



EXECUTIVE SUMMARY

Introduction

1. The credit card network in Australia is extremely well developed and credit cards are used for a wide variety of transactions. Over the past decade, the number of credit card transactions has risen four-fold; credit cards overtook debit cards (EFTPOS) in 1999 as the main non-cash means of payment. Credit cards are now widely used purely as a payment instrument by cardholders who settle their credit card account in full each time and do not use the “revolving” line of credit.
2. For cardholders, credit cards provide a range of services. They are convenient and widely accepted, both in Australia and abroad. Most provide an interest-free period that allows cardholders a month or more in which to arrange settlement of their credit card purchases. They also provide a guaranteed refund to cardholders when goods or services purchased with credit cards are not delivered. Cardholders who make use of the revolving line of credit are able to buy goods and services earlier than their incomes would otherwise permit.
3. For individual merchants, credit card acceptance forms part of their competitive strategy of attracting sales from, or not losing sales to, rival merchants. Indeed, credit card use has become so widespread that most merchants believe they have no choice but to accept credit cards. Credit cards, like cash and debit cards (EFTPOS), provide merchants a guarantee of payment, unlike a cheque which might be subsequently dishonoured.
4. Credit card services are more costly to provide than most other payment instruments. Credit card issuers incur processing costs for each transaction, funding costs in providing credit – whether the interest-free period or the revolving line of credit – and costs of fraud and credit delinquencies. Credit card acquirers – the financial institutions that provide services to merchants – also incur processing and fraud costs and must meet refund obligations if goods and services purchased with credit cards are not delivered.
5. Someone must ultimately meet these costs. Two groups do so in Australia, at least in the first instance. One group are those cardholders who use the revolving line of credit, who pay interest rates significantly above rates on other forms of unsecured lending. The other group are merchants, which pay an average of 1.8 per cent of the value of each credit card transaction – and as much as four per cent in the case of small merchants – in merchant



service fees to their acquirers. Like other business inputs, these costs have to be covered by merchants, so they are passed onto all their customers, not just those who use credit cards, in the form of higher prices for goods and services. In this way, the costs of providing credit card services are ultimately borne by the community as a whole. Prices paid by users of lower-cost payment instruments are higher than would otherwise be the case, while prices paid by credit cardholders are lower than they would be if cardholders faced the costs of the credit card services they used. Within the latter group, there is a third group which directly contributes very little to the costs of credit card schemes – these are the cardholders (known as “transactors”) who settle their credit card account in full each month. Although they normally pay an annual fee, they pay no transactions fees, enjoy the benefit of an interest-free period and in many cases earn loyalty points for each transaction.

6. It is not surprising that credit card usage in Australia has increased strongly in recent years in view of the price incentives facing consumers. Consumers using a debit card (EFTPOS) pay a fee to their financial institution (beyond a fee-free threshold) for accessing their own funds; “transactors” using a credit card pay nothing, and may be paid in the form of loyalty points, for using the funds of their financial institution. Nor is it surprising that banks and other deposit-taking institutions are promoting most actively the credit card because it is the payment instrument for which they receive the highest return, and yet it is one of the most expensive for merchants to accept.
7. This unusual structure of incentives is not the result of normal competitive processes. It is the consequence of the regulatory framework established by the credit card schemes and the fact that it is the same group of banks and other deposit-taking institutions that sets the fee structures for credit cards and the other main payment instruments in Australia.

The regulations of credit card schemes

8. The major credit card schemes in Australia have a set of regulations, which their Australian members collectively determine or agree to enforce, that:
 - (i) 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;
 - (ii) in the case of MasterCard and Visa, prevent merchants recovering from cardholders the cost of accepting credit cards; and



(iii) restrict membership of the schemes, broadly speaking, to authorised deposit-taking institutions supervised by the Australian Prudential Regulation Authority (APRA).

This regulatory structure is unique in Australia; a comparable set of restrictions has not been permitted in any other market without authorisation under the *Trade Practices Act 1974*.

