

CREDIT CARD QUESTIONS

Interchange fees

1. *Is an interchange fee necessary to the functioning of an open credit card scheme? If so, why? If not, what are the alternatives?*

Benefit in Maintaining the Interchange Fee

The existing interchange fee provides a mechanism for card issuers to be compensated for their investment and participation in the credit card payment system. There are three principal parties to this payment system; the merchant, the acquirer and the issuer. All currently share in the benefits and costs of providing this payment service.

The merchant benefits by way of:

- increasing the choice of payment options which has value to the consumer and the merchant
- enjoying a credit-risk free guarantee of payment
- reduced administrative and credit costs of alternative payment mechanism such as cheques which sometimes do not clear and the effort involved in banking the cheques, and cash which brings special administrative and safety problems of its own
- ability to offer payment terms to consumers which flow through directly to increased sales
- ability to share the benefits of reward schemes which again flow through to increased sales.

The merchant shares the costs by paying a merchant service fee which allows both the acquirer and the issuer to be compensated for their part in providing the credit card network.

The acquirer enjoys a financial compensation by virtue of the merchant service fee. This fee, however, is calculated to cover the costs of acquiring, the costs of issuing (by way of interchange fee) and a profit margin for the acquirer. The acquirer provides:

- the merchant terminal facility (this includes equipment, account support, helpdesk, account balancing and consumables)
- the network, so transactions can be electronically transmitted from the merchant to the ultimate card issuer (network costs, data communication equipment and computer equipment to switch transactions)
- the cost of switching the credit card transactions
- a settlement-risk free environment to protect the system from a merchant failure.

The acquirer's costs can be summarised as network investment, transaction transportation, settlement risk and systems support.

The issuer is compensated by virtue of the interchange fee. In return the issuer has the following costs and responsibilities:

- costs of card acquisition (application, authorisation and card distribution)
- costs to promote the card and use of the card (marketing, loyalty, direct mail)
- cost of providing the network, so transactions can be electronically transmitted from the acquirer through to host computing systems (network costs, data communication equipment, IT and other computer equipment to switch transactions)
- settlement costs (societies' staff costs, ASL costs, cost of funds transfer)
- cost of switching the credit card transactions
- cost of fraudulent transactions
- cost of systems support (complaints & charge-backs)
- costs of scheme participation (card/PIN production, scheme fees, marketing costs, scheme enhancements).

Again, in summary, the issuer costs are acquisition, network investment, transaction transportation, fraud risk and systems support.

This does not include the credit-risk costs which the issuer faces. The issuer does initial credit assessment but especially on a revolving credit product meets the system risk of credit losses. There is a valid argument that this cost be incorporated into the interest rate.

So we have a system where each of the merchant, the acquirer and the issuer share in the benefits of a complex, open and safe credit card payments system. The acquirer clears approximately 1.5% for their part, the issuer clears approximately 0.95% and the value to the merchant is very substantial and would dwarf the acquirer / issuer benefits (reduced costs and increased sales). The system works, is easy and is equitable to all parties.

The Alternatives

The alternatives need to address the compensation to issuers that is currently achieved by interchange fees inherent in the credit card system.

There is no practical alternative to the interchange fee. How does an issuer receive compensation when the underlying transaction is between the consumer, the merchant and the merchant's acquiring institution? To provide compensation back to the issuer, under a user pays rule, the consumer should pay the merchant, who pays the issuer via the acquirer. This is in fact what happens with an interchange fee.

The only alternative is a surcharge where the merchant charges an extra fee to the consumer who chooses to use a credit card. This surcharge would not be retained by the merchant but would be paid back to the acquirer instead of an interchange fee. There needs to be a mechanism for the surcharge to be paid by the acquirer to the issuer.

Surcharging would be equivalent to the existing interchange system with the exception that a consumer chooses to use the credit card and accept the “visible” surcharge rather than paying by other means (cheque or cash). The customer receives the “correct” signals about pricing at the merchant level. It is debateable whether this will add any visibility or market influence to any interchange fee that would be retained.

If a surcharge is applied for use of credit cards, a surcharge should also be applied when a consumer used a cheque or paid in cash. With cheques the processing and credit costs are high for the merchant. On the other hand, cash requires management, and incurs fraud, theft and banking costs. These costs would be high. Should there not be a surcharge placed by the merchant on the consumer because the consumer chooses to use a high cost alternative to credit cards.

With a credit card surcharge, the consumer would be wearing an extra cost on a transaction which is inherently less expensive to the merchant than the alternatives.

What could happen and this has been confirmed in countries that do not allow a no surcharge rule, merchants would decide not to impose a credit card surcharge for a number of reasons. They would not want their customers resorting to payment methods that impose either a higher cost or a higher risk; they would not want to be the point where credit card holders vent their anger at “additional” surcharge fees and they would not want to confuse their customers with different prices for different payment options. So there is high confidence that abolition of the no surcharge fee will achieve nothing, either in use of credit cards or visibility of the underlying interchange arrangements.

