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## CHAPTER 1: BACKGROUND TO REFORM

### 1.1 Introduction

Australia has world-class debit card (EFTPOS) and credit card payment networks which, over recent years, have become the main means, other than cash, by which Australians make their payments. Debit and credit card transactions currently account for around 45 per cent of the number of non-cash payments, almost trebling their share over the past decade and displacing traditional payment instruments, particularly cheques, in the process (Table 1.1).

**Table 1.1: Number of non-cash payment transactions**  
per cent, May 2001

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Cheques	21
Credit cards	24
Debit cards	21
Direct entry credits	25
Direct entry debits	9
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	<b>100</b>

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Source: Australian Payments Clearing Association.

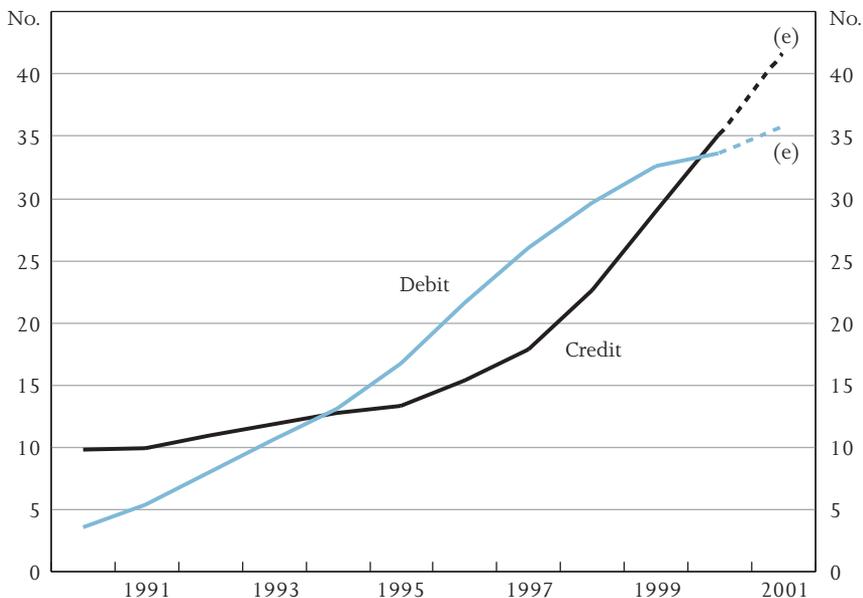
Card-based instruments enable payments to be made by transferring funds between the cardholder and the recipient across the books of financial institutions. A debit card (commonly known as EFTPOS) is a method of accessing a transaction account held with a financial institution; the cardholder has funds 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 strong growth in popularity of card-based instruments nonetheless masks some divergent trends in the usage of debit and credit cards. After the debit card system was established over a decade ago, debit card usage rose sharply for a number of years but growth has tapered off more recently. In contrast, credit card usage, which grew only moderately in the first half of the 1990s, has accelerated as cardholders have switched to credit cards for routine payments such as supermarket purchases and utility bills, and “remote” payments such as theatre tickets and purchases over the Internet. Many cardholders use their credit cards as a pure payment instrument: preliminary data from the Reserve Bank’s new payments statistics collection suggest that around 25 per cent of credit card balances do not incur interest because cardholders have not made use of the revolving line of credit. This changing pattern in how payments are made has coincided with the widespread introduction of loyalty programs by credit card issuers, and has seen credit card usage reach annual growth rates of around 26 per cent over the past three years. The number of credit card payments per capita has risen to 42 a year, overtaking debit card payments per capita of 36 a year (Figure 1.1).

**Figure 1.1: Number of debit and credit card payments per capita per year**



(e) estimate

Source: Reserve Bank of Australia Bulletin and ABS Catalogue No. 3101.0.