9. These credit card scheme regulations have become the focus of closer public scrutiny in recent years, in Australia and elsewhere. The Financial System Inquiry (the Wallis Committee) highlighted interchange fee arrangements and restrictions on access to credit card schemes as areas of policy concern. In response, the Payments System Board of the Reserve Bank and the Australian Competition and Consumer Commission (ACCC) undertook and published (in October 2000) a detailed study of debit and credit card schemes in Australia, which concluded that Australia has a higher cost retail payments system than necessary, and that much of this cost is borne by consumers who do not use credit cards. The legal status of interchange fee arrangements under the *Trade Practices Act 1974* has also been separately reviewed by the ACCC.
10. Against the background set out in Chapter 1 of the consultation document, the Reserve Bank formally brought the Bankcard, MasterCard and Visa credit card schemes in Australia under its regulatory ambit in April 2001. Since then, it has consulted with a broad range of interested parties about whether the regulations established by the credit card schemes are in the public interest. The Reserve Bank's involvement is in fulfilment of the Payments System Board's mandate to promote efficiency and competition in the Australian payments system, consistent with overall financial stability.

The rationale for credit card scheme regulations

11. The normal competitive processes that drive markets ensure that consumers respond to efficient price signals and that resources are free to move to exploit profit opportunities. The community's welfare is enhanced as a consequence. Credit card scheme regulations have the effect of suppressing some of these processes. Nonetheless, the credit card schemes and their members have argued that the regulations are essential for the growth of credit card networks and, thereby, for community welfare.

Collective setting of interchange fees

12. Interchange fees in credit card schemes play a pivotal role in determining the incentives for consumers to use, and merchants to accept, credit cards.



Interchange fees are a type of transfer payment that enables credit card issuers to recover some of their costs from acquirers and, in turn, from merchants through the merchant service fee. Revenues from interchange fees allow credit card issuers to “subsidise” cardholders to use their credit cards, by charging them less than the cost of the credit card payment services they use or even offering rebates in the form of loyalty points. The burden of this subsidy falls initially on merchants, which are charged more than the costs incurred by their acquirers, but it ultimately falls on the community as a whole through higher prices for goods and services in general.

13. In the consultation process, the Reserve Bank has addressed two particular questions about interchange fee arrangements in Australia:
 - (i) what is the need for interchange fees in credit card networks; and
 - (ii) will card scheme members acting in their own self-interest collectively set the “right” interchange fees from the community’s perspective.
14. The subsidy to credit cardholders through the interchange fee has been defended on the basis that cardholders would not use their credit cards if they faced issuers’ full costs; merchants would therefore be denied the full benefits of participating in credit card schemes. The subsidy, it is claimed, is needed to ensure that credit card networks reach their optimum size and deliver maximum benefits to cardholders and merchants. These arguments are carefully examined in Chapter 2 of the consultation document. It concludes that, while there may be a case for issuers to pass some of their costs onto merchants through interchange fees, there is presently no “science” in determining the level of such fees.
15. Credit card schemes and their members have also argued that interchange fees set collectively are efficient for the community as well as for the schemes. Their claim is that competition between credit card schemes, and between credit cards and other payment instruments, prevents interchange fees going too high or too low. There is no strong support for this argument in the emerging economic literature in this area, while the practical counter is the reality of interchange fee setting in Australia. Interchange fees have been rigid – rates have not changed at all in 27 years in the Bankcard scheme and only once in the past decade in the MasterCard and Visa schemes (when, in the latter case, they rose) – and the fee-setting process itself has lacked transparency and any objective benchmarks. The “checks and balances” that would be provided if there were robust competition in the payments system do not seem to have operated. Overlapping governance arrangements mean that the



four major banks dominate the credit card schemes in Australia and are also the main providers of competing payment instruments; because there are no other large credit card acquirers, merchants have not had a strong and independent voice in interchange fee setting. This environment provides no assurance that the current level of interchange fees passed onto merchants, and ultimately onto the community, is in the community's interest. When merchants have limited ability to resist credit cards, the risk is that interchange fees can be pushed above the efficient level, allowing issuers to further subsidise credit cardholders and resulting in the overprovision of credit card services and underprovision of alternative payments instruments.

