that Australia retains its world class electronic payments networks, providing long term benefits to all participants - consumers, merchants and financial institutions. To ensure on-going investment and development, financial institutions need to be able to generate appropriate long-term returns on investment after allowance for associated risks. Only through considerable long - term strategic investment, with ongoing enhancements, will Australia retain its enviable position in electronic payments and enable the deployment of infrastructure for new and emerging technologies."*

Further, the submissions expressed concern:

> *" … for the long-term implications for investment in electronic payments systems if reduced returns to financial institutions from electronic payments systems lessen the incentive for financial institutions to invest in the maintenance of existing facilities or the development of new technologies."*

The Bank is very concerned that regulatory intervention in credit card schemes has already increased the (regulatory) risk associated with investment in payments infrastructure and brings uncertainty to those planning significant investment in such networks. The Bank is concerned that one outcome of the draft Standard on interchange fees will be reduced (or deferred) investment in electronic payment systems as the Reserve Bank's draft Standard does not allow issuers to make an appropriate return on their investment in payment services to merchants. Put simply, this is a wrong principle which will have investment implications.

This disincentive will lead to a fall in investment in payments infrastructure with adverse consequences for the quality and efficiency of payments in Australia.

For example, suppose an open credit card scheme has developed a positive business case that shows that issuers' fraud costs will be significantly reduced by the introduction of microchip technology on cards and these savings will provide an appropriate return on the total investment required by issuers and acquirers over the course of a number of years. Under the Reserve Bank's draft Standard on interchange fees, the reduction in fraud costs (less the cost of the investment) for issuers would be completely offset by corresponding reductions in the calculated interchange fees. Issuers would make no return on their investment and therefore would be unwilling to agree to make the necessary investments. The direct result of the proposals would be a shift of value from the issuer (who makes the investment) to merchants.

The Bank notes that the Reserve Bank did not address the investment implications of its proposed reforms in the Consultation Document at all. The Bank questions how the Reserve Bank can consider that it has undertaken a thorough assessment of the likely impacts of the proposed reforms when it has not considered the likely impacts on future investment in payments infrastructure in the light of increased regulatory risk.

The Bank assumed a leadership position in facilitating what turned out to be protracted dealings with the Australian Competition and Consumer Commission (ACCC) through 1999, 2000 and 2001 with regard to, inter-alia, credit card interchange fee methodologies. To a large extent, that work provides background to the Reserve Bank's current deliberations. The Reserve Bank was a party to that process - both directly and by way of its relationship with the ACCC. Those dealings with the ACCC culminated in the following position being put to the ACCC (and copied to the Reserve Bank on 16 March 2001) by the 'review banks':

- A significantly revised methodology for the setting of interchange fees – based on a cost recovery approach - only including cost categories for services provided by issuers from which merchants and merchant acquirers benefit directly. (In particular, the principle proposed was that merchant acquirers and hence merchants should pay for card related costs of the payment enabling functions of the network, such costs being the same as merchants would incur for similar, substitute products such as proprietary store cards.) The 'review banks' believed that the revised proposal met the six key features previously advised by the ACCC in consultation with the Reserve Bank.

- The methodology was detailed as providing an aggregate interchange cap, allowing for determination of different interchange rates for different transaction types.

- The methodology would be transparent and, as proposed, be subject to audit, authorisation (on the basis of no admission of contravention of the Trade Practices Act) and regular review.

- The methodology would be supplemented by an immediate reduction in domestic interchange fees.

This proposal was summarily dismissed by the ACCC and was immediately followed by the passing of the matter to the Reserve Bank for consideration of "designation" under the PSRA.

As noted in our April 2001 submission (refer submission M.2, pages 2, 3 and 5):

> *"While the approach put forward by the banks may have included cost components that the Commission considered inappropriate, those could easily have been dealt with, in the established manner, in the normal course of the authorisation process.*
>
> *The Review Banks further advised the ACCC that they were seeking expeditious resolution of the matter and had already engaged expert consultants to undertake the necessary development of the costing methodology and accounting manual. It seems, therefore, given the powers of the ACCC to grant authorisations subject to any conditions it considers appropriate, that the authorisation process and the right of appeal to the Tribunal would have reached an outcome in relation to the setting of interchange fees.*
>
> *In considering designation it should be borne in mind that the banks were effectively constrained from entering a proper authorisation process by virtue of the ACCC initiating litigation that it had undertaken not to do."*

The Bank has now been subject to another year of regulatory uncertainty with regard to credit card schemes and rather than permit the credit card schemes to proceed with voluntary changes to interchange fee setting arrangements, we are faced with unjustifiable imposed restrictions on 'eligible costs' in interchange fees. The current overlapping regulatory powers of the ACCC and the Reserve Bank do not advantage the people and businesses of Australia.

As a final introductory comment, the Bank notes its Chief Solicitor wrote a letter to the Reserve Bank dated 28 February 2002 regarding the ACCC allegation that the collective setting of interchange fees amounts to a breach of the Trade Practices Act. As was pointed out in that letter, this allegation is unproven and the banks were prepared vigorously to defend themselves against the allegation.

2.2 General Themes and Outline of Submission

The Reserve Bank proposes to regulate credit card schemes in Australia by:

- Determining a Standard for interchange fees;
- Determining a Standard for merchant pricing; and
- Imposing an Access Regime for credit card schemes.

This Submission addresses these proposed reforms in turn, and presents the Bank's views on each.

The Bank is of the view that:

- draft Standard No. 1 (Draft Standard for Designated Credit Card Schemes – the Setting of Wholesale ("Interchange") Fees) is fundamentally flawed as a result of the application of unjustifiably narrow "eligible costs" and the inappropriate application of Section 18 of the PSRA, when Section 12 is the correct power to apply;

- draft Standard No. 2 (Draft Standard for Designated Credit Card Schemes – Merchant Pricing for Credit Card Purchases) is unnecessary but in any event, without comparable application to three party schemes, results in an uneven playing field; and

- the draft Access Regime for Designated Credit Card Schemes is incomplete and inappropriate to implement as the detail of the proposed prudential standards to apply to the proposed new category of participants is yet to be developed.

This Submission also addresses matters that have been discussed between the Reserve Bank and the Bank in the course of clarifying the Reserve Bank's intent of draft Standard No. 1.

2.3 Summary of Recommendations

Notwithstanding our strong belief in the inappropriateness of the fundamental principles of the proposals, the Bank has made various recommendations based on the specific details set out in the Consultation Document. These comments do not, however, constitute support for the overall proposals.

The Bank recommends that:

Draft Standard No. 1

1. All of the cost of the interest-free period be included in 'eligible costs' in draft Standard No. 1;

2. A proportion of issuers' costs of statementing, remittance processing and collections be included in 'eligible costs' in draft Standard No. 1;

3. Draft Standard No. 1 be amended to include 'a return on the capital committed to providing payment services to merchants' as an 'eligible cost';

4. Draft Standard No. 1 be amended to include 'issuers' costs of implementing and complying with this Standard' as an 'eligible cost';

5. Draft Standard No. 1 be amended to include 'GST on interchange fees' as an 'eligible cost' and the words 'exclusive of GST' be inserted after the word 'paid' in Paragraph 13;

6. The Reserve Bank consult with each scheme after 15 March 2002 to determine appropriate implementation plans before the Reserve Bank determines the date under Paragraph 6 and the implementation timetable under Paragraph 14;

7. The Reserve Bank not specify and regulate four interchange fees but regulate interchange fees on an average basis for each scheme;

8. The Reserve Bank should clarify its intentions with respect to 'payment guarantees' in consultation with schemes and their members prior to finalising draft Standard No. 1;

9. Once the clarification process (in Recommendation 8) has been completed, the definition of 'payment guarantee' be amended;

10. Draft Standard No. 1 be amended to allow the independent expert to include portions of eligible costs from other financial years provided this is done in consultation with the Reserve Bank;

11. Paragraph 12 (i) of draft Standard No. 1 be deleted;

12. Draft Standard No. 1 be amended to require publication of the actual interchange fees charged (including GST) for each transaction type, rather than the calculated interchange fees;

13. The Reserve Bank not be given the power to require earlier calculations than the three years set out in Paragraph 15 of draft Standard No. 1;

14. The Reserve Bank reconsider whether it is regulating interchange fees under the correct head of power;

Draft Standard No. 2

15. If the Reserve Bank is intent on allowing merchants to surcharge for credit card transactions, then the surcharge should only be for the excess cost of accepting credit cards over the cost of accepting cash (legal tender);

16. The Reserve Bank not implement draft Standard No. 2 unless and until it applies from the same date to the three party schemes;

Draft Access Regime

17. The Reserve Bank not implement the draft Access Regime until after the Australian Prudential Regulation Authority (APRA) has published draft prudential standards for specialist credit card service providers and conducted a consultation process similar to that envisaged under the PSRA;

18. Paragraph 11 of the draft Access Regime be deleted;

Process

19. The Reserve Bank publish all submissions received as a consequence of the Consultation Document;

20. The Reserve Bank place on the public record:

- a summary of the submissions received as a consequence of the Consultation Document;
- the arguments raised in the submissions; and
- a detailed statement of the Reserve Bank's reasons for the decisions it takes; and

21. The Reserve Bank adopt the review mechanisms set out in Chapter 7 of the submission by the Australian Bankers' Association.

