bankcard

Bankcard
Association of
Australia

Level 4, 724-728 George Street,
Sydney, NSW 2000
PO Box K55, Haymarket NSW 1240
Telephone (02) 9281 6633
Facsimile (02) 9281 6637

Confidential communication

6 June 2001

Our Ref. GM:01/186

Mr John Veale
Head of Payments Policy
Department
Reserve Bank of Australia
65 Martin Place
SYDNEY NSW 2000
Fax (02) 9551 8024

Dear John

Questions to Bankcard Association of Australia

I refer to the facsimile from Michelle Bullock to Bankcard dated 30 April 2001 attaching a list of Credit Card Questions, the meeting between representatives of Bankcard and the Reserve Bank on 2 May 2001 and your letter to me dated 3 May 2001.

Please find enclosed a document setting out Bankcard's response to the Reserve Bank's Credit Card Questions of 30 April 2001, and the additional issues that arose from the meeting of 2 May 2001.

I reiterate that Bankcard has already resolved to make substantial changes to its membership rules reflecting the spirit of previous conversations with both the RBA and ACCC. The new membership rules will make it possible for a wider range of institutions to become Members of the Bankcard Scheme, including Members who intend to act as pure acquirers and self-acquirers. These changes take Bankcard into totally untested territory and are not without significant challenges and risk to both the Scheme and its Members.

Given the potential risks with the new rules, which are expected to come into force by 1 July 2001, Bankcard does not propose to make any further changes to its membership rules until it has had time to assess the impact of the new rules on the Bankcard Scheme itself and on the market.

Bankcard will review the operation of these new rules in due course. If practice shows that the new rules are prudentially unsafe or unworkable, Bankcard will reconsider its position and reassess its options to protect the Scheme and its Members.

Should you have any further questions, please contact me.

Yours sincerely

Ken Douglas
Chairman

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

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?*

There is general agreement amongst economists that an interchange fee is a necessary component to the functioning of the open credit card schemes, such as Bankcard.

An interchange fee is an efficient means of recovering the cost imbalance between card issuers and merchant acquirers that usually exists in open credit card networks. An interchange fee determines the extent to which issuers and acquirers share the joint costs (and joint benefits) arising from the decision by a cardholder to use the scheme's credit card with a merchant that accepts that card.

The Reserve Bank/ACCC Joint Study into Interchange Fees showed that in Australia, absent an interchange fee, card issuers' costs exceeded the costs of acquiring for merchants. Without an interchange fee (or similar arrangement) to cover the shortfall between cardholder revenues, and card marketing and servicing costs, issuers would not have an incentive to offer credit cards and the viability of open credit card schemes would be seriously undermined.

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?*

An open credit card scheme faces competition from many other payment instruments, including closed system credit cards.

An open credit card scheme also needs to balance the costs and benefits of an issuer with the costs and benefits of an acquirer, to ensure vibrancy in both issuing and acquiring within the scheme.

The interchange fee is one of the mechanisms by which the scheme may seek to achieve such a balance, and also to assist the scheme to compete with other payment instruments.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

In other words, there are competitive forces which operate on the interchange fee, but any equilibrium will be affected by developments in other payment instruments and by any need to adjust the incentives as between issuers and acquirers. A fee which is too high will discourage merchant acceptance and merchants will look to cheaper payment alternatives; conversely, an interchange fee that is too low will force issuers to raise cardholder fees and discourage cardholder acceptance. Hence, an interchange fee that is set at the right level will make it sufficiently attractive for cardholders to adopt credit cards and for merchants to accept them.

Looking forward, Bankcard expects to adopt a new methodology for setting its interchange fees which will directly reward efficiency and thereby provide incentives for members to ensure that the Bankcard Scheme remains competitive with other credit card schemes and other payment instruments.