Restrictions on merchant pricing

16. Restrictions on merchant pricing imposed by MasterCard and Visa prevent merchants recovering from cardholders the costs of accepting these credit cards. Merchants therefore have an “all or nothing” choice in accepting credit cards and no alternative but to recover their credit card costs by passing them through to all their customers in the form of higher prices of goods and services. These restrictions are defended as the means of preserving the subsidy to credit cardholders made possible by interchange fee revenues. The claim is that merchants as a whole would be denied the full benefits of participating in credit card schemes if the subsidy to credit cardholders were unwound at the till. Although this claim is made by the card schemes on behalf of merchants, merchants themselves have argued strongly against the restrictions.
17. Arguments for restrictions on merchant pricing are weighed, in Chapter 3 of the consultation document, against the adverse consequences of these restrictions. Restrictions on merchant pricing are a restraint on trade. Card scheme members are free to provide incentives to their customers with a view to maximising their profits, but collectively deny merchants the same opportunity. For consumers who do not use credit cards, the restrictions are harmful because such consumers pay higher prices for goods and services than they would otherwise; in this way, they contribute indirectly to the costs of the credit card schemes. Because credit cardholders are using what appears to them to be a free payments service, the price signals that normally guide markets to an efficient use of resources are suppressed.

Restrictions on entry

18. Credit card schemes impose minimum entry standards that are intended to ensure the safety of the schemes. Broadly speaking, only authorised



deposit-taking institutions supervised by APRA are eligible for membership. The card schemes also prevent their members specialising in credit card acquiring, or impose financial penalties on members whose main activity is acquiring, in the interests of “balanced development” of the schemes. The arguments for restrictions on entry to credit card schemes are analysed in Chapter 4 of the consultation document.

19. The Reserve Bank acknowledges that some minimum entry standards can be justified because credit card issuing and acquiring does generate risks. Issuers need to assess the creditworthiness of cardholders and settle transactions with acquirers. Acquirers need to assess the creditworthiness of merchants and, under card scheme rules, finance refunds to cardholders if goods or services purchased with a credit card are not delivered. The failure of any one card scheme member to manage its risks becomes an exposure for all other members because of loss-sharing arrangements in each scheme.
20. Reliance on prudential supervision by APRA may provide a cost-effective and objective screening device to determine eligibility for membership. In seeking to promote safety, however, scheme restrictions deny access to non-financial institutions that may have the skills, financial substance and distribution networks to become effective competitors in the credit card market. The exclusion of such institutions was a particular concern to the Financial System Inquiry. Experience suggests that long-term incumbents in a market may not provide the spark for more intense competition – new entry was the key, for example, to more competitive pricing in the residential mortgage market in Australia. The additional scheme restrictions on credit card acquiring in the interests of “balanced development” are particularly difficult to defend in a market that, on a number of indicators, needs a spur to competition.

Reform of the credit card schemes

21. Having weighed a range of arguments from interested parties, the Reserve Bank is of the opinion that the main regulations established by the credit card schemes in Australia do not meet the public interest test. The regulations suppress or distort the normal market mechanisms in ways that work against, rather than contribute to, the community’s welfare. The pricing of credit card services is sending consumers a quite misleading signal about the cost to the community of different payment instruments, while barriers to entry are quarantining the credit card schemes from the competitive pressures that non-financial institutions of substance could bring to bear. Overall, the community is paying a higher cost for its retail payments system than is necessary.



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22. The Reserve Bank is therefore proposing a reform of credit card schemes that will promote efficiency and competition in the Australian payments system. Although it is using its payments system powers for this purpose, the Reserve Bank is not adding a further layer of regulation to the credit card market; on the contrary, the reform measures, taken together, will ensure that where competitive forces have not been allowed to work, they will now be better able to do so. The reform measures involve:
- (i) an objective, transparent and cost-based methodology for determining interchange fees;
 - (ii) freedom for merchants to recover from cardholders the costs of accepting credit cards; and
 - (iii) a more liberal access regime that allows for the entry of specialist credit card service providers, both issuers and acquirers, to be supervised by APRA.

These reform measures, which have been endorsed by the Payments System Board of the Reserve Bank, are in line with changes that have been introduced or are contemplated in other countries in which credit card scheme regulations have come under scrutiny.