The debit card payment network in Australia had its origins in proprietary systems set up by each of the major banks, and subsequently linked through bilateral arrangements to enable cardholders to use their debit cards at any terminal. The three major credit card schemes established in Australia were, however, collective endeavours. Bankcard, a collaboration between Australian banks, was the first credit card to be issued in Australia. Introduced in 1974, it was accepted nationally by 1977. MasterCard and Visa, the two international schemes in which Australian financial institutions participate as members, followed in the 1980s. There are now around 15 million credit cards on issue in Australia. Estimates of the market share of the main credit and charge card schemes, in terms of cards on issue, are provided by a survey of cards held by respondents (Table 1.2). Around 60 per cent of the survey respondents who are over 18 have a credit card.

**Table 1.2: Market shares of major personal credit and charge card brands**  
per cent of cards on issue, 2000/01

Visa	53.4
MasterCard	22.7
Bankcard	15.4
American Express charge card	3.6
American Express credit card	2.9
Diners Club	1.9
	<b>100.0</b>

Source: Roy Morgan Research.

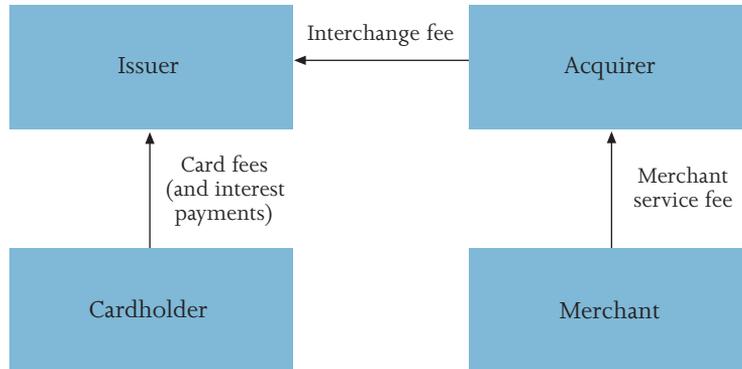
Bankcard, MasterCard and Visa are known as “four party” card schemes because four parties are typically involved in the payment process. These parties are:

- the *cardholder*;
- the *issuer*, the financial institution that issues the credit card to its customer;
- the *acquirer*, the financial institution that serves the merchant accepting the credit card for payment; and
- the *merchant*.

The flow of fees (and interest payments) in a four party scheme is shown in Figure 1.2.



**Figure 1.2: Fee flows in a four party card scheme**



This structure contrasts with that of American Express and Diners Club, which are “three party” card schemes. In these proprietary schemes, American Express and Diners Club generally act as sole issuers and acquirers, and the participation of financial institutions is limited to marketing and distribution roles.<sup>1</sup> Three party card schemes have traditionally issued charge cards, which provide the cardholder with an interest-free period but no revolving line of credit; more recently, American Express has also issued a credit card (the “Blue card”) which provides a revolving line of credit similar to those of the four party schemes.

## 1.2 Regulations in credit card schemes

Payment instruments that involve the transfer of funds across the books of financial institutions require co-operation between these institutions to ensure that payments can be effected. Co-operation normally takes the form of various rules and regulations agreed by participating institutions, either bilaterally or on an industry-wide basis, covering such matters as procedures for funds transfers, technical and operational procedures and criteria for participation.

The Bankcard, MasterCard and Visa credit card schemes have extensive rules and regulations that govern their operations. The main characteristic of these schemes, which distinguishes them from the three party schemes, is that the rules and regulations are determined collectively by the financial institutions (issuers and acquirers) that are members of each scheme, but that are otherwise competitors

<sup>1</sup> The one exception in Australia is the American Express card issued by AMP Bank Limited.



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in providing credit card services to cardholders and merchants. In particular, members of each card scheme collectively:

- set the wholesale fees (known as “interchange fees”) that are paid to the issuer by the acquirer whenever a merchant accepts a credit card for payment;
- determine the criteria for membership of the schemes and the membership fee (ie the price for access); and
- in the case of the MasterCard and Visa schemes, impose restrictions that prevent merchants passing on the cost of accepting credit cards to cardholders – the so-called “no surcharge” rule. (These restrictions are also imposed on merchants by the three party card schemes.)