Cost of Structural Change

The interchange fee is used to offset some of the benefits (perceived or otherwise) of a credit card. Should interchange fees not be passed on to the card issuer or substantially reduced, then the profitability of the credit card product will be changed and other forms of income will need to be activated.

This will also apply to “credit card” transactions on debit cards. Loss of such commission could be passed on directly to the debit card customer in the form of transaction fees and/or the removal of the product all together.

Whereas the Reserve Bank may be wishing to foster competition it is more likely that institutions with a large card base and a strong investment in acquiring will increasingly dominate. This will be a result of the shift of income generation from the card issuer to the card acquirer.

An important question is how can interchange fees be structured in a more equitable way for all participants with a high degree of transparency. This cannot be achieved by dealing with the credit card system in isolation from the debit system.

2. *In the open credit card systems operating in Australia, are there competitive forces that generate an equilibrium interchange fee? If so, what are they?*

Not that we can see. Overall, building societies are small players in the credit card system. There are certain minimum fees that must be paid to participate in the schemes that building societies fail to meet these numbers.

Societies are generally regionally based and do not participate in the acquiring business. While they would like to provide small business customers with acquiring capability, the cost of membership of schemes such as Bankcard had prohibited societies involvement.

Most building societies are “price takers” in credit card business.

3. *How do you think interchange fees for the card schemes operating in Australia should be determined in practice? Please spell out the advantages and disadvantages of your proposal.*

The average cost of issuing a credit card transaction should be assessed periodically according to an agreed and objectively set formula. The formula should be established out of the designation review and should include all cost components necessary for facilitating a credit card network from an issuer's point of view. This could be a set fee per transaction, or continuation of the existing *ad valorem* interchange or *ad valorem* with a cap. The set arrangements should be standard for all issuers.

The RBA designation process should determine the initial interchange fee that would remain in place for 3 years, increasing in line with CPI until the expiry of the initial term. At that stage, the robustness of the formula should be tested perhaps in conjunction with the ACCC.

The view of building societies is that establishing the formula and managing credit cards should remain with the respective schemes subject to overview by a regulatory authority. An alternative is an organisation such as APCA which has a well-established mechanism for regulating interchange.

4. *How frequently should interchange fees be revised? Please detail the arguments for and against your proposal.*

Refer to question 3 above.

In practice, the frequency would depend on what the consumers, issuers and merchants see as acceptable. Considering that the fees are based around

providing the service/product then the optimal time would be influenced by systems, infrastructures, interest rates, loyalty costs and the like.

Reviews will add to costs and any amendments will involve system changes which will add further to costs.

A yearly review would be the minimum accepted by the merchants/acquirers, and the issuers would argue against anything more regular than this. If a review produced only minor variations to pricing, implementation should be deferred as costs of change would not be justified.

Access

5. *What specific risks do acquirers bring to a scheme, independent of their status as issuers?*

Acquirers control the merchants who perform the transactions. The level of risk to both the merchant and issuer is directly attributable to the accuracy with which the merchant performs their tasks. If the merchant performs their functions correctly in accordance with scheme requirements the risk lies completely with the Issuer who has provided the card with consequential credit risk.

The 'per transaction floor limit' can result in a merchant holding a significant number of below floor limit transactions amounting to several thousand dollars and never obtain an authorisation. While the merchant is likely to be aware of the extent of the value held, it is not their risk and there is no obligation to alert the issuer of the level of transaction activity. There is frequent abuse of the transaction floor limit by merchants.

A further risk is incurred by acquirers if goods are not delivered.

Responding more at a prudential level, acquirers under the control of a regulatory authority provide a greater degree of comfort to all involved in the system than if an organisation fell outside control of a regulatory authority. If the acquirer was not an ADI, then we would have concerns on the integrity of the payments systems and the potential associated risks. This would be the case whether an institution was an acquirer or an issuer although the building societies would have even greater concerns in the case of the latter.

6. *What specific risks do self acquirers bring to a scheme? Please note where those risks are different from the risks for third party acquirers.*

We have no comment to make.

7. *In the presence of an interchange fee and membership fees, what is the justification for net issuer penalties? How large are such penalties?*

One significant penalty faced by building societies is that to be an acquirer card schemes require that the institution be an issuer also. Given the saturation of credit cards in the Australian market, any requirement to be a card issuer in order to be an acquirer poses a severe impediment. The recommendation of societies is that, if the acquirer is at least an issuer of one other major card, then the net issuer penalties be removed.

No surcharge rule

8. *Do you agree that the no surcharge rule is integral to the success of the open credit cards systems? If so, why and if not, why not?*

Refer also to question 1 above. We do not see how the removal of the no surcharge rule would significantly alter the current success of the open credit card systems. The introduction of surcharges has the objective of adding transparency to transactions which has the potential to alter transaction patterns. However, it is likely that surcharges would favour larger merchants (they usually have lower merchant costs) and would be more able to absorb a surcharge rather than flow it on and others might increase prices generally to compensate for not applying a surcharge. The transparency benefits would therefore be dissipated.