Understanding

The Bank is of the understanding, from discussions with Reserve Bank officers, that the Reserve Bank intends to amend Paragraphs 7 (i), 7(ii) and 7(iii) of draft Standard No. 1 to ensure that all Category B and C costs (refer Section 3.4 and Attachment C) are 'eligible costs'. If the Reserve Bank does not amend the paragraphs as represented, there will be under-recovery of appropriate costs.

If the Reserve Bank is not going to implement this understanding, the Bank requests that it be given the opportunity to make a further submission on the appropriate wording of Paragraphs 7(i), 7(ii) and 7(iii) of draft Standard No. 1 prior to the Reserve Bank finalising the Standard.

3.0 DRAFT STANDARD NO. 1 – THE SETTING OF WHOLESALE (“INTERCHANGE”) FEES

3.1 Introduction

Draft Standard No. 1:

> *“seeks to ensure that interchange fees … are calculated on the basis of an objective, transparent and cost-based methodology and are regularly reviewed. The methodology is based on the credit card payment services which are provided for merchants, and for which card issuers recover costs through interchange fees.”* (Consultation Document, page 54).

The Bank agrees with these objectives. However, the Bank notes that there is no discussion or description in the Consultation Document as to what comprises the ‘payment services which are provided to merchants and for which issuers recover costs through interchange fees’.

Furthermore, there is no definition of the basis of establishing an ‘objective’ outcome. The Bank believes that this should be based on the public benefit test, reinforced by the Reserve Bank’s stated principle that the reforms should not materially change the credit card product.

In the absence of a description of the payment services, the Reserve Bank then states its opinion that the only relevant costs to be included in interchange fees are the costs of receiving, verifying, reconciling and settling transactions from other scheme members, fraud and fraud prevention costs and authorisation costs.

The Bank disagrees with the Reserve Bank’s opinion that these are the only relevant costs associated with the payment services to merchants to be recovered through interchange fees.

If the Reserve Bank is intent on implementing a cost recovery based interchange regime, the Bank is of the opinion that at least the following issuer costs should be included in ‘eligible costs’:

- Interest-free period;
- Costs that are common to all transactions (on-us and not-on-us) that the wording of Paragraph 7 (i) of draft Standard No. 1 unintentionally excludes;
- A proportion of costs of statementing, remittance processing and collections;
- Return on the capital committed to providing payment services to merchants;
- Costs to implement and comply with draft Standard No. 1; and
- GST on the interchange fee itself.

An evaluation of ‘eligible costs’ requires consideration of the Reserve Bank’s principles for interchange fee methodologies and definition of the ‘payment services to merchants’ provided by credit cards.

3.2 Principles

Set out in Attachment 1 is a summary of the principles for determining regulated interchange fees as communicated to the Bank by the ACCC in February 2001, in consultation with the Reserve Bank, and the changed principles as set out by the Reserve Bank in December 2001 in the Consultation Document.

In the Bank's opinion, the latest principles appear to have been designed to unjustifiably narrow eligible costs beyond those indicated previously by the regulators and beyond those determined by efficient pricing principles.

Principle (ii) (Consultation Document, page 42) requires interchange fees to be:

> *"based on credit card payment services which are provided to merchants, and for which card issuers recover costs through interchange fees"*.

The Bank contends that the credit card payment services to merchants are the ability for merchants to sell their products to customers on a **buy now, pay later** basis and for merchants to sell their product to customers on a **sell now, receive guaranteed funds tomorrow** basis. Cash, cheque and debit card forms of payment enable merchants to only sell their products to customers on a buy now, **pay now** basis.

The Reserve Bank (Consultation Document, page 50) recognises this payment service to merchants.

> *"The payment services of a credit card – in particular, its "buy now, pay later" feature and guaranteed refund – have not changed since the credit card was first introduced."*

Further, the Reserve Bank (Consultation Document, page 1) explains the different payment services that a credit card provides over a debit card.

> *"Card-based instruments enable payments to be made by transferring funds between the cardholder and the recipient across the books of financial institutions. A debit card (commonly known as EFTPOS) is a method of accessing a transaction account held with a financial institution; the cardholder has funds taken from that account at the time the card is used to make a transaction. Such accounts may include an overdraft limit, but that is a separate decision for the financial institution and use of the overdraft is paid for separately by the cardholder. A debit card as such provides a pure payment service.*
>
> *By comparison, a credit card provides a payment service and a credit facility. The latter usually involves an interest-free period before the account needs to be settled and a pre-approved line of credit, also known as a "revolving" line of credit, on which users pay a rate of interest. The cardholder pays their credit card account some time after the card is used to make a transaction, according to an established billing cycle."*

The important difference between a credit card purchase over other forms of payment is that all credit card purchases (whether made by 'transactors' or revolvers') do not have to be paid for until *'some time after the card is used to make the transaction, according to an established billing cycle'*.

This creates incremental demand with benefits to merchants.

Merchants recognise the competitive advantages this brings to their businesses. For example, the ARA notes (ARA submission H.4, page 13):

> *"In fact it is a disadvantage for retailers not to accept credit cards due to their potential loss of sales to other retailers."*

Shell notes (Shell submission R.1, page 13) similarly:

"In the case of Shell (as in the case of most other retailers) the non-acceptance of credit cards is simply not an option. Card acceptance is necessary simply to gain entry to consumer consideration."

The Reserve Bank's draft Standard No. 1 does not recognise any benefit to merchants (and therefore cost) of the 'buy now, pay later payment service to merchants'.

A major benefit and cost of this service to merchants is, of course, the interest-free period.

3.3 Interest-free Period

The Bank is strongly of the view that the cost of all of the interest-free period should be included in 'eligible costs' for the following reasons:

- As discussed above, the interest-free period is the major benefit and cost of the buy now, pay later payment service to merchants which is the distinguishing feature of credit cards (i.e., the ability for merchants to sell goods and services today to consumers on a buy now, pay later basis but for the merchant to receive guaranteed funds the next day).
- The cost of the interest-free period for the three party schemes, which the Reserve Bank (Consultation Document, page 120) describes as *"close substitutes"* for open credit cards, is met by merchants;
- The European Commission has agreed to include the "cost of free funding for cardholders" in its objective benchmark against which to assess the Visa intra-regional multi-lateral interchange fee. The Bank recognises that the European Commission has not published whether this is a cost category where a percentage of the cost component would be taken into account for the purpose of calculating the cost benchmarks. Nevertheless, the European Commission has recognised that merchants should bear up to 100% of the cost.
- The Reserve Bank / ACCC Joint Study (page 50) recognised arguments *"that merchants as well as cardholders benefit from the interest-free period and merchants should bear some proportion of the cost"*. The Consultation Document did not acknowledge this argument nor indicate why the Reserve Bank is now of the view that all of the cost of the interest-free period should be met by cardholders.

Rather than address the above points, the Reserve Bank seems to have relied solely on its Principle (iii) to exclude any proportion of the interest-free period from interchange fees. The Reserve Bank (Consultation Document, page 49) states:

"In the Reserve Bank's view, since the provision of the interest-free period is a matter exclusively between individual card issuers and their customers, passing the costs of the interest-free period to merchants through interchange fees would not meet the Reserve Bank's principles for interchange fee setting."