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 Bankcard Association believes that interchange fees should be determined having regard to:

(a) the costs of providing credit card services, including the categories of costs in the system, the drivers of these costs, their characteristics and costs that may be specific to some participants of the scheme;

(b) benefits provided by the credit card system, including the nature and types of benefits, their sources and the participants to whom they accrue;

(c) where relevant, the relationship between credit card arrangements in Australia and overseas;

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

(d) the economic framework defined as relevant for assessing the efficiency and effectiveness of the current interchange fee arrangements. This would include:

(i) forward looking pricing principles based on directly attributable costs;

(ii) the ability of scheme members to recover some of these costs from other sources and the appropriate mechanism for the allocation of recovery; and

(iii) additional and alternative cost-recovery bases and the efficiency associated with each of them.

Any framework developed for the open card schemes would need to promote efficiency (allocative, technical and dynamic) and address inter-scheme competition. Additional policy criteria for assessing simplicity and transparency of the current arrangements would also need to be developed.

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

The optimal frequency for review and adjustment depends on the need to balance the costs and uncertainty arising from frequent reviews and adjustments of interchange fees against the risk that the fees will get out of line with market conditions.

Bankcard currently expects that once it has adopted a new methodology, Bankcard would review its interchange fees annually, along with its review of its other fees.

Bankcard considers that the methodology itself should be reviewed every 5 years, or sooner if market conditions require. Bankcard considers that a regular review period shorter than 5 years would probably be inefficient, as it would unduly increase administrative costs and create uncertainty for members and potential members.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

Access

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

Acquirers bring to a scheme the following key risks:

(a) risk of financial failure, leaving merchants unpaid for purchases made and issuers unpaid for charge backs;

(b) risk of fraud, committed by the acquirer or the employees of the acquirer;

(c) risk of operational failure, which could damage the scheme's reputation or expose other participants to risk;

(d) risk of failure to enforce scheme rules (particularly rules dealing with the scheme's security), which could lead to costs being imposed on other scheme participants;

(e) risk of failure to adequately control merchant fraud, which could lead to costs being imposed on cardholders and issuers;

(f) risk of failure to adequately deal with disputes (eg, disputed transactions), which could undermine the confidence that parties have in the scheme and the ongoing viability of the scheme;

(g) risk of failure to adequately assess merchant's credit risk, which could lead to the acquirer signing up poor quality merchants (which in turn, would increase the risk of merchant failure or fraud);

(h) risk of intentional acceptance of high risk merchants or high risk merchant models (eg, aggregators) due to a desire to minimise acquisition costs and increase profits; and

(i) risk of direct damage to the scheme's brand and merchant base, for example, by introducing unreasonable additional fees or by terminating unprofitable merchants.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

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.*

In the absence of support from suitably quarantined prudential capital or other collateral, a key risk with admitting merchant self-acquirers as members of the scheme would arise from the absence of an interposed party (ie, an independent acquirer) to shield the other scheme participants from the consequences of the self-acquirer's financial failure.

Further, self-acquirers may face a conflict of interests between their role as acquirers and their role as merchants and as a result could fail to comply fully with their obligations as acquirers (ie, they may fail to control merchant fraud and to ensure merchant compliance with scheme rules). Such non-compliance, while beneficial to the merchant self-acquirer, could impose significant costs on other parties involved with the scheme.

These costs would be in addition to the costs a merchant self-acquirer would bring to the scheme as a "pure acquirer", in the event the self-acquirer was not a significant issuer of the scheme's cards.

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

The issuers in a scheme can normally be relied upon to promote the scheme, at least to the extent that they receive sufficient benefits to justify their promotional expenditures at the margin. However, acquirers that are not significant issuers have little incentive to promote the scheme because the success of their acquiring business does not usually depend on the fortunes of any one scheme (because a merchant is usually wanting acquisition of multiple credit cards and other payment instruments). Hence, Bankcard's incentive fee seeks to ensure that members who are predominantly acquirers adequately contribute to the scheme's promotional costs and do not "free ride" on the promotional efforts of other members.

Bankcard is conscious that if its interchange fees were successfully to balance the incentives for issuers and acquirers, its incentive fee on net acquirers would not be needed. Bankcard, therefore, expects to review the role and the level of its incentive fee upon changes in the methodology and level of its interchange fees and changes in Bankcard's own promotional strategies and costs.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

Under the present amendments, Bankcard's incentive fee will not apply until the second full financial year of membership and will only affect members whose total acquisition volume in the previous year was more than double their issuing volume. The 2:1 ratio was adopted so that small differences between issuing and acquiring would not be relevant, and the fee would be likely to apply only to a member who makes a commercial decision to specialise in acquiring.

