Regulating Credit Cards in Australia

A Submission to the Reserve Bank of Australia

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Executive Summary

This submission considers two aspects of the RBA's consultation document, "Reform of Credit Card Schemes in Australia." First, we consider the theoretical basis for the documents draft recommendations. While in general the document clearly identifies the basic economic issues underlying credit card schemes and the setting of interchange fees, we believe that the document too readily dismisses the potential for interchange neutrality. The potential for neutrality depends on assumptions about the nature of merchant competition and the ability to surcharge. If these assumptions are satisfied in the Australian economy then concerns regarding abuse of interchange fees by the banks can be eliminated by simple structural change – the removal of the no surcharge rule on credit cards. As such, under neutrality there would be no need for the RBA to engage in (potentially costly) regulation of the interchange fee. Put simply, the removal of the no surcharge rule may be sufficient to remove any potential abuse of interchange fees.

The theoretical basis for neutrality is well understood in economics. However, there has been no systematic empirical study to determine whether neutrality is likely to hold for the Australian (or any) economy. We strongly encourage the RBA to undertake such a study before moving further down the path to price regulation. In the absence of such a study or of conclusive findings, we suggest that caution be exercised. The no surcharge rule can be removed without direct regulation of the interchange fee. The RBA can then study the effects of this change over time. If it is then felt that interchange fees were having an adverse effect on Australia's economic welfare, further price regulation could be undertaken.

Secondly, we consider the proposed methodology for setting a cap on interchange fees presented in the consultation document. We are concerned about the consistency between the methodology proposed in the consultation document and the explicit calculation of the maximum interchange fee. In our opinion, some of the avoidable costs that are excluded by the explicit calculation should, in fact, be included given the basis for the proposed methodology. A consequence of excluding these cost components might be a regulated interchange fee that is below the socially desirable fee. This will result in increased transactions costs in the economy.

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1 Introduction

This submission focuses on two aspects of the RBA's Consultation Document – "Reform of Credit Card Schemes in Australia" – released in December 2001. First, we consider the use of economic theory to justify regulation and the mix of policies recommended in the Document. Second, we examine closely the methodology for calculating interchange fees.

1.1 Policy Goals

Before doing this, however, it is worth emphasising that we share with the RBA a general scepticism that network effects can be used to justify policies regarding the use of credit cards (Section 2.3 of the consultative document). All payment instruments utilise network externalities to some extent and these network effects limit the number of payments instruments. As a result, it is not an appropriate goal of policy when analysing an individual payment instrument, such as credit cards, to maximise the positive network externalities associated with that one instrument. Rather, an appropriate policy goal is to maximise the economic welfare of both merchants and customers. In practice, this goal is most likely to be met by policies that aim at minimising the total cost of transacting *from all payments instruments* in the economy.

In our opinion, 'network externalities' could be used to justify almost any policy or practice regarding credit cards. Hence, in our work on regulating interchange fees and the role of no surcharge rules, we have assumed that network effects are not present (Gans and King, 2001c). This allows us to avoid the potential arbitrariness of the use of network externalities in theoretical work. Network externalities are undoubtedly present for all payments instruments. But in the absence of reliable and verifiable empirical data about the nature, importance and relative size of these network externalities, it is best to consider economic policy from a foundation that does not rely on any particular presumption or bias about these externalities. Our theoretical work builds on such a neutral foundation.

For this reason, throughout this document, we focus on the goal of minimising the cost of transacting in the economy.

1.2 No Surcharge Rules

We agree with the policy recommendation of the RBA that the 'no surcharge rules' be eliminated. As economists we prefer to see transparent pricing and to reduce artificial constraints on the pricing of services. This is something we have recommended through this policy debate (see Gans and King, 2001a).

Nonetheless, our own models suggest that when surcharging is permitted, retailers with market power will be able to use this as an instrument of price discrimination (Gans and King, 2001c). Professor Katz demonstrated that such price discrimination may take many forms and did not disagree with our suggestion that it may be inefficient.

The potential for price discrimination is a consequence of retailer market power. In our opinion, if such market power is a problem, then it should be dealt with directly. It is not a reason to continue a potentially restrictive pricing practice for credit cards.