Although some minimum set of private-sector regulations is likely to be necessary for the safe and orderly operation of a payment system, co-operative behaviour between competitors which involves the collective setting of prices is rarely permitted in market economies. *Prima facie*, such behaviour is anti-competitive and, where it is allowed, it typically requires some form of dispensation by competition authorities on the basis that there are offsetting benefits to the public. In Australia, the *Trade Practices Act 1974* prohibits co-operative behaviour between competitors if it has the effect of substantially lessening competition, fixing or maintaining prices, or restricting or limiting dealings with particular persons such as new entrants to a market. However, such conduct may be authorised by the Australian Competition and Consumer Commission (ACCC) if it judges it to result in a net public benefit. Several payment systems in Australia have sought authorisation to ensure that their regulations can satisfy a public interest test. For instance, the regulations and procedures for four clearing streams operated by the Australian Payments Clearing Association (APCA) – which govern the transfer of funds involved in ATM and debit card (EFTPOS) transactions, cheques, bulk electronic and high-value transactions – have been authorised under the *Trade Practices Act 1974*, and participants are thus free from the risk of prosecution for engaging in the behaviour authorised. However, none of the credit card schemes in Australia are authorised under the *Trade Practices Act 1974*. The Bankcard scheme was granted authorisation in 1980 by the Trade Practices Commission, the predecessor of the ACCC, on condition that scheme members not impose restrictions on the freedom of merchants to determine the prices they were prepared to charge customers paying either with cash or Bankcard. The authorisation was revoked in 1990, one reason being the Commission’s concerns about Bankcard’s restrictive membership criteria. Neither the MasterCard nor Visa credit card schemes has applied for authorisation.



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### 1.3 Public policy interest in credit card schemes

Over the past couple of years, credit card schemes have come under closer public policy scrutiny in Australia, and in some other industrial countries.

Some earlier official studies in Australia had raised questions about the structure and efficiency of credit card interchange fee arrangements but, aside from recommending further review, made no call for the regulations of the credit card schemes to be subject to a public interest test.<sup>2</sup> However, the inquiries had unanimously concluded that scheme restrictions on merchant pricing are anti-competitive and that merchants accepting credit cards should be free to make their own decisions as to the prices they charge.<sup>3</sup>

In its 1997 *Final Report*, the Financial System Inquiry (the Wallis Committee) highlighted interchange fee arrangements and restrictions on access to credit card schemes as areas of policy concern. The Inquiry recommended that a new Payments System Board within the Reserve Bank should consider whether interchange fee arrangements were appropriate for credit (and debit) cards; it noted that, if such arrangements were priced contrary to efficiency principles, a review by the ACCC would be warranted. The Inquiry was also concerned that the membership rules of the two international credit card schemes might be used to restrict the ability of non-deposit-taking institutions to compete in new payment technologies, and recommended that the ACCC maintain a watching brief over these rules.

Since the Inquiry, two particular developments have sharpened the public policy focus on credit card schemes in Australia. First, in response to the Inquiry, the Payments System Board of the Reserve Bank and the ACCC undertook a detailed study of debit and credit card schemes, drawing on information and data provided by Bankcard, MasterCard and Visa and by a range of financial institutions that are members of these card schemes. The findings were set out in *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (the “Joint Study”), which was published in October 2000 as a basis for community discussion.

The Joint Study concluded that in card networks, competition is not working as it should. In the case of the credit card schemes, the Joint Study found that:

- interchange fees are not reviewed regularly by scheme members on the basis of any formal methodologies;
- interchange fees are higher than can be justified by costs, and scheme members lack clear incentives to bring these fees into line with costs;

2 These studies are summarised in Reserve Bank of Australia and Australian Competition and Consumer Commission (2000), pp 2-3.

3 *ibid*, pp 53-54.



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- the “no surcharge” rule suppresses price signals that guide the efficient allocation of resources; and
  - restrictions by credit card schemes on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed.