The no surcharge rule simply equals the acceptance of all payment methods although on large value transactions it is recognised that a credit card costs the merchant more than other payment mechanisms. This, in reality, hides the real costs associated with the acceptance of a credit card. The decision of how a consumer purchases their goods should lie with the consumer and they choose (and pay) based on the price and benefits of each payment method.

9. *If the no surcharge rule were removed from the scheme regulations, do you think it would be removed from merchant agreements?*

Since societies do not have merchants, it is difficult to predict what might occur in practice.

It is likely that no surcharge rule might be removed from merchant agreements but only as new merchant agreements are negotiated. If the scheme rules permit surcharging, then there is no benefit having such a no surcharging clause in merchant agreements.

Competition

10. *Which payment instruments do open card schemes compete with? How do they compete in each case?*

The following payment types compete with credit cards for face-to-face purchases in stores:

Cheques
Cash
Debit Cards
Charge Cards
In-Store cards.

Each has its advantages and disadvantages. There is a preference for consumers to elect to use electronic means of making payments. Cheques and cash have cost and efficiency issues for both merchants and consumers.

BPAY and direct entry payment schemes compete against credit cards in MOTO transactions and reoccurring payments.

11. *Open credit card schemes appear to have much larger card bases and wider acceptance than three party schemes. Why is this so?*

They have a greater acceptance in the domestic market (a ratio of 4:1 or better) heavily influenced by the involvement of the major financial institutions in the credit card schemes.

They are open and globally accepted. They are easy for the consumer and reasonably inexpensive for merchants. Most merchants accept open card schemes and not other payment methods such as cheques because of the specific risks that come with those other methods.

It is understood that third-party schemes impose a higher merchant fee and are therefore less likely to be the preferred payment means for the merchant.

12. *How are the schemes promoted:*

- a. *At the scheme level?*

By a dedicated marketing team with a marketing plan and budget supported at the upper levels of individual schemes with the exception of Bankcard. All scheme participants benefit from scheme marketing and presence.

b. *At the individual bank level?*

The larger societies offer several cards to their customers including Cashcard debit card, Visa debit and credit cards, and MasterCard and Amex credit cards. Generally the card programs have different benefits, costs, etc. and these are set out in a brochure so that the customer chooses the card that suits them.

Most societies' systems are designed so that any card can be linked to a member's nominated account. The exception is for MasterCard and Amex credit cards where the arrangements are with another financial institution.

13. *Why are credit card interest rates around 3 percentage points higher than rates on other unsecured personal lending?*

The major reason is higher credit risk. Credit cards are a revolving credit instrument and the level of potential credit loss is considerable. With a personal loan, the term and repayments are limited and finite. There are additional risks with a credit card on fraud, loss of card, etc. in addition to those risks associated with a personal loan.

The interest rate also absorbs are the cost to punish institutions such as loyalty / reward schemes linked to credit cards, no transaction fees on credit purchases and interest-free periods.

14. *Which of your cards offer loyalty points? What is the role of loyalty points? What evidence is there that they achieve the issuers' objectives?*

Only Heritage and NRMA Building Societies have a loyalty scheme attached to their cards. Several other societies align their credit card program with another financial institution such as Citibank and American Express.

There is a view that it is necessary to provide a loyalty program either directly or via another institution in order to retain the customer's business.

Most credit card schemes with loyalty program is attached are in their infancy and it is too early to determine if they will meet societies' objectives.

15. *Does the ability of issuing banks to offer a number of different brands of cards result in more competition between schemes than would be the case if they could only issue one brand? Please detail your analysis.*

It may result in more competition between the schemes, but more fundamentally, offer the full range of schemes to the organisation's customer base so that they do not need a relationship with another financial institution. The decision on which card scheme is preferred by a customer comes down to the product, price and benefits more so than an individual card scheme.

16. Small Card Issuers

The review of credit card interchange needs to consider a number of issues from a small issuer point of view. Typically, small credit card issuers have characteristics which need to be considered when striking an industry-wide interchange framework. Firstly, there are economies of scale in a number of areas. High card volumes and high card transaction rates typical of the large card issuers means lower card creation and distribution costs, lower domestic switch costs, lower Visa transaction switch costs and lower telecommunication costs. In a review which looks at both card costs and revenues, it should be noted that the smaller card issuers suffer another disadvantage – most small card issuers are mutual by nature (not profit-maximisers) and operate in a regional / rural environment. Small card issuers therefore operate under a lower revenue framework – annual card fees, interest rate etc. The regional / rural characteristic also affects card spend behaviour. One major society has an average credit card purchase of \$65 which is much lower than the industry average. Any significant change to the interchange environment needs to consider the affect on the smaller card issuers and their place in the industry.

17. Negative Interchange on EFTPOS

The designation review also needs to consider other payment streams in any specific move on the credit card environment. Any significant change has the potential of driving substantial changes in the market place to other payment streams, particularly EFTPOS. RBA needs to be aware of the inequitable negative interchange which operates in the EFTPOS environment. Card issuers, especially the net card issuers (ie small institutions) face further discrimination if a portion of credit card transactions are diverted to the EFTPOS environment where the acquirers are already enjoying a discriminatory and unchecked interchange anomaly.