1.3 The Mix of Policies

Indeed, we go further. The removal of the no surcharge rule reduces the RBA's need to rely on many other policy instruments. Professor Katz demonstrates that the interchange fee plays the role of balancing customer and merchant interests when surcharging is not possible. However, if surcharging is permitted, that role of the interchange fee is removed. Indeed, with effective surcharging, the role of the interchange fee in real activity is non-existent or negligible.

In summary, the economic analysis by ourselves (Gans and King 2001b), Professor Katz and indeed most other economic researchers show that if effective surcharging for credit cards is feasible, then the actual value of the interchange fee has little, if any, relevance for economic policy. In particular, effective surcharging means that the value of the interchange fee has little, if any, affect on the goal of minimising the costs of transacting in the economy.

In our opinion, the main regulatory costs and risks are likely to arise if the RBA considers direct regulation of the interchange fee. Price regulation is difficult at the best of times and economists tend to prefer structural remedies when there is a competition concern. In the case of credit cards, that structural remedy exists – eliminating the no

surcharge rule and opening up access – obviating the need to regulate prices themselves.

At best, the uncertainty surrounding the regulation of interchange fees suggests that the RBA could work in steps – removing the no surcharge rule and improving access and then moving to regulate the interchange fee at a later time if the need for such additional regulation is more clearly established. In our mind, there is reason to be prudent and not to implement a full range of regulatory policies all at once. As we will demonstrate, the empirical evidence justifying direct regulatory intervention has not yet been gathered.

2 The Practicality of Theory

When discussing the need for regulation of credit card associations in Australia, the consultation document takes considerable time to review the economic theory on payment systems; including much work that has taken place since the RBA/ACCC Joint Study of October 2000. The attention to theoretical models, their assumptions and their logic is something that we commend in this document. Key assumptions are laid bare and indeed attention is paid to modelling details – in particular, in the formal report by Professor Michael Katz – in a manner that brings this debate to a higher level of rigour than is often the case for Australian microeconomic policy.

Our reservations relate to the theoretical benchmarks adopted by the policy document as the basis for policy recommendations. The document criticises our work as being based on assumptions without proof of their validity. Equally, the same criticism can be made about the approach adopted by the consultation document. The document draws conclusions based on alternative assumptions but the document does not provide significant evidence that these assumptions are empirically valid.

2.1 The Importance of Neutrality

At the centre of theoretical interest is the benchmark case of the *neutrality* of interchange fees. This is a powerful theoretical idea and one that is robust to general cost, competition and demand conditions. Nonetheless, it is based on a key assumption, that customers have the option of purchasing goods and services at a cash (or non-credit card) price independent of prices set for other payment instruments. This could occur either (i) if retail competition is sufficiently intense or (ii) if retailers were unconstrained in setting cash prices as opposed to prices applying to other payment instruments.

The consequences of neutrality are critical to the debate about credit card reform. Neutrality has two direct policy implications. If *either* of the underlying assumptions for neutrality is satisfied then:

1. Interchange fees cannot be strategically manipulated by credit card association members, either to exploit market power or network effects; and

2. Interchange fees cannot be used as an effective instrument for public policy. In particular, if it were believed that the current use of credit cards in Australia was inefficient, a change in the interchange fee would merely lead to an adjustment of prices (that is, a nominal change) and no change in usage (that is, no real effects).

2.2 Neutrality and the Implications of Changing the Interchange Fee

In theoretical analysis, neutrality compares the outcome of economic activity under alternative values of the interchange fee. Formally, it compares economic equilibria under differing fees and shows how these equilibria are identical with respect to all real economic variables. However, neutrality theory does not consider the short-term process of the economy moving between two alternative equilibria. In other words, while neutrality shows how the interchange fee cannot be used as an instrument of public policy in the medium and long term, neutrality does not show the short-term effects of a change in the interchange fee.

