DEBIT AND CREDIT CARD SCHEMES IN AUSTRALIA

A STUDY OF INTERCHANGE FEES AND ACCESS

By
Reserve Bank of Australia and
Australian Competition and Consumer Commission

OCTOBER 2000

COMMENTS

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COMMONWEALTH BANK OF AUSTRALIA

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1.0 Introduction

A Joint Study by the Reserve Bank of Australia (RBA) and the Australian Competition and Consumer Commission (ACCC) into Debit and Credit Card Scheme Interchange Fees and Access was announced in September 1999.

The Study was released on 10 October 2000 and the Commonwealth Bank (Bank) has responded separately to the Minister for Financial Services and Regulation.

As requested by the Governor in his letter to the Bank's Managing Director of 10 October 2000, this document provides our views on the issues raised in the Study and its conclusions.

The Bank's comments are grouped under the three key subject headings examined by the Study, viz:

- Credit Cards
- ATMs
- Debit Cards

In view of the relative size of interchange fees (credit cards - $550m, ATMs – $230m, debit cards - $100m), the Bank suggests that industry priority should be to review the networks in the same order. This is in line with the priority given to credit cards this year and recent industry initiatives to investigate abolishing ATM interchange fees and move towards the direct charging of ATM fees.

The Bank welcomes the opportunity to discuss these comments, or other related issues, with the Reserve Bank of Australia and / or the Australian Competition and Consumer Commission at any time.

2.0 Credit Cards

2.1 Joint Bank Review of Credit Card Interchange Methodology

In March 2000, the Australian Competition and Consumer Commission (ACCC) informed banks and the credit card schemes that it believed that the process for setting credit card interchange fees constitutes a breach of the Trade Practices Act. The Bank has adopted a leadership position in the industry in working cooperatively with the ACCC to resolve the ACCC's concerns.

The ACCC has indicated that it is not opposed to a credit card interchange system and believes that an authorised joint system would be of benefit to consumers. The Bank notes also the strong encouragement from the Payment Systems Board for financial institutions which are members of the card schemes to pursue an authorisation process for ensuring that the public interest is taken into account. The Bank notes also Governor Macfarlane's replies to the House of Representatives Standing Committee on Economics, Finance and Public Administration on 1 December that the only logical conclusion for the banks is that they should go down the path of authorisation.

Against this background, the Bank intends to continue its leadership role in the current review.

As discussed with the Reserve Bank on 8 August 2000, the review will address:

- The development of a methodology for calculating interchange fees based on efficient pricing principles. The review would consider the appropriate basis of those principles including:
  - Forward looking pricing principles based on directly attributed costs;
  - The ability of the banks to recover these costs from other sources and the appropriate allocation of recovery; and
  - Additional or alternative bases that may be equally efficient or more efficient.
- A process to determine interchange fees in accordance with this methodology which is transparent;
- A critical examination of the effect the membership rules have on efficient pricing including whether the current rules are necessary and the criteria upon which non-banks could be admitted to the system.

The agreed timetable with the ACCC sees the above review being completed and the banks indicating the way forward for setting interchange fees, including whether to seek authorisation for any or all of the process of setting interchange fees, by 22 January 2001, with a preliminary report from the review economists being provided to the ACCC by 15 December 2000.

In view of the above work program, the most appropriate way in which issues relating to credit cards can be addressed is for the review to proceed to completion. However, without pre-empting the review, the Bank comments on a couple of issues raised by the Study.

2.2 Cross Subsidisation

A theme of the Study is that cash paying consumers are cross-subsidising credit card paying consumers.

In discussing this issue with representatives of the Reserve Bank and ACCC on 25 October, it was acknowledged that in coming to this conclusion the Study did not employ definitions of cross-subsidy that are standard in the literature of economics.

Even if it could be established that the unit cost of handling credit card transactions differs from the costs of handling cash or debit card transactions, the fact that merchants charge the same price for the product cannot be taken, of itself, to indicate a cross-subsidy.

The Bank is therefore of the view that there is no basis for the proposition that cash paying consumers are cross-subsidising credit card paying consumers.

2.3 Excessive Profitability

Another theme of the Study is that financial institutions are making excessive profits on payment networks.

In considering the profitability of credit card issuing, the Study excludes the cost of loyalty schemes from its analysis of credit card costs and revenues per transaction (refer table on page 45). Loyalty schemes are a significant component in credit card, store card and charge card value propositions and product offerings and their costs should be included in the cost analysis. The exclusion of this cost distorts the Study's conclusions regarding the profitability of credit card issuing.

If the Study's average loyalty scheme costs of $0.46 per transaction are added to the issuing costs then, based on the Study's calculations and on current levels of costs and revenues (including interchange fees), the mark up over costs for credit card issuing is $0.30 per transaction which is exactly the margin over costs that the Study suggests would provide a competitive rate of return on capital for credit card issuing (refer page 46).

The Bank is of the view that the Study's analysis of the profitability of credit card issuing demonstrates that, at an industry level, credit card issuing is only appropriately profitable.

