



AUSTRALIAN BANKERS' ASSOCIATION

**Submission to the Reserve Bank of Australia
to Assist in its Consideration of
Designation of Credit Cards Schemes
as a Payment System**

06 April 2001

The Reserve Bank of Australia (**RBA**) has sought submissions regarding the possibility it may “designate” certain credit card schemes as a “payment system”. The Australian Bankers’ Association (**ABA**) sets out in this paper some considerations we believe the RBA should take into account prior to any designation. We understand that the RBA will consider whether designation is in the public interest and the comments we raise should be seen in that context.

Executive Summary

The ABA is of the opinion that designation may be in the public interest if designation, and the regulatory regime that follows, adheres to four principles:

- (i) benefits consumers;
- (ii) maintains a level playing field for all credit card schemes;
- (iii) ensures efficiency and innovation in payment systems; and
- (iv) does not inadvertently lead to financial instability.

In particular, adhering to these principles means ensuring that the RBA’s actions:

- provide a clear basis upon which businesses can ascertain whether particular business functions are within the scope of the designation;
- ensure that open credit card associations in Australia are not disadvantaged in competition with closed credit card schemes or foreign issued Australian dollar credit cards;
- continue to sustain diverse issuing participation;
- continue to encourage investment in infrastructure;
- avoid duplicative regulation by the ACCC;
- not prudentially weaken eligibility criteria for membership in credit card schemes; and
- is carried out with minimum necessary regulatory intervention and maximum regulatory certainty.

The paper will conclude by looking at the most effective process the RBA might follow post-designation to allow for a full consideration of the likely impact of the RBA’s actions.

What is a payment system?

The RBA has indicated that it is considering designating the open credit card schemes operated by Visa, MasterCard and Bankcard. However, a preliminary matter to consider is what exactly is the scope of the definition of payment system. So the initial step for the RBA, as part of designation, would seem to be the need to identify properly what that scope is.

We have formulated the following questions that will be relevant in identifying that scope:

1. ***Do open credit card schemes wholly fall within the definition of payment systems?***
It may be that all aspects of open credit cards schemes do not and so we suggest the RBA proceed by identifying the product features that make up a payment system that credit cards schemes have.
2. ***If credit cards are to be designated, should the RBA restrict its designation so that it just has an effect on open credit card schemes?*** In other words, if the RBA acts in relation to some aspects of a payment system is the RBA required to designate networks beyond just the open credit card schemes, and, in particular closed credit card schemes. It is arguable that the Australian open and closed credit card schemes are one “payment system”. From a point of view of maintaining competition and even-handedness there are also, we believe, compelling arguments to treat open and closed credit card schemes together which we discuss below.
3. ***Can individual credit cards schemes be designated?*** Whatever decision is taken in relation to open and closed credit card schemes, it is desirable that the RBA identify whether each credit card scheme must be designated separately as opposed to a designation en bloc.

Public interest

We understand that in looking at what makes up the public interest, the RBA will consider a range of factors, in particular it will consider the desirability of payment systems being:

- (i) financially safe for use by participants,
- (ii) efficient,
- (iii) competitive, and
- (iv) not to cause or contribute to increased risk in the financial system.

We consider below how regulation could best proceed in a way that takes into account all these factors.

Financial Safety and Stability

The financial safety of participants and financial stability of credit card systems could be jeopardised by regulatory uncertainty. We suggest it is paramount for the RBA to ensure that any designation regime put in place minimises that risk. There are a number of matters which might lead to uncertainty:

1. ***The form of designation adopted by the RBA*** – this should provide a verifiable basis upon which businesses can ascertain whether particular business functions are within scope of whatever designation occurs.
2. ***The litigation brought by the ACCC against the National Australia Bank (NAB)*** - all other banks have now been joined in these proceedings and the ABA is concerned that the consultation process that will be necessary for the RBA to establish a viable designation regime will be hampered if the litigation is kept on foot. While court proceedings continue we are concerned that discussions will not be as frank as they might be, resources will be diverted and that the lawyers will find a need to vet all material that might find its way into the public domain or be used against the banks in the litigation. We believe it will be of most benefit to all the parties if the ACCC were to withdraw the NAB proceedings.
3. ***The overlap of the RBA's powers with those of the ACCC under the Trade Practices Act 1974 (TPA)*** – the ABA is concerned that interchange arrangements may still need to be separately authorised by the ACCC after designation. It would contribute to financial uncertainty to have designation proceed but still leave industry participants subject to separate regulation of precisely the same conduct by the ACCC. It would also not be in the public interest for duplicative regulatory schemes to be in place. There would clearly be an added cost burden on scheme participants – and add to the potential for confusion - if there were overlapping regulatory regimes. Therefore, as a minimum, it is our view that behaviour designated by the RBA should remove the need for interchange arrangements to be separately authorised by the ACCC.