The important policy implications of neutrality were first stated by those who believed that interchange fees could simply be set at zero (Carlton and Frankel, 1995; Frankel, 1998). If neutrality is accepted, then a zero interchange fee would not lead to any change in credit card use. More generally, under neutrality, in the medium and long term, the exact choice of interchange fee is irrelevant for policy and economic efficiency. Of course this means that one can equally argue for the retention of the existing interchange fee.

Importantly, because neutrality tells us about the medium to long term, but little about the short term, even those, such as Frankel, who have argued for movement to a zero interchange fee, have noted that changing the interchange fee could result in short-term disruption before equilibrium is restored.

In summary, if the conditions underlying the neutrality argument are in place (a) there is no need to regulate interchange fees and no gain from regulating interchange fees and (b) there might be potential costs due to short-term disruption from regulating the interchange fee. Hence, if one could be reasonably assured that customers will

have retail pricing options independent of their use of credit cards, then the regulatory costs (which we will outline in detail in Section 3) associated with a regulated interchange fee need not be incurred.

2.3 Evaluating the Neutrality Argument

The discussion above shows that the central issue in the policy debate regarding interchange is whether the conditions underpinning the neutrality argument are present or not. The RBA dismisses the neutrality argument giving it "little practical weight." (p.31) From our reading of the consultation document, however, it is not clear that the RBA has fully evaluated the empirical validity of the assumptions that underlie neutrality. We would urge that the RBA proceed with caution until such a full evaluation is undertaken. To act precipitously and introduce price regulation without fully determining the need for such regulation would likely reduce economic welfare. If simple structural remedies can be used to achieve desired policy objectives then these should be favoured over potentially intrusive and costly price regulation.

One way prices might be contingent on the payment instrument is if some merchants remain as cash-only merchants. In our earlier reports, we gave the example of the 'no frills' supermarket chain, Aldi. However, there are many other instances of cash-only merchants including a large number of small retailers – butchers, bakers, green grocers, hairdressers and garden services.

Moreover, the theory requires that there exist only a reasonable non-credit card option for neutrality to hold and it is entirely possible that such options exist across many significant retail sectors. As an example, many store cards offer discounts for customers using them (e.g., the new Coles-Myer card). The discount rate is set by the store and can nominally be considered as a non-credit card price for customers. Indeed, the RBA argues that it is precisely when merchant service charges become too large, that retailers are likely to give discounts for alternative payment instruments rather than for cash-only entry to occur.

We agree with this assessment and believe that differential pricing for different payment instruments is more likely to happen if the no-surcharge rule is removed. This is something Professor Katz also suggests. In this case, the conditions favouring neutrality are more likely to hold. Later in the consultative document, the RBA argues that they expect to see little surcharging if the no-surcharge rule is

removed but there is no actual empirical evidence presented for or against this possibility.

In our opinion, the potential for merchants to differentiate between payment instruments – either through surcharging or entry – is the most important empirical issue for the reform of credit card systems in Australia. If such differentiation is possible and likely, neutrality and the important policy conclusions that flow from neutrality are valid. As such, we are disappointed that there is no formal empirical analysis either done or requested by the RBA. Instead, the RBA appears to rely on assertions by banks and card associations that they view interchange fees as mattering and the absence of examples in other submissions. Given the critical nature of the assumptions underlying neutrality, it is incumbent upon the RBA to explore whether these assumptions are true as a matter of practice, rather than to simply assume that they do not hold. The absence of formal empirical evaluation may result in both misguided policy and leaves the RBA itself open to the criticism that it has chosen its assumptions to support specific conclusions rather than dispassionately and objectively considering the policy alternatives.

2.4 What do we know?

Given the lack of empirical analysis, is there anything that we do know that can assist in the resolving the policy debate? In our opinion, there are four things we do know. They are:

(1) There is widespread merchant acceptance of credit cards in some sectors.

(2) There is limited use of cash discounting.

(3) The interchange fee has not changed in Australia since it was initially set.[1]

(4) Customers pay little – if they qualify – to use credit cards. Banks encourage credit card use over debit and other payment instruments.