The incentive fee proposed is 0.03 per cent of the member's acquisition volume. This is the current percentage rate which was adopted some time ago on the basis that it was a competitive rate. It should be noted that no fees have been collected so far under the current rule and Bankcard does not expect to collect many fees under the proposed amendment (particularly as that amendment will significantly narrow the rule's scope of operation). It is Bankcard's current intention that any fees collected under this rule would be applied to promotional activities run by Bankcard rather than being rebated to issuers or to members generally.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

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?*

Bankcard does not have a "no surcharge" rule, but Bankcard considers that it is important that it has an ability to introduce such a rule if market circumstances require.

The rule would be important to ensure that merchants do not unfairly discriminate against Bankcard in favour of other credit card schemes or in favour of other payment instruments.

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

Individual members of Bankcard are responsible for the content of their respective agreements with merchants, especially as to pricing, and so Bankcard is unable to answer this question.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

Competition

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

Open card schemes compete on two levels.

As pure payment instruments, credit cards compete with other payment instruments such as proprietary cards (ie, store cards, charge cards), debit cards, cheques, cash and direct debits.

As payment instruments that offer credit facilities, credit cards compete with closed credit card schemes, charge cards with an associated line of credit, and store cards.

In each case, these different payment instruments actively compete through their attractiveness to cardholders and to merchants. From the point of view of the cardholder, the choice of payment instrument will depend on factors such as convenience, risk, cost, payment methods accepted at particular points-of-sale, whether credit is needed and whether there are additional advantages associated with a particular payment instrument (eg, discounts for cash, bonus points offered by loyalty programs). From the point of view of merchants, competition will depend on factors such as cost, risk, number of cards on issue and the level of their use.

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

The Bankcard scheme is a not-for-profit joint venture. Accordingly, rather than pursue agency arrangements with closed schemes, Bankcard members have leveraged their core competencies in customer and relationship management to promote acceptance of the Bankcard scheme.

The openness of the Bankcard scheme means that members have maximum flexibility to tailor the features of the scheme "product". This ensures maximum appeal to customers and enables the product to rapidly adapt to meet the demands of a changing market.

In addition, the closed card schemes tend to target niche markets (e.g. high net worth individuals or customers with high travel and entertainment charge volume) with compensating network effects.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

12 *How are the schemes promoted:*

(a) *At the scheme level?*

(b) *At the individual bank level?*

At scheme level, promotion of open card schemes is predominantly achieved through advertising and sponsorship programs as well as through providing assistance to members in planning their own promotion programs and co-branded arrangements and in the provision of IT and processing facilities to assist members with implementation. The Bankcard scheme, however, has not undertaken scheme-level promotional efforts for some considerable time and Bankcard members are individually responsible for providing the IT systems necessary for the conduct of the business.

At the individual bank level, promotion occurs through advertising, development of specially tailored and marketed co-branded and affinity cards, the enhancement of card features (eg reward programs) and so on. Bankcard is unable to comment on the promotional strategies of individual members.

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

Bankcard is unable to comment, as interest rates are set separately by each of Bankcard's members.

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?*

The Bankcard Scheme does not have a loyalty program. The development and monitoring of loyalty programs for Bankcard cards is a matter entirely at the discretion of individual Bankcard members.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

15 *Does the ability of using 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.*

Given Bankcard's current market position, if banks were each allowed to issue only one brand of credit card, Bankcard would cease to exist. Further, such a rule would make it impossible for small new schemes (and possibly even large new schemes) to enter the market. Indeed, it is difficult to see how such a rule, which effectively creates a barrier to the existence of small card schemes, would assist competition in the market for payment systems.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

Additional questions (from meeting of 2 May 2001)

16 *Membership when liabilities are guaranteed by an ADI - further analysis and alternatives.*

The Reserve Bank has asked whether eligibility for Bankcard membership could be extended to include any entity that could provide sufficient collateral to cover the additional risks that its membership would bring to the system.