Principle (iii) (Consultation Document, page 42) is stated in similar terms:

"These principles would require any methodology (for determining interchange fees) to:
(i) …
(ii) …
(iii) exclude from its calculations costs that are not related to payment network considerations, and are therefore not relevant to interchange fee calculations;"

The Reserve Bank seems to be arguing that because open credit card schemes allow issuers to compete over the terms of the interest-free period then the cost is automatically disallowed by Principle (iii), even though this competition results in a more efficient and lower cost outcome for

merchants and consumers. The Reserve Bank seems to be indicating that if the schemes mandated that all issuers must offer credit cards with the same interest-free terms (comparable with the interest-free terms offered by closed schemes or store cards) then this cost would be related to 'payment network considerations' and hence not be automatically disallowed as an 'eligible cost'. As noted above, allowing competition on this product feature has positive benefits for merchants and consumers. Therefore, Principle (iii), which purports to exclude proprietary matters between issuers and cardholders from interchange fees, is an incorrect principle.

The Reserve Bank (Consultation Document, page 49) notes the product innovation of a no interest-free card. This innovation would, of course, serve to reduce the allowance in interchange fees for the interest-free period.

It is incorrect to describe the cost of an interest-free period as a "proprietary" feature as distinct from a payment network feature. As the Reserve Bank notes, "buy now, pay later" is a distinguishing and constant feature of the credit card service – the service that the Reserve Bank is regulating as a payment network. Different decisions by different issuers will affect the quantum of costs that will be included in other eligible cost categories; for example, costs of fraud prevention. The potential for different action between issuers does not render a category of costs "proprietary" and therefore ineligible. The critical factor is that merchants benefit from the interest-free period.

The Reserve Bank / ACCC Joint Study (page 45) noted that the weighted average cost in 1999 of the interest-free period for a $100 transaction was $0.26. Assuming an average period of 30 days from the date of purchase to the date settlement is due implies an average interest cost on all purchases of 3.2% pa.

If the Reserve Bank finally determines that the cost of the interest-free period is not an 'eligible cost', then issuers will need to consider whether they will provide immediate settlement to acquirers and in turn whether acquirers will provide immediate settlement with merchants. Delayed settlement with merchants is likely to cost merchants much more than the weighted average cost of including the interest-free period in interchange fees.

As stated previously, the Reserve Bank (Consultation Document, page 50) recognises that:

> *"The payment services of a credit card – in particular, its "buy now, pay later" feature and guaranteed refund – have not changed since the credit card was first introduced."*

and that *"the interest-free period has been an integral feature of a credit card"* (Consultation Document, page 49).

The shifting of the incidence of the cost of the interest-free period from merchants to cardholders changes the basic value propositions of the open credit card to both merchants and cardholders.

The Bank cannot therefore understand how the Reserve Bank (Consultation Document, page ix) can state that:

> *"The proposed reform measures will promote greater efficiency, transparency and competition in the Australian payments system, to the benefit of the community as a whole,* ***while leaving the basic structure of credit card schemes intact****." (emphasis added)*

The Reserve Bank must understand that if it does not allow the cost of the interest-free period in interchange fees then it is distorting competition by changing the basic structure of the open

credit card product but allowing store and charge cards to continue to charge merchants for the interest-free period, which in the case of American Express and Diners Club is a major benefit because most of their cards do not allow revolving balances.

Set out in Attachment 2 is a Memorandum by Edgar, Dunn and Company (EDC) which provides a brief description of the historical positioning of credit cards as an outsourced storecard and the importance of including the interest-free period in the calculation of interchange costs.

In conclusion, the Bank is of the firm opinion that the omission of the cost of the interest-free period from ‘eligible costs’ in draft Standard No. 1 changes the ‘basic structure of credit card schemes’ which is incorrect regulatory policy with uncertain and unwarranted competitive and market effects.

Therefore, the Bank recommends that all of the cost of the interest-free period be included in ‘eligible costs’ in draft Standard No. 1.

3.4 Costs that are common to all transactions (on-us and not-on-us) that the wording of Paragraph 7 (i) of draft Standard No. 1 unintentionally excludes

The Bank refers to discussions with Reserve Bank officers on 1 February, 8 February and 12 February where we clarified, without agreement or disagreement on the part of the Bank, the intent of the Reserve Bank’s draft Standard No. 1.

At the discussions on 1 February, it was acknowledged by the Reserve Bank officers that it is not the intention of the Reserve Bank to achieve under-recovery of appropriate costs. The Reserve Bank officers acknowledged that the wording of Paragraph 7 (i) of draft Standard No. 1 could result in an unintentional narrowing of the ‘eligible costs’ as this paragraph could be read to exclude many costs that are common to all transactions (on-us and not-on-us).

Therefore, at the subsequent meetings, we categorised, in consultation with the Reserve Bank officers, all issuers’ costs into three categories:

“A” COSTS

Costs that are common to all transactions (on-us and not-on-us) that the Reserve Bank intends to **exclude** from the proposed interchange fee standard.

“B” COSTS

Costs that are common to all transactions (on-us and not-on-us) that the Reserve Bank has, in discussions with the Bank, agreed to **include** in the proposed interchange fee standard.

“C” COSTS

Costs relating only to “not-on-us” transactions that the Reserve Bank intends to **include** in the proposed interchange fee standard.

The detail of the subdivision of costs into Categories A, B and C is set out in Attachment 3.

The Bank is of the understanding, from discussions with Reserve Bank officers, that the Reserve Bank intends to amend Paragraphs 7 (i), 7(ii) and 7(iii) of draft Standard No. 1 to ensure that all Category B and C costs are ‘eligible costs’. If the Reserve Bank does not amend the paragraphs as represented, there will be under-recovery of appropriate costs.

If the Reserve Bank is not going to implement this understanding, the Bank requests that it be given the opportunity to make a further submission on the appropriate wording of Paragraphs 7(i), 7(ii) and 7(iii) of draft Standard No. 1 prior to the Reserve Bank finalising the Standard.

3.5 Proportion of Costs of Statementing, Remittance Processing and Collections

In many respects, the open credit card is the equivalent of an outsourced storecard to merchants. Under a proprietary store card arrangement, the merchant meets the cost of issuing statements and collecting payments from customers (along with incurring costs such as fraud and credit losses). Therefore, the Bank is of the view that a proportion of the costs of statementing, remittance processing and collections should be included in 'eligible costs'.

Another way of looking at the same issue is that issuers incur a variety of costs in providing payment guarantees to acquirers. For the provision of payment guarantees to constitute a viable business, the guarantor must either collect the funds owing or write off the loss. In addition to issuers' costs in respect of processing, authorisation, fraud losses and fraud prevention, this would involve the following additional 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.

The Reserve Bank disallows statementing, remittance processing and collections costs of from interchange fees on the basis that:

> *"These costs are unrelated to the payment services of a credit card or to payment network considerations." (Consultation Document, page 51)*

yet this is inconsistent with the Reserve Bank's view (Consultation Document, page 55) that:

> *"The payment guarantee is a payment service provided by a credit card of which merchants are the main beneficiary."*

The Bank recognises that part of the cost of statementing, remittance processing and collections relates to revolving credit beyond the statement due date and therefore not all of these cost should be included in 'eligible costs'.

The Bank recommends that a proportion of issuers' costs of statementing, remittance processing and collections be included in 'eligible costs' in draft Standard No. 1.

3.6 Return on the capital committed to providing payment services to merchants - meaning of the word "Cost" to include Cost of Capital and Sunk Costs

Draft Standard No. 1 does not define the word "cost". The draft Standard states that data on eligible costs must be drawn from accounting records prepared in accordance with generally accepted accounting principles.

As discussed with Reserve Bank officers on 12 February, the Bank is of the view that the word "cost" must be used in an economic sense, including a normal return on capital – including, for example, investments in new technology or capital invested in the existing systems. If this concept of 'cost' is not included in the Standard, then the normal commercial

incentive for issuers to invest in the payment services to merchants will not exist and such investments are therefore unlikely to occur.