What weak conclusions can be drawn from these facts? To begin, if merchants are accepting cards, it must be the case that they prefer this

[1] There was a later introduction of a special interchange fee for electronic transactions but the basic reference rate remains unchanged.

over non-acceptance. That is, they are apparently willing to pay for credit cards despite merchant service charges that incorporate the current interchange fee. In principle, two effects could be driving the merchants' adoption decision – intrinsic benefits and strategic benefits. The intrinsic benefits to merchants include security and reliability as well as pure customer benefits. These benefits are desirable and reflect improved efficiency in transacting. The strategic benefits – discussed by Rochet and Tirole (2001) – incorporate the potential for competitive disadvantage were merchants not to accept cards. It is the possibility of strategic benefits and effects that provides the main support for the argument that there is too much credit card use (for example, Shell's response on p.39).

The supposed salience of strategic effects stands in contrast to some of the other observations above. First, if the strategic effect is strong then pressures to discount for cash would also be strong; especially, when the interchange fee is supposedly at an artificially high level (Rochet and Tirole, 2001). However, this contradicts observations that discounting is not common. Second, banks have not changed the interchange fee despite the fact that it was set when acceptance was not widespread. Indeed, at that time any acceptance that did occur would not likely have been for strategic reasons. Given this, if the interchange fee was manipulated for strategic reasons we would expect it to rise over time as acceptance becomes more common. That has not occurred. The RBA takes the lack of change in the interchange fee as indicative of a lack of competition amongst payment instruments (p.40). But equally it is evidence that the strategic reasons to manipulate the interchange fee have little empirical validity. [2]

Finally, charge cards are supposedly more costly for merchants and yet they are still accepted by some merchants. This is despite the fact that charge cards have more limited customer acceptance and would be less likely to be of competitive importance (although, this may not be the case for particular sectors). This suggests that intrinsic benefits to merchants may be relatively important.

Taken together these facts do not appear to support the RBA conclusion that credit cards are overused. The exception is the final observation regarding the costs of using credit cards for consumers. This observation suggests that the banks find it profitable to encourage credit card use over other forms of payment; in particular,

[2] Of course, this inference depends on an assumption that banks are maximising profits. If instead the banks voluntarily refrain from exercising market power, this inference could not be sustained.

debit. This is a puzzle. If credit cards are more costly overall for banks than debit, and given that at least the major banks are both issuers and acquirers for debit and credit, receiving both the costs and benefits of interchange fees,[3] we would expect to see the banks favouring debit rather than credit. Why would banks encourage a more costly means of transacting?

One possibility is that credit cards are simply intrinsically more beneficial to merchants than debit cards. Debit cards require point of sale electronic verification; something difficult for Internet transactions, bill payment and at merchants when the terminal is down. Also, the risks for merchants may be quite high when there is perfect reliance on electronic verification. Could a supermarket risk an EFTPOS system going down when their customers are used to not carrying cash? In this event, having credit card facilities can ameliorate this risk.

The constraint on surcharging could be holding debit cards back. This constraint might prevent banks from structuring merchant arrangements to encourage debit cards. It is also likely that the myriad of bilaterally negotiated interchange fees for debit cards makes it difficult for banks to encourage the use of debit. In either case, the problem lies not with credit card interchange fees.

Our observations suggest that rather than regulating interchange fees, it would be preferable to eliminate the prohibition on surcharging and see whether debit cards are encouraged. Recall that there is no reason why banks could not increase debit card interchange fees to exploit the very same strategic effects that supposedly underlie high credit card interchange fees. Nonetheless, this form of manipulation becomes far more difficult when merchants can and are encouraged to charged different prices contingent on the payment instrument used.

2.5 Summary

In summary, on the theoretical side, the RBA – and especially Michael Katz – argue that surcharging is an alternative to the interchange fee in internalising network effects or externalities that

[3] That is, the fact that interchange on debit is negative would mean that banks would charge customers more for debit than credit card use (as indicated by the lack of loyalty points on debit). At the same time, however, this would be compensated for with the banks encouraging more merchant acceptance of debit over credit cards.

may be associated with credit card systems. We agree with this point. However, the extent to which surcharging can render irrelevant any regulation of the interchange fee is a matter for empirical analysis that, at present, has not been carried out.