This approach was considered and rejected by the Bankcard Board in formulating its new membership rules. The broad arguments considered by the Board in reaching its decision are set out below.

If collateral is to provide an appropriate level of protection to the participants of a scheme in the event of the financial failure of the member providing that collateral, the following conditions would need to be satisfied:

(a) there would need to be a high probability that the amount of collateral set aside would be sufficient to cover all the member's liabilities to scheme participants following the financial failure of the member;

(b) the collateral would need to be held by an organisation or vehicle which would survive the financial failure of the entity itself;

(c) the collateral would need to be beyond the reach of any liquidator or creditor of the failed entity;

(d) following the financial failure of the member, the collateral would need to be available to make good the member's liabilities within a reasonably short timeframe (ie, it would not be subject to protracted litigation);

(e) the collateral would need to be regularly monitored against the risks and exposures inherent in the entity's activities; and

(f) there would need to be a mechanism to ensure the regular adjustment of the collateral commensurate with any changes in the risks brought by the member. Failure to increase the collateral appropriately in case of increased risk could lead to the cessation of the entity's membership and the confiscation of the collateral, if necessary, to discharge the entity's obligations to scheme participants.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

Consistent application of the conditions listed above would require considerable expertise in risk management together with appropriate administrative machinery. Apart from the fact that the Bankcard Association has neither the expertise nor the necessary administrative machinery in place, and its development would be both expensive and time consuming, the need to apply judgment in making decisions on the appropriate level of collateral would presumably be regarded by the regulatory community as both lacking transparency and a cause for concern.

The task of monitoring and assessing the required level of collateral would therefore need to be undertaken by a third party of high reputation and standing, or one of sufficient substance prepared to underwrite its own judgments. In the latter case, there would need to be a process for attesting to the third party's ability to make good its underwriting commitments.

These considerations formed the basis of the Board's decision to limit Bankcard's membership criteria to prudentially supervised entities or entities whose liabilities to the scheme are guaranteed by a prudentially supervised organization. The Board recognized that, by framing its membership eligibility criteria in this way, the pledging of collateral could play a role in some circumstances. Specifically, an entity could gain membership of Bankcard by lodging collateral with a prudentially supervised organization against a guarantee from that organization.

As the recent collapse of the HIH insurance company shows, even APRA supervision is not a failsafe mechanism for avoiding the risks that new members may bring to the Bankcard scheme. However, the Board is not convinced of the wisdom of casting a private sector organization in the role of a de facto prudential supervisor, as would be implied by a private sector arrangement for the monitoring and management of collateral. Nor is it convinced that a further watering down of entry standards, which implies the transfer of risks from the new members to the existing members of Bankcard without a corresponding level of compensation, would be in the public interest.

The Board therefore reaffirms its position that the membership eligibility criteria advised to the Reserve Bank are the appropriate criteria for Bankcard. The Board would again draw the Bank's attention to its previous observation that, if the regulatory community considers that it is in the public interest to widen Bankcard's membership further, the logical approach would be to extend the range of organizations supervised by APRA.

DESIGNATION OF CREDIT CARD PAYMENT SYSTEMS BY RESERVE BANK OF AUSTRALIA.
BANKCARD ASSOCIATION OF AUSTRALIA'S RESPONSE TO QUESTIONS POSED BY RBA.

17 *Why is there a need for voting under Bankcard's new entry requirements?*

There clearly must be some process whereby Bankcard assesses whether an applicant satisfies the entry requirements and attests to that fact. The relevant question, therefore, is not whether there needs to be voting on the issue, but who is responsible for the decision on an applicant's application for membership. The logical and practical response is that Bankcard itself must take that responsibility.

Board decisions on membership will be made through open voting procedures, in accordance with Bankcard's new voting mechanism and against the new objective entry criteria. Any vote will be open to scrutiny by both the applicant and by regulators and any apparent departure from the objective entry criteria would need to be explained. This will ensure that the transparency and objectivity of the process will be maintained.