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institutions have levied fees on cheque and debit card (EFTPOS) transactions for some years, and the fees are increasingly related to the costs of providing these services.

The expected impact of the Reserve Bank's regulatory actions, taken together, on the revenues earned by financial institutions from credit card activities is summarised in Table 7.

## **6. CONSULTATION**

Throughout the reform process, the Reserve Bank has attached high priority to consultations with interested parties.

The Joint Study published in October 2000 generated considerable comment from all sections of the community, including the credit card schemes, financial institutions, merchants and consumer representatives. In the six-month period before the designation of the three credit card schemes in April 2001, the Reserve Bank received 22 written submissions containing a wide range of views on the findings of the Joint Study and recommendations both for and against regulatory action.

Following the designation, the Reserve Bank received a further 45 written submissions over the remainder of 2001. It considered all of the material provided and held numerous meetings with organisations which had made submissions to discuss their comments in detail. This consultation process culminated in the publication of the Consultation Document in December 2001. The Consultation Document reviewed the main regulations of the four party credit card schemes from the public interest viewpoint, taking into account the issues raised in the submissions. It provided extensive discussion of the purpose and effect of the Reserve Bank's proposed reform measures in promoting efficiency and competition in the Australian payments system. At the same time, the Reserve Bank published a commissioned report on the operations of credit card schemes from an international expert in network economics, as well as all of the prior public submissions it had received.

As required under the *Payment Systems (Regulation) Act 1998*, the Reserve Bank invited submissions from interested parties on its proposed reform of credit card schemes, by a date specified to be 15 March 2002. Submissions were received by that deadline from 28 organisations and a number of members of the public. The Reserve Bank has considered all of those submissions in finalising its reform measures. Comments and other material were also received after the submission deadline, which the Reserve Bank has also considered. A list of organisations that provided submissions and other material is in [Attachment 3](#).



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All organisations that made formal submissions were invited to discuss them with Reserve Bank staff. Some 52 such meetings were conducted between mid-March 2002 and August 2002; of that total, 15 separate meetings were held with the designated credit card schemes. The Reserve Bank also received extensive correspondence from these schemes regarding the Consultation Document and the proposed reforms, to which it has provided detailed written responses. Two of these schemes or their agents made a total of nine requests for information under the *Freedom of Information Act 1982* and sought three internal reviews of the Reserve Bank's decisions on those requests.

With the exception of the designated credit card schemes, the overall tone of the submissions received by the Reserve Bank is one of acceptance of the need for reform of credit card schemes in Australia, although views on what shape such reforms should take varied widely. The main views provided in the submissions and related material are summarised in this Section. Some of the submissions also provided helpful comments and suggestions on the drafting of the standards and access regime, which the Reserve Bank has accepted. This is discussed in the following Section.

### **Designated credit card schemes**

The designated credit card schemes are opposed to the Reserve Bank's reforms. They argue that the regulations imposed by the schemes themselves are essential to ensure that credit card networks reach their optimum size and maximise community welfare.

The schemes argue that scheme regulations are needed to allow credit card services, provided in four party schemes as a "joint product", to be profitably supplied to both merchants and cardholders, with benefits for the community in the form of higher levels of consumption and lower cost payments. The schemes dispute the conclusions of the Consultation Document that there is no convincing evidence that credit cards lead to a permanent increase in aggregate consumption. They also dispute the evidence that credit cards are a relatively high-cost means of payment, claiming that credit cards generate a range of unmeasured transaction benefits to merchants and cardholders that other payment mechanisms do not provide. One card scheme provided the results of a survey on the cost of cash for a small sample of merchants in Australia, which it used to argue that the costs of cash are understated and that cash is more expensive for merchants than credit cards. More generally, the schemes claim that the Reserve Bank's proposed reforms focus on the costs of providing payment instruments and do not take sufficient account of the different benefits they offer.



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None of the schemes supports the need for a standard on interchange fees. They argue that competition between credit card schemes and between credit cards and other means of payment such as debit cards and cash means that interchange fees in Australia are as close to their optimal levels as possible. They cite the consistently strong growth over recent years in the number of merchants accepting credit cards, in the number of cardholders and in the number of credit card transactions as evidence that current interchange fee arrangements are efficient and meet the demands of both merchants and cardholders. The schemes claim that interchange fees in Australia are amongst the lowest in the world.

The credit card schemes argue that, even if there were problems with current interchange fee arrangements, the Reserve Bank's proposed approach would be counterproductive. They claim that the balances to be struck are so complex that there is no reason, either in theory or practice, to expect that regulatory action could do better than a collective fee-setting process. In particular, the schemes claim that the Reserve Bank's cost-based methodology is too narrow. The draft standard on interchange fees proposed that issuers' costs eligible for inclusion in interchange fee calculations would be confined to:

- costs incurred in processing transactions; and
- costs for fraud, fraud prevention and authorisation incurred in providing any payment guarantees.