The Reserve Bank (Consultation Document, page i) recognises that *'the credit card network in Australia is extremely well developed'*. The Bank has expressed its concerns to the Reserve Bank previously regarding the need to ensure that financial institutions continue to have the incentive to develop innovative payment instruments that meet the future needs of all Australians (refer submissions M.1, page 13 and M.3, page 2).

It is not in the public interest for investment in electronic payment infrastructure to be diminished by regulatory intervention that denies issuers the ability to earn an appropriate return on their investments in payment services to merchants.

The Reserve Bank (Consultation Document, page 52) recognises the appropriateness of issuers being able to earn an appropriate return:

> *"There would be logic in individual issuers seeking from merchants a return on the capital committed to providing payment services to merchants (eg that part of the capital costs of chip technology aimed at fraud prevention), although it is not clear how different "hurdle" rates of return for different issuers could be credibly averaged for inclusion in an interchange fee."*

Draft Standard No. 1 does not allow issuers to earn an appropriate return on the capital committed by issuers to providing payment services to merchants.

Accordingly, the Bank recommends that draft Standard No. 1 be amended to include "a return on the capital committed to providing payment services to merchants" as an "eligible cost".

In order to assist in the development of a methodology for including an appropriate return on capital in interchange fees, the Bank is willing to share with the Reserve Bank the methodology the Bank currently uses to determine the capital that supports both the operational risk and credit risk for credit card issuing.

3.7 Costs to implement and comply with Draft Standard No. 1

It is usual practice where there are regulated pricing regimes, that the costs of implementing that regime and complying with that regime are 'eligible costs'.

The Bank recommends that draft Standard No. 1 be amended to include 'issuers' costs of implementing and complying with this Standard' as an 'eligible cost'.

3.8 GST on Interchange Fees

Interchange Fees are a taxable supply under GST legislation.

Therefore, the actual interchange fee charged (under Paragraph 13 of draft Standard No. 1) needs to be not greater than the interchange fee calculated in accordance with Paragraph 10 of the draft Standard plus the rate of GST.

The Bank recommends that draft Standard No. 1 be amended to include 'GST on interchange fees' as an 'eligible cost' and the words 'exclusive of GST' be inserted after the word 'paid' in Paragraph 13.

3.9 Other Comments on Draft Standard No. 1

3.9.1 Paragraphs 6 and 14 – implementation date

Draft Standard No. 1 proposes that the new interchange fees must be calculated and published 'within [3] months after the Standard comes into force' by virtue of Paragraph 6.

While this is a matter for each scheme to discuss with the Reserve Bank, it appears to the Bank that three months is too short a period for the first setting of the fees. Each scheme will need to appoint an expert (agreed to by the Reserve Bank), data will need to be collected from nominated scheme participants for each scheme and each expert, in conjunction with each scheme, will need to develop a methodology and walk the Reserve Bank through the calculations.

The Reserve Bank mentioned to the Bank the need for the Reserve Bank to issue a "Guidance Note" as to calculation methodologies.

When the calculations are complete, the scheme must determine the actual interchange fees to be charged and ensure that systems are able to efficiently identify the four types of transactions to ensure appropriate fee charging.

The Reserve Bank will need to be guided by the systems and implementation requirements of each scheme in developing an appropriate implementation timetable.

The Bank recommends that the Reserve Bank consult with each scheme after 15 March 2002 to determine appropriate implementation plans before the Reserve Bank determines the date under Paragraph 6 and the implementation timetable under Paragraph 14.

3.9.2 Paragraph 8 – Separate Interchange Fees and 'Payment Guarantees'

Paragraph 8 requires that there be four interchange fees based on whether the transaction has electronic authorisation or not and whether the transaction is the subject of a 'payment guarantee' or not.

The Bank disagrees with the concept that the Reserve Bank micro regulate interchange fees rather than being satisfied that average interchange fees are within an appropriate benchmark. Such micro regulation is likely to stifle product innovation within and between schemes as it is not clear how interchange fees for new products will be treated by the Reserve Bank in the future.

The Bank recommends that the Reserve Bank not specify and regulate four interchange fees but regulate interchange fees on an average basis for each scheme.

The Bank is unclear as to the Reserve Bank's meaning of 'payment guarantee'. The definition in draft Standard No. 1 is somewhat circular as it states that *"'payment guarantee' means a guarantee provided to a merchant in respect of a credit card transaction"*. Interestingly, the Reserve Bank's definition involves the proprietary and bi-lateral contracts between merchants and acquirers rather than the rules that deal with the rights and obligations of issuers and acquirers. Arguably, this is beyond the scope of the Reserve Bank's powers.

As discussed with officers of the Reserve Bank, there is no current concept that payments for some credit card transactions are guaranteed and others not guaranteed. One can either view

that payment is guaranteed in respect of all credit card transactions provided certain conditions are met, or that payment is not guaranteed in respect of any transaction unless certain conditions are met.

The Bank understands, from its discussions with the Reserve Bank, that the Reserve Bank associates the concept of a ‘payment guarantee’ with chargeback processing and whether the issuer or the acquirer (with recourse to the merchant in some cases) bears the loss in respect of fraudulent and / or disputed transactions.

The Bank recommends that the Reserve Bank should clarify its intentions with respect to ‘payment guarantees’ in consultation with schemes and their members prior to finalising draft Standard No. 1.

The Bank recommends also that, once the clarification process has been completed, the definition of ‘payment guarantee’ be amended.

3.9.3 Paragraph 9 – Cost Data

Paragraph 9 requires that cost data be drawn from the accounting records of the nominated scheme participant for the previous financial year.

Major costs, such as investment in fraud prevention technologies are typically large in nature and spread over a number of years. As the draft Standard only proposes that one year’s data be included in the calculations, the Standard brings an element of luck into whether a major investment will be included in ‘eligible costs’ or not. It would not be in the public interest for all of these major investments to be made in the year data will be used for interchange fee calculations nor is it fair on issuers for major investments in other years to be excluded from the calculations. The best outcome is for investments to be made in the normal course but for the interchange fee Standard to recognise significant investment in other financial years – perhaps by way of an appropriate, and agreed, amortisation schedule.

The Bank recommends that draft Standard No. 1 be amended to allow the independent expert to include portions of eligible costs from other financial years provided this is done in consultation with the Reserve Bank.

3.9.4 Paragraph 12 – Publication of Data and Fees

Paragraph 12 requires each scheme to publish the aggregate data to calculate interchange fees and the interchange fees calculated in accordance with Paragraph 10 of draft Standard No. 1.

The Bank believes that publishing the aggregate data for each scheme will enable ‘nominated scheme participants’ to gain insights into each nominated scheme participant’s relevant costs (information that would not otherwise be available to it). Differences in aggregate costs for each scheme will reflect the different costs of nominated scheme participants and the different weightings of those costs in each scheme. As it is likely that data from the same nominated scheme participants will be included in each scheme’s calculations, it is not in the public interest for the aggregate data to be published. Similar considerations apply to each scheme gaining insights into the other schemes’ aggregate cost data and volumes.

Such data disclosure between competitors is usually viewed suspiciously by competition authorities because it can facilitate coordinated behaviour and undermine dynamic efficiency by discouraging innovation.

The Bank recommends that Paragraph 12 (i) of draft Standard No. 1 be deleted. However, the Bank has no objection to the Reserve Bank being provided with this data as proposed under Paragraph 11 of the draft Standard.

Paragraph 12 (ii) of draft Standard No. 1 requires the interchange fees *"calculated … in accordance with Paragraph 10"* of the Standard to be published.

As schemes are able to charge interchange fees less than the fees calculated under Paragraph 10, the Bank recommends that draft Standard No. 1 be amended to require publication of the actual interchange fees charged (including GST) for each transaction type, rather than the calculated interchange fees.

3.9.5 Paragraph 15 – Review of Fees

Paragraph 15 requires interchange fees to be recalculated every three years and gives the Reserve Bank the right to require an earlier recalculation of interchange fees if the Reserve Bank considers that changes in costs so warrant.