We urge the RBA to extend its excellent analysis of the theoretical issues to develop a consistent empirical methodology for testing the assumptions that drive the policy debate. Specifically, those assumptions are: (1) the extent of retail competition and market shares of cash-only merchants; (2) the extent of cash discounting; and (3) the level of surcharging that would occur if the no surcharge rule were removed. Testing each of these is feasible and would substantially reduce the key issue of uncertainty surrounding the desirability of regulating the interchange fee.

3 Regulating the Interchange Fee

The consultation document proposes a strong form of financial regulation, directly regulating the way the interchange fee on credit card transactions is to be set by the card associations. Regulatory economics is our main discipline and for that reason we comment on the RBA's proposed methodology from that perspective.

When regulating a price, it is often useful to make the regulation cost-based. There are two reasons for this. First, economic efficiency is supported by setting prices close to the relevant costs. Second, setting prices to cover relevant costs ensures the viability of the regulated firm.

But there are two difficulties associated with cost-based regulatory pricing. First, the cost measures used for regulation need to reflect that actual costs of providing the relevant service. In particular, some costs may be common with those of another service and some costs may be mere accounting and not economic costs. Second, the cost measures need to be accurate and not subject to strategic manipulation by the regulated firm. If they are manipulable then the regulated firm will attempt to raise the cost measures in order to increase the regulated price.

When deciding upon a regulatory methodology it is important to separate out and pay attention to each of these concerns.

3.1 Basic Principles and Methodology

In our earlier submission (Gans and King, 2001d), we laid down five principles that we believed should govern the regulation of interchange fees. They were:

> **Principle 1:** *Interchange fees should be based only on issuer and acquirer costs and information relating to the direct net benefits customers and merchants receive from using a particular payment instrument.*
>
> **Principle 2:** *Issuer and acquirer costs should not be included in the determination of the interchange fee if they relate purely to an extended line of credit (e.g., beyond one quarter). On the other hand, costs related to payment functionality should be considered in the determination of interchange fees.*

> **Principle 3:** *Issuer and acquirer costs that represent transfers to customers and merchants should not be included in the determination of interchange fees.*
>
> **Principle 4:** *Interchange fees should only be based on those cost components of issuers and acquirers that would be avoided (over the long-term) if credit card services were no longer offered.*
>
> **Principle 5:** *Adjustments to interchange fees based on changes in customer or merchant mix or transaction type should be permissible and accommodated within the fee setting methodology.*

These principles correspond to those laid down by the RBA (pp.42-43) including the cost-based justification (Principles 1 and 3), the exclusion of costs not related to payment functionality (Principle 2) and the provision for different interchange fees based on transaction type (Principle 5). In addition, we would also agree with independent and regular reviewing of the fee (see Gans and King, 2001d, pp.40-44).

We suggested that the shared avoidable cost methodology – the only methodology derived from a formal model – was consistent with these principles. This methodology took issuer (c_I) and acquirer (c_A) avoidable costs, as well as a measure (α) of the proportion of benefits from credit card services enjoyed by merchants and calculated the interchange fee (a) as:

$$a = \alpha(c_I + c_A) - c_A$$

We suggested that since it was uncertain as to who enjoyed most benefits – customers or merchants – that $\alpha = ½$ so that:

$$a = ½(c_I - c_A)$$

meaning that the avoidable cost faced by an issuer (that is, $c_I - a$) was equal to the avoidable cost faced by an acquirer (that is, $c_A + a$). This means that when any issuer or acquirer is setting its relevant price, it is basing its choice on the same avoidable cost.

The methodology presented in the consultation document appears to accept that the price be based on the general shared avoidable cost formula above. This is exemplified by the principle that interchange fees "be based on the credit card payment services which are provided to merchants and for which card issuers recover costs through interchange fees." (p.42) This suggests that α be set equal to 1 so that $a = c_I$. Note that, *all other things equal*, this interchange fee is higher than the one we proposed.