When the incentives in an economy reflect demand and relative cost conditions, consumers can make well-informed choices and it would be expected that lower cost and more efficient payment instruments would thrive at the expense of the more expensive or less efficient ones. The Joint Study concluded that this was not the case in Australia. Instead, it concluded that Australia’s card payment arrangements are encouraging consumers to use credit cards at the expense of other payment instruments, particularly debit cards and direct debits, that consume fewer resources. As a result, Australia has a higher cost retail payments system than necessary, and much of this cost is borne by those consumers who do not use credit cards.

The second development, independent of the Joint Study, was a two-year investigation of interchange fees in credit card schemes by the ACCC, in response to a complaint by a merchant. The ACCC reached the conclusion that the collective setting of these interchange fees was a breach of the price-fixing prohibitions of the *Trade Practices Act 1974*. It advised Bankcard, MasterCard and Visa and their members, in March 2000, that they should seek authorisation of the interchange fee agreements if they could demonstrate that those agreements were in the public interest; otherwise, the conduct had to cease.

From that point, the ACCC began discussions with a group of banks (the “review banks”) about a possible application for authorisation. The banks initially proposed to conduct a review of the arrangements for setting interchange fees but not of restrictions on membership, notwithstanding the ACCC’s preliminary view that these restrictions may significantly exacerbate the anti-competitive effect associated with the collective setting of interchange fees. In September 2000, the ACCC instituted legal proceedings against one major bank. Soon after, the banks agreed to widen their review of credit card regulations to include membership issues. The review was submitted to the ACCC in January 2001. After a series of further discussions and a revised proposal, the ACCC concluded that the authorisation process was unlikely to meet the competition and efficiency concerns raised in the Joint Study, within an appropriate time-frame.

Accordingly, the Chairman of the ACCC wrote to the Governor of the Reserve Bank in March 2001 recommending that the Payments System Board consider using the powers available to it, under the *Payment Systems (Regulation) Act 1998*, to achieve reform of the credit card schemes in Australia in the public interest. After



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consultation with a range of interested parties, the Board took the decision to bring credit card schemes in Australia under the Reserve Bank's regulatory oversight. In April 2001, the Reserve Bank formally "designated" the credit card systems operated in Australia by Bankcard, MasterCard and Visa as payment systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*. Following that action, the ACCC discontinued its legal proceedings.

The Reserve Bank did not designate the three party card schemes in Australia, American Express and Diners Club. These schemes do not have collectively determined interchange fees, nor access rules which discriminate on the grounds of institutional status. They do, however, impose restrictions on merchant pricing. For this reason, the Reserve Bank confirmed that any decisions it took about restrictions on merchant pricing in the public interest with respect to the designated credit card systems would also apply to the three party card schemes.

Credit card schemes are also currently under official or judicial review in some other industrial countries. In Europe, the European Commission has been investigating Visa's interchange fee arrangements for intra-regional operations and its "no surcharge" rule. In the United Kingdom, the Office of Fair Trading has been assessing an application by MasterCard/EuroPay for authorisation, under UK competition laws, of its interchange fee arrangements for domestic transactions. In the United States, following action by the Department of Justice, a US District Court recently ruled in favour of MasterCard and Visa on their overlapping ownership structure but against their "exclusionary" rules preventing their member banks from issuing "rival" cards. In a separate and pending legal action, a group of US merchants has sued MasterCard and Visa over their so-called "honour all cards" rules, which require merchants to accept debit cards issued by the schemes as a condition of accepting their credit cards.

#### **1.4 The Reserve Bank's payments system powers**

The designation of the Bankcard, MasterCard and Visa credit card schemes is the first step the Reserve Bank must take to exercise its powers under the *Payment Systems (Regulation) Act 1998*. These powers were granted to support the mandate of the Payments System Board, which was established on 1 July 1998 as part of a major reform of Australia's financial regulatory structure. The mandate charges the Board with responsibility for determining the Reserve Bank's payments system policy and it must exercise this responsibility in a way that will best contribute to:

- controlling risk in the financial system;
- promoting the efficiency of the payments system; and
- promoting competition in the market for payment services, consistent with the overall stability of the financial system.