The schemes argue that, if a cost-based methodology were to be introduced, there are additional costs that should be borne by merchants, such as costs of funding the interest-free period, credit losses and the costs of credit card loyalty programs. The schemes argue that any significant reduction in interchange fees would lead to the demise of four party credit card schemes in Australia because of cardholder sensitivity to any increase in fees or reduction in current incentives such as loyalty points. On the contrary, the schemes argue that continued expansion in credit card usage afforded by interchange fees set entirely by the schemes is in the public interest because of the substantial community benefits.

MasterCard and Visa have proposed to the Reserve Bank that the methodologies they have applied in some other countries could form the basis for interchange fee setting in Australia, without the need for a standard on interchange fees. MasterCard has advised that its methodology used in some other countries treats the interchange fee as the means by which issuers recover costs for specific services provided to acquirers (and hence to merchants). In addition to the eligible costs defined in the draft standard, costs include funding the interest-free period and credit losses. Visa has advised that its methodology used in some other countries treats the interchange fee as a financial adjustment which reduces the imbalance



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between the costs of credit card issuing and acquiring. The methodology is treated by Visa as secret.

The international credit card schemes oppose the Reserve Bank's proposal to remove scheme restrictions on merchant pricing (so-called "no-surcharge" rules). They argue that these restrictions are integral to credit card schemes because they ensure that cardholders are not discouraged from using their credit cards, from which both they and merchants receive benefits. One scheme provided an economic model which simulated the choice between cash and credit cards to argue that removal of the restrictions would be inconsistent with maximising community welfare. The schemes also claim that removal of the restrictions would give large merchants, or merchants in remote areas, power to exploit consumers. Conversely, the schemes claim that removal of the restrictions will be ineffective because merchants in countries where such restrictions have been abolished (the United Kingdom, the Netherlands and Sweden) have not adopted surcharging in any material way, and because merchants in Australia are already free to offer discounts for cash.

The designated credit card schemes argue that the Reserve Bank's standards on interchange fees and on merchant pricing, taken together, would confer a strong competitive advantage on the three party schemes and would encourage cardholders and financial institutions to migrate to the latter schemes. The designated credit card schemes claim that a reduction in interchange fees would mean that issuers would no longer be able to offer loyalty programs with the previous level of rewards, while the three party schemes would not be forced by competitive pressures to match the corresponding reductions in merchant service fees. The effect on competition would be accentuated, it is argued, if three party schemes were allowed to maintain their restrictions on merchant pricing. Submissions from the three party schemes, on the other hand, argue that these schemes would not be immune from competitive pressure on merchant service fees, particularly if restrictions on merchant pricing were lifted for all schemes.

The designated credit card schemes argue that the Reserve Bank's proposed access regime is not needed. The international credit card schemes interpreted the access regime as mandating that all institutions supervised by APRA be granted membership in the schemes and that schemes would not be allowed to impose their own risk management or other criteria in assessing applications for membership. The schemes also argue that there are avenues for non-traditional organisations to become involved in credit card activities through co-branding or outsourcing arrangements. If the access regime were to be introduced, however, there was support for APRA's role in authorising and prudentially supervising applicants for participation in the schemes, subject to the opportunity to assess



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APRA's draft prudential standards for the new class of specialist credit card institutions.

Two card schemes oppose the prohibition on “net issuer” or “balanced portfolio” rules and two card schemes oppose the prohibition on financial penalties and loadings for participants seeking to specialise in acquiring. One card scheme argues that these prohibitions would lead financial institutions to cease issuing its cards and would reduce competition between card schemes. One card scheme expressed concerns about the elimination of the prohibition on self acquiring.

### **Financial institutions**

The Reserve Bank received nine submissions from financial institutions which are participants in the designated credit card schemes, and their respective industry associations. Most financial institutions accept that interchange fees in these schemes should be determined on the basis of an objective, transparent and cost-based methodology, but argue that the categories of costs that the Reserve Bank proposed for inclusion in the standard on interchange fees are too restrictive. Most institutions support an interchange fee model set out in the submission by the Australian Bankers' Association, involving a wider range of cost categories which were claimed to be at the core of the credit card product.