In doing this, the consultation document has effectively suggested that interchange fees be set purely with regard to merchant benefits and should not be a mechanism of sharing customer and merchant benefits. This means that if customers benefit from the availability of credit card services, the interchange fee will be set too high forcing merchants to bear most of the costs of the system. This will likely lead to too little merchant acceptance of credit cards.

In addition, the methodology propounded in the consultation document excludes the consideration of acquirer costs. These costs also play an important role in the network and should not be ignored as they change over time. Recall that, not only are merchants guaranteed payment, customers are guaranteed service. So if a retailer (e.g., Ansett) goes bankrupt, customers can receive a refund. This set of guarantees improves confidence in the payment system and is something only provided by credit card acquirers; reducing potential transactions costs for consumers.

The consultation document proposes only to use the methodology to set a maximum interchange fee. The logic behind this is sensible given the concern that card associations would otherwise have incentives to manipulate interchange fees upwards to exploit strategic effects among merchants. In reality, the interchange fee will be below this figure (if Schmalensee (2001) and Wright (2001) are to be believed). In this respect, it can be argued that the methodology proposed in the consultation document is only a weak form of price regulation.[4]

However the consultation document also appears to take a rather limited view of issuer avoidable; that is the cost components that make up c_I. In our opinion, their exclusion of some cost components is too restrictive, violating their own principles that the interchange fee be cost-based and related to payment functionality.[5] Excluding some legitimate issuer costs also raises the risk of setting a cap on interchange fees that is below the socially desirable level for these fees. We review each of these exclusions in turn.

[4] It also avoids the need to calculate acquirer costs.

[5] We, of course, agree with their exclusions of loyalty points (these are issuer-customer transfers) and issuer sunk costs (these are not avoidable costs). This agreement has been noted by the RBA.

3.2 Credit Losses

The consultation document argues that credit losses – that is, from non-payment of credit card debt to issuers – should not be part of the interchange fee. The reason is that issuers currently mark-up the interest rate on credit card debt to recover those losses. To include them in the interchange fee would be, in effect, double counting. This, in turn, would lead to low standards in extending credit to cardholders as banks strategically manipulate their credit losses.[6]

First of all, it is not entirely clear that double counting currently occurs. To be sure, it may be that part of credit losses is built into the interest rate premium and part comes from interchange fees. Given the lack of transparency of existing interchange arrangements, it is simply difficult to tell.

But, more importantly, if there is to be 'single counting' imposed, are cardholders the right agents to face the cost of credit losses? Remember that if the cost of unpaid debt is covered by putting a premium on interest rates, you are forcing debt-paying cardholders to fund the debt defaulters. Alternatively, if credit losses are recovered through interchange fees, merchants are paying for those losses. Merchants, as a group, benefit from the pooling of risk of unpaid debt and, as such, would appear to be the natural party who should pay for this benefit.[7]

3.3 Credit Costs and the Interest Free Period

The consultation document argues that the interest free period should not be included in the interchange fee (p.49). This is based on the fact that the interest free period is determined by card issuers and, indeed, its length is a pricing rather than a pure cost component for them. To include it would not reflect economic costs, and would also open the interchange fee up to strategic manipulation.

But, in effect, the costs of funding the interest free period is at its heart an artefact of the internal accounting practices of card issuers. Those issuers themselves cannot easily identify which customers will

[6] As an aside, we are not sure that such low standards do actually exist. CoRE Research was denied a credit card by a major bank and was forced to apply and was accepted for a charge card instead; where no double counting could possibly exist.

[7] For a related view see Chakravorti and Emmens (2001).

be transactors – paying off credit card debt before interest has occurred – and those who are revolvers – who incur some interest bearing debt at certain times. The very nature of credit cards means that both types of customers will exist. Moreover, allowing payment on extended credit terms relaxes cash-flow constraints facing individual customers and, by increasing the depth of the market, yields benefits to merchants.

For this reason, the nature of credit cards as opposed to any other payment instrument requires that included in the costs borne in part by merchants are the costs of funding the debt that occurs – whether cardholders are actually charged interest or not. That is, cost-based regulation requires that we separate out cost components from revenue components and set prices on the basis of the former only. If an accounting practice, such as the cost of funding the interest free period, confounds the two then the solution is not to eliminate those costs entirely but to create the right measure.