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Under the *Payment Systems (Regulation) Act 1998*, the Reserve Bank may:

- designate a particular payment system as being subject to its regulation;
- determine rules on access to a designated system for new participants;
- set standards for safety and efficiency for that system;
- arbitrate on disputes in that system over matters relating to access, financial safety, competitiveness and systemic risk, if the parties concerned wish; and
- gather information from a payment system, whether designated or not, or from its participants.

Section 12 empowers the Reserve Bank to impose an *access regime* on the participants in a designated payment system. The access regime must be one that the Reserve Bank considers appropriate having regard to the public interest, the interests of current participants in the system, the interests of people who may in the future want access to the system, and any other matters the Reserve Bank considers relevant. Access is defined as:

“... the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable.” (Section 7)

An access regime deals specifically with the terms and conditions on which a “person” (ie a constitutional corporation) can participate in a payment system, and covers matters such as eligibility for participation, restrictions on the activities new participants may undertake and the price of access (ie participation or membership fees).

Under Section 18, the Reserve Bank has a general power to *determine standards* to be complied with by participants in a designated payment system, if it considers that this is in the public interest. The legislation does not define or limit the matters on which the Reserve Bank may determine standards. Standards deal with terms and conditions that apply to *all* participants in a payment system, whatever the arrangements for entry might be.

Before imposing an access regime or determining a standard, the Reserve Bank is required under Section 28 to consult widely. It has, in fact, given high priority to the consultation process. It has received submissions from and met with (often several times) a range of interested parties – including the designated credit card schemes, the three party card schemes, financial institutions, retailers, billers and consumer representatives – in the preparation of and in response to the Joint Study and, specifically, to discuss designation of credit card schemes ahead of the Payments System Board’s deliberations. Since designation, the Reserve Bank has received additional submissions and has had a further series of meetings with interested



parties. The submissions have addressed the public policy concerns about efficiency and competition in credit card schemes raised in the Joint Study and summarised in the Reserve Bank's media release on designation. Interested parties seeking further guidance on submissions were provided with a detailed set of questions on the operation of credit card schemes.

In total, 30 separate organisations have formally provided their views on the operation of credit card schemes in Australia. A list of these parties is provided in the Appendix. Submissions that these parties were prepared to put on the public record are published in two companion volumes to this consultation document.

Throughout this process, the Reserve Bank has also continued to consult closely with the ACCC.

### **1.5 The public interest test**

The Reserve Bank may use its powers to impose an access regime or determine a standard if it is in the public interest to do so. The public interest test is the critical test for any intervention in the normal competitive processes of the market, whether it be proposed action by regulatory authorities or potentially anti-competitive conduct by market participants (which must be authorised under the *Trade Practices Act 1974*). The designated major credit card schemes have already established their own regulatory framework, in the form of rules and procedures agreed collectively by the respective scheme members that are otherwise competitors in the provision of credit card services. This regulatory framework is unique: in no other market in Australia are competitors permitted, without authorisation under the *Trade Practices Act 1974*, to act collectively to set wholesale prices, prohibit merchants from passing on these prices and restrict entry to the market in a way that substantially lessens competition. The regulatory framework of the credit card schemes benefits the schemes and their members, as well as credit cardholders; however, the Joint Study raised serious doubts about whether the community as a whole also benefits. For this reason, the Reserve Bank's starting point has been to assess whether the regulations of the credit card schemes themselves can meet the public interest test.

The *Payment Systems (Regulation) Act 1998* provides the relevant definition of the public interest. The Reserve Bank is to have regard to the desirability of payment systems:

- “(a) being (in its opinion):
  - (i) financially safe for use by participants; and
  - (ii) efficient; and
  - (iii) competitive; and



- (b) not (in its opinion) materially causing or contributing to increased risk to the financial system.

The Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so.”

