



## **Australian Bankers' Association**

Submission to the  
**Reserve Bank of Australia**

Inquiry into Credit Card Systems

### **ABA Supplementary Submission: Implications of the Ansett Collapse for Credit Card Reform**

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## ABA Supplementary Submission: Implications of the Ansett Collapse for Credit Card Reform

Among the many significant consequences of the Ansett insolvency are consequences for participants in credit card schemes, particularly Ansett’s acquirer for the schemes, those cardholders who pre-purchased Ansett tickets with their cards and those who received card-linked Ansett Global Rewards loyalty points. The episode thus has important implications for some of the RBA’s deliberations on card scheme rules, particularly in respect of proposals to liberalise entry into credit card acquiring.

The liability of National Australia Bank, in its capacity as acquirer to the Ansett group of companies and for travel agents doing business with them, has yet to be determined, indeed cannot at present be determined. However, based on early estimates, ABA believes that the ultimate loss suffered by NAB will be very substantial. This cost will be a combination of the amount of the charge backs, to the extent that they are not recoverable from the merchants, and the actual operational expense of processing the charge backs.<sup>1</sup> This money will be repaid, via their credit card issuers, to people who pre-paid for Ansett tickets using their credit cards, Of course, that travel will evidently not now be delivered. This refund is guaranteed by the rules of the credit card schemes to all people who present an unused flight coupon and request a refund. This case illustrates a number of salient points.

### **The benefit of credit cards in comparison to other forms of payment**

People who paid for their Ansett tickets using credit cards will be repaid in full. In contrast, people who pre-paid using cash, cheque or debit will not receive refunds except to the degree that they — and indeed holders of Ansett Global Rewards points — have become unsecured creditors of Ansett. It might be reasonably assumed that the probability of them recovering their money (or value for their points) is small. This case illustrates, again, that credit cards offer a *higher quality* payment service than other forms of payment, and comparisons of the resource costs of providing credit card payments and other payments must take this into account. The RBA/ACCC *Joint Study* did not do this.

### **Credit card acquiring poses significant settlement risk**

According to the *Joint Study* (p 57),

“Acquirers pay their merchants and receive funds from issuers; as net receivers of funds, they do not introduce settlement risk for other financial institutions in the system”.

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<sup>1</sup> It is also possible that other financial institutions will face liabilities if they have acquired the credit card transactions of travel agents who sold Ansett tickets, and customers who bought those tickets are not refunded by those travel agents.

As the Ansett case shows, this statement is not true. National Australia Bank must settle a significant amount of money. Fortunately NAB is a well-capitalised, financially sound institution, and its ability to settle this amount is not in doubt.<sup>2</sup> However, it is not difficult to think of hypothetical examples where a credit card acquirer, which was not a supervised deposit-taking institution, would have a great deal of difficulty making settlement in this instance. Obviously (see below) if Ansett had self-acquired the transactions, the issuers would have even less hope of settlement, thus introducing risk to issuers to the extent of the guarantee given to cardholders.

### **Chargebacks are also a cost to issuers**

The Ansett failure will pose a cost to every issuer on whose cards an unused Ansett ticket was purchased. The cost to issuers of processing chargebacks is typically around \$70 per chargebacked transaction. Under typical interchange calculation methodologies, the cost of processing chargebacks is included in interchange costs. Although issuers are ultimately paid by the acquirer for chargebacks, the size and suddenness of the Ansett situation will undoubtedly result in a large, unanticipated spike in the volume and cost of chargebacks.

### **Self-acquisition poses a potential principal-agent problem**

This chargeback cost issue is not directly tied to the risk associated with acquiring but it is an indication of the need for a seamless network and working relationship between issuers and acquirers for not-on-us transactions if the process is to appear seamless to the consumer and maintain the consumer's confidence. It is likely that a self-acquirer that fails would certainly disrupt this process and significantly impact consumer confidence in the credit card network in general. As ABA has argued on previous occasions, self-acquisition poses a significant principal-agent problem.

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<sup>2</sup> The cost to NAB of this single episode puts in further doubt the claims made in the *Joint Study* about “excessive” profitability in the industry particularly as measured using data over a short time period (e.g. one year) as the RBA has done in the *Joint Study*. The return on capital in any industry needs to reflect the associated risks; and this episode has demonstrated with great clarity some of the risks faced by both acquirers and issuers.

### **Workability and reliability of means to ensure non-ADI ability to settle**

In previous discussions, the RBA has indicated that one justification for seeking expanded participation in acquiring is that some large corporates may have as strong if not stronger credit standing than some supervised ADIs, and that large corporates could "firewall" assets to meet the settlement risk (although it has never been made clear what this means), and the relevant arrangements could somehow be independently monitored by or for the credit card schemes. The failure of Ansett starkly indicates the broader scheme risk from merchant failures. It also indicates the increased risk to the schemes of merchant members, particularly if they make any significant sales where payment precedes delivery, who self acquire — concentrating commercial and financial risk in one entity. Debate over employee entitlements and corporate resistance to quarantining those funds legally due to employees in special accounts away from operating funds and normal capital, indicates the great commercial difficulties to achieving the RBA's non-specified "firewalling". Furthermore, it has not been demonstrated how firewalling would be effective against the law concerning the priority of creditors on the winding up of a company. The RBA proposal underestimates the significance of the risk and the difficulty of achieving comparable capital and liquidity adequacy arrangements with a corporate.

However, this does not mean that self-acquisition should be ruled out completely, or even ruling out the possibility that non-FI's can become acquirers. What is important is the need for card systems to gain and maintain, in a workable and efficient way, a high degree of assurance that acquirers will meet their obligations, ie a high degree of assurance that any settlement risk to which acquirers may expose the system will be kept very low. For a small domestic scheme like Bankcard the only efficient way to do this for non-ADI prospective acquirers was considered to be to rely on them obtaining a guarantee from an ADI or an FI supervised by an APRA-recognised overseas regulator, such guarantee being one which would survive the failure of the acquirer (and which the prudential regulator would take into account as an exposure of the guarantor ADI). On this basis, Bankcard is now willing to contemplate non-ADI acquiring and self-acquiring.

As previous discussions with the RBA have pointed out, a distinction can be made between essentially cash-and-carry type merchants and those who receive payment well before they deliver what is paid for, but Bankcard's solution leaves it to the guarantor to apply those distinctions (in the size and cost of the guarantee), rather than having the scheme's small central administration apply and monitor them. Possibly, however, such a scheme could provide guidelines covering these aspects to its ADI members (or others) who may provide guarantees.

As emphasised in the ABA's submission of July 2001, the Bankcard approach offers a non-restrictive way of addressing the risk posed by the principal-agent problem, in the Australian context and in the specific context of that scheme. ABA again stresses that the Bankcard approach should not be extrapolated to the international open schemes.