In this case, the right measure is the expected cost of funding credit card debt. To do this, one would have to measure the expected average duration of that debt and also the cost of funding it. This would capture the cost component driving a key benefit to merchants – the liquidity afforded by credit card payments.

The consequences of not including debt cost would be to lower the regulated interchange fee. As we explain below, this does not necessarily mean that credit cards will cease to have an interest free period. However, it may mean that there would be a reduction in the use of credit cards and consequently, a reduction in merchant benefits. This is because at certain times of the year – for example, Christmas – merchants derive benefits from having a liquid payment instrument with an unsecured line of credit and that is likely to lead to a greater level of consumption than might otherwise occur.[8]

3.4 Cardholder Services

Cardholder services are to be excluded from the interchange methodology propounded in the consultation document because they are only of benefit to cardholders. It is not apparent to us that this is

[8] Professor Katz argues that payment instruments shift around transactions amongst them but do not necessarily raise the volume of transacting. While this may be true in general and a reasonable assumption to motivate the goals of policy, potential seasonal credit constraints need to be taken into account.

so and, moreover, examination of the incidence of costs for other payment instruments suggests otherwise. That is, merchants bear part of the accounting and other costs associated with cash, cheques and debit. This is certainly an issue worthy of closer empirical examination.

3.5 The Included Costs

The consultation document methodology, however, includes the following cost components: (i) issuers' costs incurred in processing credit card transactions received from an acquirer that would not be incurred if the issuer was also the acquirer of those transactions (including costs of receiving, verifying, reconciling and setting such transactions); (ii) issuers' costs incurred in respect of fraud and fraud prevention; and (iii) issuers' costs incurred in providing authorisation of credit card transactions.

While this appears to exclude costs associated with on-us transactions, this is not a restrictive issue as it would also (we presume) exclude the volume of those transactions when calculating an average. Also the use of a weighted average across all issuers would appear to reduce the potential for strategic manipulation of such costs.

3.6 The Consequences

Looking at the data from the Joint Study, the consequence of this methodology will be some reduction in the interchange fee from its current levels. The impact of this will be borne mostly by high cost issuers – the smaller banks – who may not find it profitable to remain in the market.

In terms of pricing, this will lead to some reduction in merchant service charges although it will also lead to an increase in cardholder fees, interest rates on card payments, and a curtailing of loyalty point schemes. Thus, it is difficult to say how large the fall in credit card usage might be. If neutrality holds (as might be the case if the no surcharge rule is eliminated), there will be no fall (aside from that caused by other changes to the system) as all these changes offset one another.

There have been concerns raised that the exclusion of particular cost components may change the nature of credit cards. In our opinion,

these concerns are unlikely to eventuate. Take, for example, what might happen if credit losses are not included. This reduces the interchange fee but would not necessarily turn credit into charge cards. This is because the availability of a line of credit is still what makes credit cards attractive to customers and merchants. If they are willing to pay for this option, then they will bear the increase in cardholder fees (or lower loyalty points) that might accompany the lower interchange fee. There would be no need for this option to be removed as it would only reduce the benefits of credit cards without changing issuers' average interchange revenue.

The same is true for the interest free period. One advantage for customers of credit cards is that all transactions are billed at the one time making the organisation and timing of their finances easier. This cannot be done without an interest free period. This benefit would not go away if it is not compensated through the interchange fee. All that would change would be how issuers' would have to change their customer charging to reflect this change. Customers would directly bear these costs and with merchants indirectly bearing them through customer choice of payment instrument.

3.7 Summary

We are concerned that the consultation document has too easily dismissed important cost components that should be built into the interchange fee and, as a consequence, violated its own principles as to how interchange fees should be calculated. The exclusion of credit losses forces good debtors to pay for the poor ones when this cost should fall on the merchants who are the primary beneficiaries of this function. The exclusion of the costs of funding short-term credit also fails to acknowledge the importance of this functionality for merchants. In the end, the exclusion of these components leads to an interchange fee that may be too low from a social perspective and increase the costs of transacting in the economy.

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