In applying this public interest test, the Reserve Bank’s approach is consistent with the broad objectives of competition policy in Australia. The blueprint for this policy was set out in the report of the National Competition Policy Review (the Hilmer Report) in 1993 and endorsed by Federal and State Governments at Council of Australian Governments (COAG) meetings in 1994. Broadly speaking, competition policy seeks to promote efficiency and enhance community welfare through the encouragement of effective competition and the protection of the competitive process. The Hilmer Report identified three dimensions of economic efficiency, which are as relevant to markets for payment services as they are to other markets for goods and services:<sup>4</sup>

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

If it is to meet the broad objectives of competition policy, the payments system in Australia needs to give maximum rein to the workings of the price mechanism and the free movement of resources, provided the safety of the system is not compromised. For this reason, the Reserve Bank sees the following competition “benchmarks” as underpinning the public interest test in the payments system:

- relative prices charged by financial institutions to consumers who use payment instruments should reflect the relative costs of providing these instruments as well as demand conditions;
- merchants should be free to set prices for customers that promote the competitiveness of their business;
- prices of payment instruments should be transparent;
- any restrictions on the entry of institutions to a payment system should be the minimum necessary for the safe operation of that system; and

4 Independent Committee of Inquiry (1993), p 4.



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

If markets for payment services meet these benchmarks, the community can be confident that the price mechanism will allocate resources efficiently to meet the demand for different payment instruments, while the “contestability” of the markets – that is, the threat of entry by new competitors – would ensure that payment service providers earned no more than a competitive return on their investments over time.

Even within a competitive environment, there is likely to be a role for private-sector regulations to ensure the safe and orderly operation of a payment system. However, if such regulations suppress or distort the normal market mechanisms, the onus must be on those institutions imposing the regulations to demonstrate that community welfare is not harmed.

## 1.6 Outline of the consultation document

This consultation document reviews the main regulations in the Bankcard, MasterCard and Visa credit card schemes against the competition benchmarks outlined above. It also sets out the Reserve Bank’s proposed reform of credit card arrangements in the public interest.

Chapter 2 discusses **collective wholesale fee setting** in credit card schemes. It reviews the various justifications for interchange fees in credit card networks and the processes by which these fees have been set by card scheme members in Australia. The Chapter then provides a set of principles for interchange fee setting, against which proposals by the credit card schemes and their members to improve the efficiency and transparency of interchange fees are assessed. A draft standard on wholesale fee setting is provided. **Restrictions on merchant pricing** in Australia, imposed by MasterCard and Visa and by the three party card schemes, are discussed in Chapter 3. The potential impact of these restrictions on community welfare and arguments for and against their abolition are analysed. A draft standard on merchant pricing for credit card purchases is set out. Chapter 4 discusses the **restrictions on entry** imposed by the MasterCard and Visa schemes, and the membership requirements of the Bankcard scheme which have recently been liberalised. The Chapter analyses the risks which credit card issuers and acquirers bring to card schemes, and assesses how the schemes’ membership restrictions address these risks. A draft access regime is provided.

Chapter 5 draws the analysis together by reviewing the main regulations of the credit card schemes against the competition benchmarks that underpin the public interest test. In the Reserve Bank’s opinion, there is a need for greater efficiency



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and competition in Australia's card payment arrangements. It is therefore proposing to use its payments system powers to promote reform of credit card schemes in Australia. The reform measures involve:

- an objective, transparent and cost-based methodology for determining maximum interchange fees;
- freedom for merchants to recover from cardholders the cost of accepting credit cards; and
- a more liberal access regime that allows for the entry of specialist credit card service providers, both issuers and acquirers, to be supervised by the Australian Prudential Regulation Authority (APRA).

The Chapter discusses the likely impact of these reform measures and analyses some of the objections that have been raised to credit card reform. It also sets out the next steps in the consultation process before the Reserve Bank's proposed standards and access regime are finalised.

Although Bankcard, MasterCard and Visa are well-established schemes, the economic analysis of credit card networks is complex and relatively undeveloped. Much of the recent theoretical literature has been sponsored by Visa itself. To help it evaluate the arguments in the various submissions, the Reserve Bank commissioned a report on the operations of credit card schemes from an international expert in network economics – Professor Michael Katz, Arnold Professor of Business Administration, Haas School of Business at the University of California. Professor Katz's report, *Network Effects, Interchange Fees and No-Surcharge Rules in the Australian Credit and Charge Card Industry* (August 2001) is published in a separate volume to this consultation document.