23. The Reserve Bank's reform measures deal only with the regulations of the credit card schemes governing the collective setting of wholesale fees, entry to the schemes and restrictions on merchant pricing. The measures do not deal with the relationships between individual scheme members and their customers which are not covered by scheme regulations. Hence, they do not cover the setting of credit card fees and charges to cardholders and merchants, or interest rates on credit card borrowings.

A standard for interchange fees

24. The Reserve Bank acknowledges that interchange fees can have a role in credit card schemes, as a means of enabling issuers to recover the costs of providing specific credit card payment services that are of benefit to merchants. The Reserve Bank's draft standard provides an objective and transparent method for determining interchange fees. The credit card schemes and Australian banks have proposed a much wider range of costs for inclusion in interchange fees, but without convincing explanations of why these costs should be passed to merchants. Some of these other costs are proprietary matters between individual card issuers and their cardholders and are not intrinsic to credit card schemes, while the inclusion of costs such as credit losses would involve



an element of double-counting since these costs are already being recovered in credit card interest rates.

25. The draft standard requires that credit card schemes publish their interchange fees and the aggregate costs that have been included. This will ensure that the calculation of interchange fees is entirely transparent and can be readily understood by card scheme members, the merchants to which the interchange fees are passed, and the community. Identifying the specific costs involved will also give card scheme members and merchants an incentive to address these costs.

A standard for merchant pricing

26. In the Reserve Bank's opinion, scheme restrictions on merchant pricing are a source of serious inefficiencies in the pricing of payment instruments. In no other market can a small number of institutions dominating the provision of a widely-used product seek to promote that product over others by preventing merchants charging its costs to their customers. The Reserve Bank's draft standard, which follows a decade of official concerns about these particular restrictions, is straightforward. It prevents credit card schemes and their members from preventing merchants recovering from cardholders the costs of accepting credit cards. Whether merchants avail themselves of the freedom to recover these costs will be for their commercial judgment.

An access regime for credit card schemes

27. Though some minimum entry standards are appropriate, the Reserve Bank believes that the current barriers to entry to the credit card schemes unduly restrict competition. The Reserve Bank's draft access regime liberalises access to the credit card schemes by allowing non-financial institutions of substance to enter the credit card market in their own right. Such institutions will need to be authorised and supervised by APRA. They will need to demonstrate to APRA that they have the skills, staffing and operational capacity for the scale of credit card activity proposed, and will have to meet ongoing prudential standards no less strict than those currently imposed by APRA for given types of risks. The draft access regime will make credit card issuing and acquiring open to greater competition, without undermining the comfort from having credit card scheme members prudentially supervised or the benefits to the credit card schemes of "outsourcing" membership eligibility to APRA.



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28. The draft access regime specifically prohibits any card scheme restrictions or financial penalties on members that wish to specialise in credit card acquiring. These restrictions have no basis in risk management and, whatever their original rationale, have the effect of handicapping potential competitors.

Impact of the Reserve Bank's reform measures

29. The Reserve Bank's proposed standards and access regime will apply to the three designated credit card schemes, Bankcard, MasterCard and Visa. The "three party" card schemes – American Express and Diners Club – do not have collectively set interchange fees nor restrictions on entry enforced by existing members, and the Reserve Bank saw no case on public interest grounds to designate these schemes to deal with these issues. 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.
30. 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. 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, but the reduction will pass through to all consumers in the form of prices of final goods and services that will be lower than they otherwise would be. Over time, the freedom of merchants to recover their credit card costs from cardholders and the possible entry of new types of credit card service providers will strengthen the workings of competition. Of course, reform will have a direct impact on credit cardholders and the current subsidy they receive, although it will be a matter for individual card issuers, in competition with other issuers, to determine how they will price their credit card services to customers. That is the market mechanism at work. Objections to reform of the designated credit card schemes – that it would give a "free kick" to the relatively small, higher cost three party schemes or that gains to merchants would not be passed onto consumers – are, at their heart, a vote of no confidence in the competitive process in Australia. This is a view that the Reserve Bank does not share.