One way to prevent the risk of breaches of the TPA is to pass regulations under s.51(1) of the TPA at the same time as designation. However, this option may not deliver sufficient certainty as such regulations may only have a duration of two years.

Consequently, that may be an inadequate way to proceed and the most practical solution would seem to be to develop sufficient precision in the form that designation and a post-designation regime take so that the industry participants are protected. Both the ABA and the member banks are happy to work with the RBA on the form that post-designation regimes should take to provide sufficient precision (but also on the form of any government regulation should that be required.)

4. ***Changes to membership rules*** - this also impacts financial stability. The eligibility rules currently in place rely on the prudential regulator ensuring that scheme members have sufficient capital and liquidity and are otherwise financially sound. The key rationale for these eligibility rules are to give a high degree of assurance to all scheme participants (cardholders, merchants, issuers, acquirers and the schemes themselves) that those organisations which must make final payment are able to do so. In particular, the need for financial soundness extends not only to issuers but also acquirers, because of the obligation on acquirers to refund purchase prices to cardholders in the event of failure to deliver by merchants. Altering the eligibility criteria may undermine this assurance and introduce a damaging uncertainty.

Efficiency and Competitiveness

We consider that there are four main issues relating to efficiency and competitiveness:

1. ***Equity between open and closed credit card schemes*** – no doubt the RBA will wish to consider the economic and financial functioning of open and closed credit card schemes to determine if they can be considered functionally separate. If there were no significant functional difference between closed and open credit card schemes,¹ and yet one type were regulated differently from the other, there will be adverse effects on the efficiency, competitiveness and innovation in payment systems, as well as for financial services and the banking industry generally. As a matter of equity and even-handedness it is unwarranted to regulate the open schemes yet not the closed. In addition regulation should extend to credit cards issued by foreign institutions denominated in Australian dollars to avoid advantaging issuers of such cards which will otherwise enjoy a higher interchange rate (likely to be the international default interchange rate).

¹ One often expressed difference is that the closed schemes do not have interchange fees, however, closed schemes have implicit rather than explicit interchange fees. It is also worth noting that American Express may no longer be an entirely “closed” scheme given that AMP is now an issuer of American Express credit cards.

2. ***Increased fees for open credit card holders*** - the RBA should consider the efficiency and competitive impact of increasing fees and charges for open credit card holders. The Joint Study has indicated that a greater contribution by cardholders to the costs of using a credit card would provide scope to lower interchange fees and arguably the price of goods and services. However, the Joint Study also acknowledged that higher direct charges on cardholders might be expected to lead to some contraction in open credit card usage (see p. 52) and also acknowledged the competitive risk inherent in regulation (see p. 5):

“...the study is mindful that its findings on credit card schemes may have implications for the competitive position of credit cards vis-à-vis store cards and charge cards.”

Clearly this is an issue of equity with “closed” credit card schemes which will continue to offer very low or nil cardholder fees. Regulatory intervention should at least maintain a level playing field.

3. ***Schemes with higher merchant service fees are likely to increase market share*** - there is a strong reason to suspect that the “closed” schemes, unless regulated jointly with the open credit card schemes, will increase market share. Where the average merchant service fee charged by the closed schemes is higher than that charged by the open scheme members, which appears to be the case, the net cost to the community will be higher. As greater numbers of credit cardholders acquire the credit cards from the “closed” schemes – because they offer lower cardholder fees or more extensive loyalty benefits – it is likely that merchants will accept higher cost credit cards in order to maximise sales. This has been the experience of Visa in Canada where we understand, despite higher interchange fees than MasterCard, Visa has grown far more rapidly.² The wider acceptance of the closed schemes will in turn encourage more credit cardholders to switch to those schemes. There is thus a danger that the competitive playing field for credit cards could become permanently skewed by uneven regulatory intervention.
4. ***Efficiency should include dynamic efficiency*** - the RBA should define efficiency following the practice of other Australian regulators to cover productive efficiency, allocative efficiency and dynamic efficiency.³ This allows consideration to be had of

² Also note the growth of new high cost payment schemes such as Bartercard which is growing rapidly despite merchant fees of 6.5% [source: Bartercard prospectus].

