Response by the Australian Retailer's Association ("ARA")

Australian Banker's Association ("ABA") Submission to the Reserve Bank of Australia ("RBA")

28 August 2001

The following document responds to the main points raised by the ABA in their submission to the RBA dated July 2001.

1. Participants in the credit card payments network should be allowed the opportunity to earn a return on their past investments.

This is not an unacceptable request of participants in the payments system, however in the context that the ABA has raised it, this reference is specifically directed towards financial institutions being able to earn a return on their investment.

It would appear to be the case that these institutions have been able to earn quite handsome income streams for many years. The question must be asked just how long does it take the banks to recoup their investment. In fact it could be argued that the returns earned by the banks over the years would have resulted in the banks recouping their investment many times over.

The ABA's argument fails to recognise the contribution of many retailers to the payments system, and the investment that has been made by those retailers. All participants should be allowed to earn a return on their investment – not just financial institutions.

It has been a common theme throughout all submissions in favour of the current interchange regime that the costs of retailers, as well as the investment by retailers in the system, have been ignored. An equitable system would recognise the costs and investments made, by all participants.

2. Externality benefits

A consistent argument flowing through most submissions in support of the current interchange mechanism is that of network benefits. According to this argument, the greater the number of credit cards on issue, and the greater the number of consumers that use credit cards, the greater the benefits to merchants. Retailers are said to enjoy the benefits of increased sales that credit cards generate, and so should pay an interchange fee as payment for those benefits.

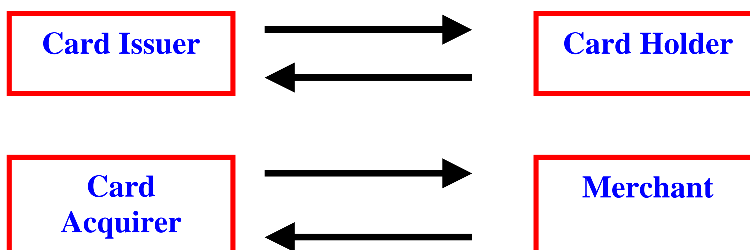
This argument is flawed, in that if there are externality benefits generated to retailers, then surely the other participants in the network also benefit from those network effects. For example, credit cards and their subsequent use will generate fee income and interest income to card issuers and acquirers, as well as the benefit to consumers

of increased utility. Yet it is only the retailer who pays for these perceived additional benefits. Other networks do no require the service provider to pay a fee. For example, a builder is not required to pay the bank a fee for approving a loan that leads to a contract to build a residence.

3. Interchange fees should be based on "unavoidable costs"

- **costs that are necessary to provide credit card functionality**
- **for example fraud costs, credit losses and collection, cost of equity capital, sunk costs, operating costs, marketing, promotional and retention costs**

In a credit card transaction, specific relationships exist as illustrated in the diagram below. In principle those parties to each relationship should only incur costs associated with that relationship.



The merchant should only be concerned with the costs associated with its relationship with the acquirer, whereas the costs associated with the card issuer – cardholder relationship should be maintained within that relationship. This is because costs ought to relate to the service / benefit for the user of the service.

The costs nominated by the ABA as avoidable costs associated with the provision of credit card services – fraud costs, credit losses and collection, operating costs, sunk costs, marketing etc – are associated with the card issuer – cardholder relationship. The retailer should not be required to contribute to these costs.

Fraud is a cost that is managed by the card issuer, but which the retailer is unable to influence but currently pays for. Credit card issuers have the opportunity to introduce PIN based security to improve the level of security on credit cards, but whilst the cost of fraud is being met by the retailer, the card issuers have no incentive to improve the product's security.

All parties to a credit card transaction incur processing costs, however it is only the processing costs of the card issuers that are recovered from retailers through interchange. The cost of the acquirer's processing is recovered from retailers by way of the MSF excluding interchange. The retailer does not hold a relationship with the card issuer, but rather with the acquirer. Therefore the retailer should only be required to pay the processing costs of the acquirer.

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4. **Current rules ensure the prudential stability of the system.**

Due to the changing nature of the payments system, requiring card issuers and card acquirers to be ADIs to ensure the prudential stability of the network, represents a barrier to entry, and is inappropriate. Prudential stability is still very important but should be managed differently. Non ADI's participation and involvement in the network is increasing, and whilst stability of the system is necessary, true competition and efficiency will only be achieved if non-traditional participates can challenge the existing structure.

5. **Loyalty schemes maintain externalities that are enjoyed by participants, the costs of which should be recovered through the interchange mechanism.**

The inconsistencies in the network benefits argument have been discussed earlier in this paper, so that argument will not be readdressed here. Loyalty programs represent an effective marketing tool to encourage consumers to use credit cards over and above other payment forms. Loyalty points represent a benefit to the consumer, and therefore should represent a cost to the relationship between the card issuer and the consumer.

It can also be argued that loyalty programs do not necessarily benefit all participants. For instance loyalty programs encourage tender switching by point chasers which increases the cost to retailers as credit cards are the most expensive form of payment.

6. **The cost of credit losses should be included in the interchange fee, even though it has been argued that these costs are recovered through the interest rates charged.**

Bad debts are a cost that the retailer is unable to control, but is required to pay. The retailer is not able to contribute to the credit assessment process, and so is unable to influence the decision of whether or not to grant credit. Despite this, the retailer is required to pay for the cost of bad debts. If, for example, a card issuer wanted to increase their market presence by issuing more cards, they would reduce their credit standards to ensure more consumers were eligible to qualify for credit. In lowering their credit standards the card issuer is increasing the risk of default. However it is the retailer who underwrites the risk, despite being unable to contribute to the credit assessment process.

7. **The fact that merchants accept credit cards reflects the benefits that merchants receive from this form of payment.**

Initially merchants were able to gain a competitive advantage by accepting credit cards as a form of payment, because it allowed merchants to attract additional consumers and potentially additional sales. However widespread acceptance of credit cards means that the competitive advantage is no longer available, and there is a strong argument that credit cards do not provide incremental sales.

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In terms of the relative costs of payment types, the ABA contends that credit cards are in fact a less expensive form of payment. Evidence from retailers would again suggest that this is incorrect, and that credit cards are in fact many times more expensive to retailers than debit cards and cash. Despite incurring significant costs, merchants play an important role in the collection and processing of data on behalf of financial institutions, but receive little recognition for this participation.

The credit card offer is the same as all other key service elements. It is essential for retailers to offer the credit card payment option or face losing customers to competitors. More importantly, once an offer to the consumer has been introduced, and the consumer becomes familiar with that offer, it is very difficult to withdraw the service without running the risk of losing those customers to competitors.

It must also be remembered that consumers incorrectly value credit cards because they are essentially free, or much lower than other payment types due to the non transparent subsidisation by retailers (through interchange). Therefore the retailer must respond to the needs of consumers. It is the same as heating and electricity. Retailers must provide heating and lighting to customers, but the market prevents unrealistic electricity charges.

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