The Reserve Bank's intervention in credit card schemes has already increased the regulatory risk associated with providing credit card services to both merchants and cardholders. Future investment in these services will be subject to careful commercial assessments as to the likelihood of the Reserve Bank changing its requirements with little notice such that the business models under which investment decisions are made are rendered obsolete. Regulatory uncertainty creates additional business risk and in the absence of participants having access to satisfactory mitigants to the Reserve Bank's regulatory powers, new investments in payments infrastructure will require higher expected returns and very short payback periods.

The right of the Reserve Bank to require earlier recalculation of interchange fees creates unacceptable regulatory risk (without a satisfactory mitigant) which will result in future development of Australia's credit card payment systems having regard to even shorter payback periods. This is in contrast to the longer timeframes that participants considered when developing Australia's current world class card and electronic payment systems.

The Bank notes that the Reserve Bank did not address the investment implications of its proposed reforms in the Consultation Document at all. The Bank questions how the Reserve Bank can consider that it has undertaken a thorough assessment of the likely impacts of the proposed reforms when it has not considered the likely impacts on future investment in payments infrastructure in the light of increased regulatory risk.

In order to provide participants with some business certainty, the Bank recommends that the Reserve Bank **not** be given the power to require earlier calculations than the three years set out in Paragraph 15 of draft Standard No. 1.

3.10 Regulation of Interchange Fees under Access Powers not Standards Powers

The Bank is of the view that any regulation of interchange fee setting should be under the Reserve Bank's powers under Section 12 of the PSRA rather than under Section 18. To support this view, the Bank provided the Reserve Bank in July 2001 with a copy of advice from Jeffrey S Hilton SC (refer Attachment to submission M.3).

The Bank requested in its 3 July 2001 submission (submission M.3, page 4) that if the Reserve Bank proposed to take a contrary view of the way the PSRA operates, then discussions on this

issue should take place between the Reserve Bank and Bank prior to the publication of the Consultation Document. These discussions did not take place.

The Reserve Bank (Consultation Document, footnote page 54) states that the Reserve Bank, *"drawing on advice from senior counsel"*, does not accept that interchange fee setting should be regulated via an access regime rather than a standard.

In the absence of the requested discussions, the Bank requested on 1 February 2002, and the Reserve Bank kindly provided, a copy of an advice from the Reserve Bank's senior counsel.

The Bank has considered that opinion and taken further advice from its lawyers, including Mr Hilton, who remains of the opinion that the preferable construction of the PSRA is that:

- if the Reserve Bank exercises its powers under the PSRA to impose pricing regulation on credit card systems, the regulation must be imposed under section 12 of the PSRA as part of an access regime, together with other conditions of access that have a commercial and financial impact; and
- the Reserve Bank may not impose pricing rules and principles as a standard under section 18 of the PSRA. Such standards should be confined to standards of a technical or operational character or standards pertaining to financial security.

The Bank recommends that the Reserve Bank reconsider whether it is regulating interchange fees under the correct head of power.

4.0 DRAFT STANDARD NO. 2 – MERCHANT PRICING FOR CREDIT CARD PURCHASES

4.1 Case for Reform

The Bank's views on proposals to abolish the 'no surcharge' rules have been provided to the Reserve Bank previously (refer submission M.2, page 4 and submission M.3, pages 11 and 12) where we indicated that:

> *"The Commonwealth Bank considers that, at best, the empirical evidence of a public benefit resulting from abolition of "no surcharge" rules is weak, and is unlikely to outweigh the consumer detriment involved in exposing cardholders to pricing uncertainty and the actions of unscrupulous merchants. Moreover, unlike its European counterpart that was sanctioned by the European Commission, the "no surcharge" rule does not prevent price discrimination via cash discounts.*
>
> *The Commonwealth Bank considers that, in the absence of evidence of a public benefit from their abolition, the "no surcharge" rules do not provide any justification for the designation of the card schemes." (submission M.2)*
>
> *"In the Bank's 20 December 2000 submission, the Bank expressed the view, based on the work of Frontier Economics, that there is no basis for the proposition that cash paying consumers are cross-subsidising credit card paying consumers. In addition, if merchants were able to surcharge, it results in over-compensation of the merchant to the detriment of the cardholder as the merchant is not paying their fair share from participating in the credit card system and as a consequence the cardholder pays too much.*
>
> *The Bank notes that any decisions the RBA takes in this area would apply to both credit card systems and "three party" systems. As the "three party" systems are not subject to the current designation, the consultation document would need to set out the proposed method of including "three party" systems within the scope of any decision." (submission M.3)*

The 'no-surcharge' rule is part of the **basic** value proposition to credit cardholders; ie issuers offer the following proposition to their potential customers:

> *I would like to provide you with a payment card where you will pay the same price for your goods and services as you will pay for a cash purchase but you will not be able to do this everywhere. Merchants who have agreed to sell you their goods for the same price have our scheme's decal in their shop window.*

The Reserve Bank seems to be arguing that under no circumstances can anyone ever again offer a payments product to consumers in Australia that has such a value proposition. That the proposition has been popular with consumers and the vast majority of merchants is not a reason that it should now be made unlawful.

This is another example of the Reserve Bank proposing to alter the basic value propositions (product features) of credit cards to merchants and cardholders which again contradicts the Reserve Bank (Consultation Document, page ix) statement that:

> *"The proposed reform measures … (leave) the basic structure of credit card schemes intact."*

While the Reserve Bank (Consultation Document, page 74) dismisses the need for any *"materiality tests"* in its proposed reforms, the Bank (refer submission M.3, page 5) has pointed out that the Reserve Bank should only introduce regulation where:

- *"there is a clear divergence between private interests and the public interest – ie, there is a clear case of "market failure";*
- *that market failure is giving rise to, or is likely to give rise to, a significant loss of social welfare, materially greater than the cost of regulation;*
- *the precise nature of the factors giving rise to the market failure have been unambiguously identified;*
- *the regulation will directly address the causes of market failure or, if that is not possible, its immediate consequences (ie no attempt should be made to "offset" the problems in one market through regulation of another);*
- *the regulation complements, as far as possible, any mechanisms established by the private sector to address the identified market failure; and*
- *the regulation will, or is likely to, have in practice an impact which results in a material net increase in social welfare."*

The Australian Retailers Association state in a letter to the Australian Financial Review published on 1 March 2002 that:

> *"As for merchants applying a surcharge when a credit card is used, it is highly unlikely that retailers would apply a surcharge because competitive pressures would discourage this payment.*
>
> *Choice magazine's March 2002 issue refers to the UK experience and says removing the no-surcharge rule "isn't likely to mean you'll pay more at the till for using a credit card".*
>
> *Surcharging on credit-card transactions would be a non-issue if fees were reduced and were more in line with other forms of payment."*

These comments seem to support the Bank's view that there has not been or is likely to be a case of market failure that requires regulation.

Merchants in Australia are able to offer cash discounts which is the economic equivalent of surcharging. The fact that merchants do not generally do so, strongly suggests that the net benefits of accepting credit cards is positive. As merchants have the option of cash discounts, the prevention of surcharging cannot be a source of material economic inefficiency.

With the Reserve Bank (Consultation Document, page ix) expecting that:

> *"The draft standard on interchange fees is likely to result in a significant reduction in bank fees; in this instance the initial beneficiaries will be merchants that accept credit cards …"*

the case for proceeding with draft Standard No. 2 is significantly weakened. Conversely implementation of draft Standard No. 2 and the draft Access Regime negates completely the need for draft Standard No. 1.

Consequently, the Bank is of the view that the Reserve Bank's (Consultation Document, page viii) opinion that:

> *"scheme restrictions on merchant pricing are a source of serious inefficiencies in the pricing of payment instruments"*

is a vast overstatement of the true position.