³ Dynamic efficiency considers the ability to take and the incentives for taking advantage of innovation and changing technology. Allocative efficiency considers whether the prices of resources reflect their underlying costs and are then allocated to their highest value uses. In the Joint Study, *Debit and Credit*

the effects of regulation on incentives to invest. An unintended consequence of access pricing regimes can be to create disincentives for investment and innovation. In any scheme imposing a pricing regime for credit card interchange fees the RBA should be sensitive to the need for continued investment in the networks and the need for a commercial and efficient return on capital. The Productivity Commission, in its discussion paper released on 29 March 2001 reviewing the National Access Regime, warned against the costs that may emanate “from the alteration of property rights under access regulation”, including “reduced incentives to invest in infrastructure facilities” and “inefficient investment in related markets” (see p. 53).

Consultation Process

On 21 March 2001 the Governor of the RBA, Mr Macfarlane, wrote to the CEOs of the “review banks” indicating that, beginning 26 March, the RBA was happy to consult with a range of interested parties over a two week period. In a letter to Mr Geoff Ferguson of the Commonwealth Bank of Australia, dated 22 March 2001, Dr Laker, Assistant Governor (Financial System) also indicated that there would be bilateral discussions with the “review banks” and opened the possibility of even broader consultation. Again on 28 March 2001 at a meeting with bank CEOs, the Governor asked for views to be put forward on the most appropriate process post-designation.

The RBA has already indicated that, if it decides to designate, it will precede the formal consultation period by the release of an Issues Paper. This is certainly a move we would encourage to provide for a full hearing of all the issues that will follow designation.

We also believe the RBA should publish reasons as to why designation has taken place and for the form in which it occurs. We believe that this would greatly assist the banks and, indeed, all stakeholders, in the post-designation process to follow.

If the RBA does designate a payment system, an “access regime” or “standard” may be imposed if the RBA considers that is in the public interest. In relation to the imposition of access regimes (which may extend to pricing) the RBA must also have regard to the interests of current participants in the system and the interests of future access seekers.

However, the procedure for consultation that should precede the imposition of an access and/or pricing regime or the determination of standards is untested. The procedure laid down simply provides for the RBA to cause a notice to be published in the Gazette (a) advising of

Card Schemes in Australia, A Study of Interchange Fees and Access (October 2000), conducted by the ACCC and RBA the focus is on productive efficiency, i.e. producing goods and services at least cost.

the proposed action; (b) summarising its purpose and effect; (c) inviting people to make submissions within a specified time to the RBA on the proposed action; and (d) consider any submissions that are received within that time limit. Any action taken after designation to impose an access regime or determine a standard must also be published in the Gazette.

The RBA is left with some scope regarding how it is to call for and consider submissions prior to taking action, in other words, how it is to engage in consultation. We would encourage the RBA to make all submissions public, as other regulators typically do, except for any commercially sensitive information provided.

Once the formal consultation process has begun there must clearly be a sufficient and substantial level of consultation to allow the banks – and other stakeholders – properly to assess the business impact of a post-designation access regime or determination of standards.

We would envisage that process to last at least some months. The RBA has indicated that it envisages that all the major work needed will be completed by the end of this calendar year.

In this respect the processes adopted by the ACCC and other regulators, such as the Office of Regulator-General in Victoria and the Independent Pricing and Regulation Tribunal in NSW are models of a sufficient consultation process. Typically those regulators, prior to access and pricing regulation, release an Issues Paper and call for submissions. A consultation process then commences that includes meetings with industry participants, other stakeholders, receipt of submissions and, sometimes, public fora. After this process, a Draft Recommendation or Position Paper is produced that invites a similar round of consultation and receipt of submissions. A final decision is the result of this process. We believe that this type of process is similar to that proposed by the RBA in various meetings it has had with bank representatives.

We would recommend a similar process here. It is especially warranted given the unprecedented nature of designation and the potentially great domestic and international significance of a post-designation regime for the payment system in Australia generally and on the banks and credit card issuing institutions in particular.

Thus we propose a model for consultation on the following lines:

Consultation Post-Designation