Some financial institutions argue that the concept of an “outsourced store card” provides the appropriate analogy for considering interchange fees in four party card schemes. On this view, merchants that accept credit cards are effectively “outsourcing” the provision of a proprietary store credit card; they should therefore pay for whatever costs they would otherwise incur if they were to issue a card themselves. As a minimum, the cost of funding the interest-free period should be included in the interchange fee, on the basis that the interest-free period is a defining feature of most credit cards compared to other payment instruments. Other costs that could be included on this argument are marketing costs such as loyalty programs and advertising costs, capital costs and periodic cardholder-related costs, such as statement production and mailing and the processing of account payments; some institutions would add the cost of credit losses, including credit losses on cardholders who do not have a revolving credit balance and thus may not have paid any interest.

Some financial institutions argue that there would be no reason, in the public interest, for a standard on interchange fees if restrictions on merchant pricing were removed and access to credit card schemes liberalised. Under this scenario, which was considered as option (ii) in Section 4 above, changes in interchange fees would lead to changes in prices facing credit cardholders, and rebates to these



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cardholders, of the same amount and in the same direction; the interchange fee would therefore be “neutral” in that it would not affect net prices to consumers or market behaviour. This view is supported by two academic economists who commented independently on the Reserve Bank’s reforms. These economists also argue that where there are different payment instruments that each benefit from larger network size, the goal of maximising the economic welfare of both merchants and customers would most likely be met by policies that aim at minimising the total cost of the payments system.

In general, financial institutions do not object to the abolition of scheme restrictions on merchant pricing or the proposed access regime. Some financial institutions strongly support elimination of “net issuer” rules and associated financial penalties and loadings.

### **Merchants and other non-financial corporations**

The Reserve Bank received submissions from 11 retailers and other non-financial corporations, including technology companies, energy companies, small business owners and associations representing these groups; four other parties offered comments after the March 15 deadline. Most submissions support the Reserve Bank’s standard on interchange fees. Some, however, dispute the view that merchants should contribute to the cost of credit card issuing and argue for the abolition of interchange fees altogether. On this view, issuers and acquirers should recoup their costs directly from their customers on a “fee for service” basis.

Most of the submissions support the abolition of restrictions on merchant pricing and the liberalisation of access to the credit card schemes, although one submission raised concerns about the potential impact of a “fee for service” for credit card acceptance on inward tourism, where many visitors use credit cards. Some smaller merchant associations claim that the Reserve Bank’s reforms could benefit larger merchants at their expense, on the argument that larger merchants will charge a “fee for service” for credit card usage to encourage customers to switch to the store cards of these merchants and patronise their shops in preference.

### **Consumer representatives**

The Reserve Bank received submissions from two consumer organisations and comments from a number of members of the public. Consumer groups support the Reserve Bank’s reforms, on the basis that the current inefficiencies and distortions in credit card schemes are increasing costs for all consumers. At the same time, they recommend maintaining a watching brief on the use of a “fee for service” for credit card acceptance so that merchants do not exploit this freedom.



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Of the comments from individuals, some are strongly supportive of the Reserve Bank's reforms while others are concerned that they would be charged higher fees for credit card services.

### **Consultation with other government agencies**

The Reserve Bank has kept the ACCC informed throughout the development of its reform measures. It has worked with the Australian Securities and Investments Commission (ASIC), and will be consulting with State and Territory fair trading authorities, to ensure that the disclosure requirements imposed on merchants by fair trading legislation are clear to merchants that choose to charge according to the means of payment. The Reserve Bank has also consulted with APRA about the draft authorisation guidelines and prudential standards for the new class of specialist credit card institutions.

## **7. CONCLUSION AND FINAL REFORM MEASURES**

The Reserve Bank has considered the views put to it in submissions from and discussions with a wide range of interested parties.

The Reserve Bank acknowledges the widespread acceptance of credit cards in Australia and the benefits that they can provide to individual cardholders and merchants. At the same time, however, it is not persuaded by arguments that allowing normal market mechanisms to operate more effectively in the Australian payments system is against the community's interest. It does not accept that continued growth in the use of credit cards at the expense of alternative payment instruments necessarily adds to the community's welfare. In particular, it remains of the view that the benefits of credit cards to cardholders and merchants as a whole – in the form of a permanent increase in sales or a reduction in transaction costs – are overstated. Other payment networks can also gain from being larger in size and the mix of payment instruments in these circumstances ought to be one for consumers to decide in a competitive market place, in response to efficient price signals. These conditions do not prevail in the retail payments system in Australia.

The Reserve Bank accepts that interchange fees can play a role in redressing imbalances between the costs and revenues of issuers and acquirers in four party credit card schemes. However, it is not convinced that community welfare would be maximised if the setting of interchange fees, which play a pivotal role in determining price incentives for cardholders and merchants, were left entirely to the schemes and their members in Australia without any external scrutiny or