Notwithstanding the above, the Bank recommends that if the Reserve Bank is intent on allowing merchants to surcharge for credit card transactions, then the surcharge should only be for the excess cost of accepting credit cards over the cost of accepting cash (legal tender). The Australian Retailers Association (refer Submission H.2, page 20) quotes the cost of accepting cash at 0.7%. To allow merchants to surcharge for the whole cost of accepting a credit card payment means, as pointed out by the Bank (refer submission M.3, page 12), that:

> *"it results in over-compensation of the merchant to the detriment of the cardholder as the merchant is not paying their fair share from participating in the credit card system and as a consequence the cardholder pays too much."*

4.2 Application to Three Party Schemes and the Date the Standard Comes into Force

The Bank's July 2001 submission (refer submission M.3, page 11) notes that:

> *"The 12 April RBA Media Release stated:*
>
> > *"The RBA/ACCC study was also critical of "no surcharge" rules in card schemes that prevent merchants passing on to cardholders the cost of using their payment cards. In the study's view, such rules — which are imposed by the credit card systems as well as American Express and Diners' Club — suppress price signals that guide the efficient allocation of resources. The (Reserve) Bank will review whether the imposition of "no surcharge" rules by card schemes is in the public interest. Any decisions taken by the (Reserve) Bank in this area would, of course, apply to both credit card systems and "three party" systems.""*

The Bank noted also in that submission (refer page 12) that:

> *"any decisions the RBA takes in this area would apply to both credit card systems and "three party" systems. As the "three party" systems are not subject to the current designation, the consultation document would need to set out the proposed method of including "three party" systems within the scope of any decision."*

The Reserve Bank does not set out in the Consultation Document the method by which the three party schemes will be included in the scope of a decision to implement draft Standard No. 2.

Instead, the Reserve Bank (Consultation Document, pages ix, 79 and 118) states simply:

> *"However, American Express and Diners Club do impose restrictions on the freedom of merchants to recover credit and charge card costs from their cardholders. The Reserve Bank will be consulting these schemes as to why they should not also be required to meet the standard on merchant pricing." (page ix)*

"The Reserve Bank will consult the three party card schemes, American Express and Diners Club, on why the standard on merchant pricing should not apply to them." (page 79)

"However, the three party card schemes impose the same restrictions on merchant pricing as the designated credit card schemes. The Reserve Bank will therefore be consulting with the three party card schemes on why they should not meet the proposed standard on merchant pricing." (page 118)

The Reserve Bank has made it clear that any decision to make the 'no–surcharge' rule unlawful in Australia for open credit card schemes will also apply to three party schemes, including American Express, Diners Club (and arguably the Coles Myer card scheme which is provided by a third party, GE Capital Finance Limited, with over 2 million accounts and acceptance in 1,800 locations Australia wide).

Therefore, the Bank recommends that the Reserve Bank not implement draft Standard No. 2 **unless and until** it applies from the same date to the three party schemes. Failure by the Reserve Bank to follow this recommendation will establish a regulated competitive disadvantage of four-party schemes over three-party schemes.

The Bank envisages that the prerequisites for the implementation of draft Standard No. 2 are either the three party schemes voluntarily change their merchant agreements and advise each merchant in an manner similar to that proposed in Paragraph 10 of draft Standard No. 2 or the Reserve Bank designates the three party schemes and implements a similar standard to draft Standard No. 2 with respect to these schemes.

5.0 DRAFT ACCESS REGIME FOR DESIGNATED CREDIT CARD SCHEMES

It is primarily a matter for the credit card schemes to respond on the draft Access Regime.

As a matter of principle, the Bank supports strong and vibrant competition, provided such competition is conducted on a 'level playing field' and with appropriate consumer, merchant, participant and scheme protections.

The PSRA promotes competition through providing access arrangements in appropriate circumstances but provides that access arrangements should not be put in place at the expense of compromising prudential security. Thus when assessing whether access proposals are in the public interest, the PSRA (section 8(b)) provides that the Reserve Bank is to:

> *"have regard to the desirability of payments systems … not (in its opinion) materially causing or contributing to increased risk to the financial system."*

As a participant in the three open credit card schemes, the Bank is therefore concerned with the integrity of each scheme and that any widening of participation does not increase the brand or financial risks to the Bank.

The schemes' current Authorised Deposit-Taking Institution (ADI) membership eligibility criteria are in place to ensure the integrity of the schemes and their members and have served both merchants and consumers well. Creating a new category of supervised entity will bring new challenges and risks and should not be taken lightly. Recent domestic and international corporate failures demonstrate the difficulties in regulatory supervision.

The Bank is therefore most interested in the prudential and risk standards that will apply to "specialist credit card service providers" (SCCSPs) but the Bank notes that these standards are yet to be determined.

The Reserve Bank (Consultation Document, page 108) states simply that:

> *"the APRA Board has agreed in principle that APRA will authorise and supervise specialist credit card issuers and acquirers."*

The Reserve Bank (Consultation Document, pages 108 and 109) states that:

> *"As an assurance to the credit card schemes and the community generally that such institutions (SCCSPs) 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."*

However, the Bank is not aware of any statements by APRA to this effect nor has APRA set out a timetable / process of consultation that it intends to follow to develop its prudential requirements for SCCSPs.

As the detail of the prudential supervision of SCCSPs has not been determined, the Bank is unable to comment in detail on whether the draft Access Regime will result in acceptable or unacceptable risk to consumers, merchants, participants and schemes.

As the activities of these specialist institutions will be limited to issuing credit cards and / or acquiring credit card transactions in four party credit card schemes (essentially a separately capitalised monoline business), these institutions will have a concentration of risk and an undiversified business base to absorb risk. In these circumstances, the Bank believes that the necessary prudential capital requirements should be greater than those applying to more diversified ADIs.

The proposal that APRA establish a new class of participants appears to amount to the Reserve Bank delegating its powers to APRA. APRA's proposed role is to determine the prudential standards of companies who are eligible to apply for access to the credit card systems. The Reserve Bank has not (at least, publicly) provided APRA with any guidance as to how to exercise the power and therefore there is no guarantee or likelihood that the power would be exercised by APRA as required by the PSRA. It is doubtful that:

- the Reserve Bank's powers under the PSRA can be delegated to APRA; and
- an open ended delegation without any requirement that APRA take into account the public interest factors in the PSRA is likely to meet the public interest requirements of the PSRA.

For the above reasons, the Bank recommends that the Reserve Bank not implement the draft Access Regime until after APRA has published draft prudential standards for SCCSPs and conducted a consultation process similar to that envisaged under the PSRA.

As a separate issue, the Bank believes that it is an unreasonable requirement for schemes to be required to publish on a relevant website the *"the rules of a Scheme which govern the eligibility for participation, and the terms of participation" (draft Access Regime Paragraph 11).*

As there are only three schemes, initial information search costs are quite low and all potential participants are companies which are either (or intend to be) authorised deposit-taking institutions or specialist credit card service providers. There seems little public benefit in requiring these rules to be publicly available to both potential participants and individuals in general.

The Bank recommends that Paragraph 11 of the draft Access Regime be deleted.

6.0 NEXT STEPS

The Bank's Submission has addressed a number of issues that the Bank recommends be amended in the Reserve Bank's proposed reform of credit card schemes in Australia. The Bank's recommendations have been summarised in Section 2.3 above.

Again, the Bank appreciates the opportunity to make this Submission and looks forward to engaging with the Reserve Bank in further consultation prior to the Reserve Bank finalising its reforms.

The Bank recommends that, in the interests of transparency and openness, the Reserve Bank publish all submissions received as a consequence of the Consultation Document. The Bank believes that only legitimate commercial-in-confidence aspects of the submissions should be suppressed – all other aspects of submissions should be put on the public record. To this end, the Bank agrees to, and requests, publication of this Submission. To facilitate its publication on the Reserve Bank web site, the Bank will provide the Reserve Bank with a copy of this Submission in "pdf" format.

Finally, when the Reserve Bank makes its final decisions on matters raised in the Consultation Document and exercises its powers under the PSRA, the Bank recommends that the Reserve Bank place on the public record:

- a summary of the submissions received as a consequence of the Consultation Document;
- the arguments raised in the submissions; and
- a detailed statement of the Reserve Bank's reasons for the decisions it takes.

The Bank recommends that the Reserve Bank adopt the review mechanisms set out in Chapter 7 of the submission by the Australian Bankers' Association.

All of these disclosure recommendations are in the interests of openness, transparency and equity.

Commonwealth Bank of Australia
Sydney
15 March 2002

Attachment 1

Principles for Interchange Fee Methodologies – Changing Regulatory Requirements

The Reserve Bank (Consultation Document, page 42) states its principles for interchange fee methodologies as follows:

> *"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 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;*
> *(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."*

These principles were not previously known to the credit card schemes or their members and are different to the ACCC's key features set out in a letter from the Chairman of the ACCC to the Review Banks dated 21 February 2001 where the Chairman noted that the Reserve Bank and the ACCC were in agreement on the key features necessary to ensure that a cost based methodology for calculating interchange fees will operate in the public interest.

The key features stated in that letter for a regulated interchange fee methodology are that it:

- *"Provides a cost based justification for the level of interchange fees that is transparent to merchants, cardholders and the community in general. In doing so, the methodology should address the effect of the level of the interchange fee on the efficient pricing of credit card services to both merchants and cardholders.*
- *Excludes from its calculations costs and revenues that are not related to network considerations, and therefore not relevant to interchange calculations.*
- *Since interchange fees provide a mechanism by which card issuers can recover some of their costs from merchants, only those issuer costs that are appropriately passed on to merchants should be included as a legitimate cost in the methodology. I would expect that a rigorous application of such a methodology would justify differential interchange fees, for instance, lower interchange fees for card not present transactions that do not provide a payment guarantee to merchants.*
- *Incorporates forward looking pricing principles to enable future cost reductions and efficiency improvements to be quickly passed on.*
- *Incorporates effective procedures to ensure the integrity of the data used in the interchange fee calculations and that the methodology is rigorously applied.*
- *Is subject to regular reviews."*

  These key features were taken into account in the submission by the Australian Bankers' Association of an appropriate methodology to be used for regulating interchange fee setting (Submission G.2, page 45).

The main difference between the key features of 21 February 2001 and the principles of 14 December 2001 is the inclusion of the word **'payment'** in Principles (ii) and (iii) which serves

to narrow the costs which can be included. The other difference is the dropping of the ACCC's fourth key feature – forward looking pricing principles.

As the Reserve Bank did not share its evolving thinking, schemes and members were unaware that the Reserve Bank would judge interchange fee methodologies against new (and previously unpublished) principles. It is not surprising, therefore, that the Reserve Bank (Consultation Document, page 46) formed the following judgement:

> *"In the Reserve Bank's judgment, none of these methodologies fully meets the principles for interchange fee setting established earlier. Each includes costs which are not related to payment network considerations or to specific services provided to merchants. A number of cost categories do not meet the principles."*

In an earlier letter from the ACCC to the Review Banks dated 16 June 2000, the ACCC set out the following issues that the ACCC expected to be part of an application for authorisation (under the Trade Practices Act) for interchange fee setting:

- *"The development of a methodology for calculating interchange fees based on forward looking efficient pricing principles and, as far as possible, directly attributable costs, and which has regard to the ability of banks to recover these costs from other sources.*
- *A process to determine interchange fees in accordance with this methodology that is transparent and contains an appropriate dispute resolution mechanism, as well as providing for on-going review into the future.*
- *The principles governing access to credit card schemes, including, for example, whether membership of credit card schemes should be limited to deposit taking institutions; other ways in which membership criteria such as prudential standards and technical requirements can be met; and the effect that access arrangements have on the costs of participating in credit card schemes and interchange fees; and*
- *The incorporation of any revised mechanism for interchange fees and access into the rules and regulations of credit card schemes."*

Representatives of the National Australia Bank and the Bank met with the Reserve Bank on 8 August 2000 to inform the Reserve Bank of the joint bank review of credit card interchange methodology. As noted in the Bank's Comments dated 20 December 2000 (Submission M.1, page 4) the review was designed to address:

- *"The development of a methodology for calculating interchange fees based on efficient pricing principles. The review would consider the appropriate basis of those principles including:*
  - *Forward looking pricing principles based on directly attributed costs;*
  - *The ability of the banks to recover these costs from other sources and the appropriate allocation of recovery; and*
  - *Additional or alternative bases that may be equally efficient or more efficient.*
- *A process to determine interchange fees in accordance with this methodology which is transparent;*
- *A critical examination of the effect the membership rules have on efficient pricing including whether the current rules are necessary and the criteria upon which non-banks could be admitted to the system."*

The Reserve Bank made no suggestions at that time that interchange fees based on 'forward looking efficient pricing principles' would be unacceptable, nor that only 'payments' related costs would be acceptable.

Attachment 2

MEMORANDUM

TO:	Commonwealth Bank of Australia
FROM:	Edgar, Dunn & Company
DATE:	13 March 2002
SUBJECT:	Interchange Framework: Outsourced Store Card

The Commonwealth Bank (CBA) asked Edgar, Dunn & Company (EDC) to provide a brief description of the historical positioning of credit cards as an outsourced store card and the importance of including the interest free period in the calculation of interchange costs. This memo provides our response to that request.

Overview

Many of the arguments to support interchange fees centre around network externalities and merchant benefits such as higher sales and gross margins. However, when interchange fees were first developed they were based on offering the merchant a payment product that was competitive to (or superior to) their own proprietary store card at lower cost and, in the case of small merchants, a payment product the smaller merchant could not afford to offer themselves. As such, the four party credit card was initially introduced as an outsourced store card.

Acquirers provide credit card payment services to merchants that substitute for the features available with store cards and eliminate the related costs of merchants providing a store card themselves. An example is the interest free period by which the customer can buy now and pay later. When this feature is provided by the four party credit card schemes, merchants receive near immediate good funds and do not incur the transaction funding costs related to payments made with store cards. This was one of the original and attractive characteristics to the merchants of the bank-sponsored schemes.

As the original three party credit card schemes evolved to four party credit card schemes, the outsourced store card service continued to be provided by the acquirer but the cost of funding the free period and the associated risk of the transaction was incurred by the issuer. As such, the cost of the interest free period is included in the calculation of interchange costs as a method to match this cost of the outsourced store card payment service with the revenue received. The matching of revenues to costs was (and is) a basic business tenet and is a required aspect of offering a viable four party buy now, pay later product.

The RBA does not discuss interchange based on providing outsourced store card services. Their conclusion that there should be an interchange fee and that it would flow from the acquirer to the issuer is reinforced by the economics of an outsourced store card. These economics also provide a market driven basis for determination of the minimum costs that should be included in the calculation of interchange costs.

Background

If credit cards are to be priced to be economically viable in the long term, they must offer a value proposition (attributes / functionality provided in comparison to user cost) that is competitive to their close substitutes: store charge cards, store credit cards and three party charge and credit cards.

The origins of the four party schemes were regional and bank three party schemes in the US. As regional schemes consolidated and added members, members focused on issuing or acquiring and expanded in terms of acceptance there was a need to exchange transaction information (as it was not efficient for each card issuer to sign up each merchant). This also raised the question of whether there should be commercial arrangements associated with the exchange of transactions.

The assessment of commercial arrangements was required because until then the provision of payment services was an end-to-end undertaking (eg three party schemes and store cards). With the division of the business into an issuing function (with a direct relationship with the cardholder) and an acquiring function (with a direct relationship with the merchant) it was necessary to ensure that costs and revenue sources were appropriately matched. This is one of the foundations on which the commercial arrangements for interchange fees were based.

The Outsourced Store Card basis for Four Party Credit Cards

Store cards provided a basis for pricing of credit cards by the acquirer to the merchant and to match revenues and costs for non on us transactions (the acquirer and the issuer are different organizations).

1. Four party credit cards are a product with joint costs that are jointly consumed. In the credit card world neither the card issuer nor the payment transaction acquirer could exist without the other. They are the joint providers of credit card payment services. In essence, the four party schemes separate the issuing and acquiring functions that are provided as an integrated whole by store card and three party card payment service providers.

2. The payment services provided by these joint providers (issuers and acquirers) drive the costs incurred. The sum of the costs comprises the end-to-end costs of the payment services.

3. In the case of three party schemes (charge cards and store cards), all costs are incurred by one party (who acts as the end-to-end payment service provider). In the instance of four party schemes there is a logical split in the activities (and related costs incurred) between the issuers and acquirers.

4. The cardholder and the merchant are the joint "consumers" of the credit card payment services. The cardholder cannot use the card to make a purchase unless the merchant accepts the card.

5. Together the cardholder and the merchant are the only sources of revenue from which to recover the costs of card-based payment services, regardless of whether the service is provided by an integrated three party scheme or a four party scheme. A core issue

becomes how revenues and the costs should be matched if the issuer and acquirer are not the same party.

- ❑ Because four party credit card services are jointly provided and jointly consumed, it does not necessarily follow that cardholders should pay the costs of the issuers or merchants should pay the costs of acquirers just because the issuer has a direct relationship with the cardholder (and the acquirer with the merchant).
- ❑ The separation of payment service activities between issuers and acquirers is based on efficiency of providing these services and not because of the relationship of the provider of the service with either of the end consumers (the cardholder or the merchant). Activities are divided between issuers and acquirers based on logical business considerations such as efficient flow of information, grouping of related tasks and so forth.
- – For example, it would not be efficient for the acquirer to authorise transactions but then have the issuer process the completed transaction and post it to the cardholder account.
- – Likewise, it would not be efficient for the issuer to issue cards and process chargebacks but not assume responsibility for fraud mitigation efforts.
- ❑ There is no practical way to apply pure economic theory to quantitatively determine how much of the end-to-end costs each party (the cardholder and the merchant) should pay.
- – Economic theorists suggest that supply and demand curves would supply the answer to this question. This would be difficult to develop in the "real" world. For example, a large merchant would be strongly tempted to indicate a low demand for these services if it would result in a low merchant service fee.
- – The RBA' proposed eligible interchange costs do not appear to be based on economic theory (nor any consideration of comparable product economics such as store cards or three party charge cards).
- ❑ It is unlikely that the incidence of four party payment service costs is coincident with the demand for payment services. That is, it is unlikely (or would be coincidental) that the acquirers' costs are equal to the merchants' fair share (based on demand) of end-to-end credit card payment service costs and that pricing to the merchant can therefore be based on acquirers' costs. The same holds true for issuers and cardholders.

6. Because there is no straightforward practical method to apply supply and demand curves to the assignment of jointly provided costs, a reasonable approach was to let the market make the determination.

- ❑ At that time (and now) merchants had (and have) a number of options if they wanted to offer the consumer a "buy now, pay later" payment option.
- – Store ledger credit (small merchants such as neighbourhood grocers)
- – Store cards (large merchants such as Sears and Macy's)
- – Instalment sales
- – Charge cards such as Amex and Diners

Not all merchants offered these options as each option had a cost (e.g. administrative, funding and risk (fraud and credit loss) costs). The merchant

made the decision if offering any of the buy now, pay later payment options made commercial "sense".

- As four party schemes evolved, rather than make an arbitrary determination of the demand for payment services, actual buy now, pay later payment products in the marketplace provided an indication of "what the market would bear". What the merchant was willing (or should have been willing) to pay was based on what they were paying for three party cards and what costs (in the instances where they issued their own card) they incurred for providing their own buy now, pay later card.
- The RBA has alluded to this approach with their statement: "standard observation that the price of close substitutes is a key determinant of the price of a good or service" (Page 120 of the Consultation Document).

7. Therefore, interchange fees were based on costs (but not all costs) that the merchant would incur itself in offering a buy now, pay later payment service. In that manner it was expected that the outsourced payment service (the four party credit card) would be competitive and in fact superior with the merchants' alternatives.
   - General purpose retailers were some of the early merchants to adopt credit card payments because of the attractive value proposition of an outsourced store card.
   - Hotels, restaurants, retailers catering to international tourists and so forth followed in part because credit cards offered a lower cost payment option compared to three party charge cards.
   - Over time other merchant categories (such as special purpose retailers, white goods stores and so forth) began to accept four party credit cards. It is likely this delayed acceptance was because of (1) the need to demonstrate additional benefits (eg higher sales) and (2) the merchants' entrenched position with their proprietary store cards. This is beside the point in terms of the outsource store card pricing rationale and has more to do with the spread of acceptance and not the underlying pricing concepts.

8. It is illogical for retailers to state they receive no benefits from buy now, pay later payment products. If that were the case they would not issue their own store card or provide store credit. By issuing their own card they created a "market" for buy now, pay later products and once they created / established the market, competitive forces (three party and four party schemes) worked to provide the merchant and consumer with alternative products[1].

9. Credit card payment services provided to the merchant have not changed over time. As the RBA states: "The payment services of a credit card – in particular, its "buy now, pay later" feature and guaranteed refund – have not changed since the credit card was first introduced." (Page 50 of the Consultation Document). More specifically these services are:
   - No or minimal risk: A guaranteed payment, which eliminates direct credit and fraud losses, if certain procedures are followed.
   - Immediate funds: Eliminating the need for the merchant to directly fund the payment, which reduces their need for (and cost of) working capital.

[1] The evolution of three party cards was based primarily on facilitating travel and entertainment expenses rather than offering a store card substitute.

- Reduced administration: Eliminating the need for the merchant to incur the internal costs for statement preparation, collections, customer inquiries and so forth.

10. In order to have a fair, objective and transparent approach to the calculation of issuer costs that should be included in the commercial arrangements for interchanged transactions (i.e. the interchange costs), it was decided that the following cost categories were at the core of the buy now, pay later product and should at a minimum be included in the interchange cost calculation:

    - Risk costs such as credit losses and fraud losses.
    - Funding the free period because the merchant receives immediate funds and the issuer does not receive funds until the cardholder pays his or her statement or interest begins to accrue on the purchase transactions
    - The cost of presenting the transaction to the issuer for payment because it is typical in financial services for merchants to pay the costs of presenting payment information to receive good funds.

    Most other issuer costs (e.g. marketing, card production and so forth) would be recovered from the cardholder.

    Over time and in some markets, commercial arrangements were made such that cardholders paid some of the above costs. In those instances, only the costs not recovered from cardholders were (and are) included in minimum calculated interchange costs. In some markets it was determined that conditions warranted an interchange fee higher than the calculated minimum interchange costs

11. While the desire for more objectivity, transparency and rigour may be prudent in Australia in the setting of interchange fees, there is no inherent problem with the time-tested methodology described above to determine minimum interchange costs. That methodology, properly applied, is likely to lead to fewer distortions and inefficiencies than the RBA's proposed standard.

    - The RBA proposed eligible interchange costs exclude a cost that is critical to buy now, pay later payment products offered to merchants as an alternative to three party charge cards and store cards. This cost is the cost of the interest free period. Because there are only two sources of revenue for the issuers (the cardholder and the acquirer), removing this cost from the calculation of interchange costs requires the issuers to recover the cost from their cardholders. Research has shown that cardholders are unlikely to pay this cost.
    - This effectively destroys a fundamental attribute of credit cards that allows them to compete with three party charge cards and store cards. This is a potentially a significant regulated advantage to the three party schemes and store cards and would deny the Australian consumer access to as wide a choice of payment products.

In summary, the marketplace has historically provided a sound basis for the determination of minimum interchange costs that are recovered by the issuer from the acquirer. The cost of the interest free period has been an important element of this approach. There is no reason that this methodology properly applied in Australia would not form the basis for a competitive and efficient market for credit card payment services.

Attachment 3

"A" COSTS

Costs that are common to all transactions (on-us and not-on-us) that the Reserve Bank intends to **exclude** from the proposed interchange standard:

- Card Product Development (except card features to mitigate risk (e.g., fraud prevention))
- Account Acquisition
- Account Retention
- Customer Service
- Card Production and Delivery (except secure card delivery)
- Funding Costs (Outstanding Balances)
- Statementing
- Payment Processing
- Collections
- Bad Debt Losses
- Centre Management
- Corporate Overhead Allocations
- Return on Capital

"B" COSTS

Costs that are common to all transactions (on-us and not-on-us) that the Reserve Bank has, in discussions with the Bank, agreed to **include** in the proposed interchange fee standard:

- Card Features to Mitigate Risk (e.g., fraud prevention)
- Secure Card Delivery
- Fraud Prevention
- Fraud Investigation
- Fraud Write-offs
- Authorisation Processing (except card association fees related to authorisation (refer "C" Costs))
- Referral Processing
- Clearing
- Settlement
- Chargeback Processing
- Chargeback Losses

"C" COSTS

Costs relating only to "not-on-us" transactions that the Reserve Bank intends to **include** in the proposed interchange fee standard. Typically these are card association fees for:

- Authorisation Processing
- Clearing and Settlement Processing
- Chargeback Processing