2.4 Credit and Debit Cards as Substitutes

Credit and debit cards are, by their very nature, different products. However, the Study suggests that credit cards and debit cards are substitutes. The Study asserts also that debit cards are a more efficient means of payment than credit cards on the basis that the resource costs of debit cards are lower than the resource costs of credit cards. The Bank does not view this as a valid comparison as credit cards offer a completely different value proposition to consumers and merchants than debit cards. Credit cards are more closely aligned to store cards and charge cards than debit cards but such comparisons were outside the scope of the Study.

In addition, to say that the acceptance of credit cards has become a "necessity of doing business" overstates the situation as not all merchants accept credit cards. Merchants accept credit cards when their acceptance improves their overall profits.

2.5 Store Cards / Charge Cards

As discussed in Section 2.4 above, the open credit card payment schemes are most strongly in competition with store cards / charge cards than with debit cards, as there are large similarities in product features. Store cards / charge cards both:
- Offer unsecured line of credit facilities;
- Have similar annual and transaction fees (although merchant fees for charge cards are usually much higher than for open credit card schemes); and
- Offer the same auxiliary benefits to cardholders to differentiate their products (eg. loyalty schemes, travel insurance).

The Study did not address the impact of closed store cards and charge cards on the open credit card networks, nor did it investigate why closed charge card merchant fees are much higher than for the open credit card schemes.

Open credit card payment schemes provide store card substitutes for the smaller retailers who cannot afford to provide their own store cards. Larger retailers value being able to provide a branded store card to their customers, albeit at higher cost and with additional expenses, because they believe that the cards generate additional sales, customer loyalty and additional profits. Strong product differentiation is usually required between closed and open card schemes to encourage customers to apply for and use the cards. These differentiation benefits to consumers include features such as free gifts and "special" treatment such as discounts on marked prices.

Open card schemes cannot remain vibrant competitors to store cards and charge card systems if issuer revenues (including interchange fees) do not at least cover the cost to issuers of providing the "package" of features similar to those that merchants are normally prepared to offer to closed scheme sales. To remain competitive, the interchange fees of open credit card schemes need to cover, inter alia, the cost to issuers of providing product features to consumers similar to typical "sales inducements" offered by merchants.

In passing, we note that the Study was mindful that its findings on credit cards may have implications for the competitive position of open credit card schemes vis-à-vis store cards and charge cards. We question the benefit of such a development.

2.6 Way Forward

As mentioned in Section 2.1, the most appropriate way forward is for the agreed review to proceed to completion.

3.0 ATMs

3.1 Purpose and Profitability of the Bank's ATM Network

Interchange fees have played an important role in the Bank providing a valuable service to both the Bank's customers and customers of other financial institutions. The Bank operates Australia's largest (by far) ATM network, with over 4,100 ATMs (including Colonial) across Australia.

The Bank's substantial investment in the ATM network has taken place over many years - bringing it from the confines of single proprietary bank network, to establishing bilateral interchanges and bringing national and international access to the network.

Our ATM network has been established with the primary purpose of servicing the needs of the Bank's customers. 78% of transactions at Commonwealth Bank ATMs are by Commonwealth Bank customers and only 19% of the Bank's customers ATM transactions are conducted at other financial institutions' ATMs.

The Bank provided data to the Study showing that the fees (including interchange fees) received by the Bank during 1998/99 for the provision of ATM services were less than the costs of providing ATM services. In the Bank's view, the Study would have been enhanced by reporting, at an industry level, the overall costs and revenues of providing ATM services (both 'on us' and 'foreign' transactions). This would have enabled public debate on ATM interchange fees to be considered in the context of the overall provision of ATM services to consumers.

In order to continue to meet customer needs, the Bank plans to invest significantly in upgrading the ATM network with more technically advanced machines (some of our older ATM models are up to 20 years old). In addition, our communications network is now being upgraded to further improve ATM availability, and provide an enhanced platform for delivering new functions to our customers. Such investment is only possible when we can expect appropriate returns.

3.2 Consumer Choice and Fee Transparency

As a result of the Bank's investment in payment technology, customers have a wide variety of choices to gain access to their funds via electronic means. For example, a customer is able to withdraw funds from their own bank's ATM, another bank's ATM, cash-out at own or another bank's merchant EFTPOS, or at branches. Attached to these choices are different fees, which are communicated to our customers via our point-of-sale staff and through product documentation.

There are customers who are prepared to pay the foreign ATM fees for accessing funds at convenient locations where their bank does not have an ATM presence. However, it should be noted that there are always cheaper options available to customers (eg. via cash-outs at EFTPOS merchants or using their own bank's ATM network), where they will incur a lower fee (often no fee) for accessing their funds.

The wide variety of choices available to our customers today has enhanced the value proposition provided by the Bank. The 'direct charging' model of ATM services has appeal to the Bank but we are mindful of the need to ensure the maintenance of customer value and service that best meets our customers' needs. We believe the current model is robust, provides many alternatives for cash withdrawal to customers, and provides appropriate disclosure of consumer fees.

3.3 ATM Direct Charging Model (Surcharging)

As stated above, the Bank favours the ‘direct charging’ model for ATM fees and to this end, the Bank has participated in discussions with another bank regarding the relative merits of the direct charging model. However, we remain mindful of the risk of disrupting the current simple pricing structure experienced by our customers and the need to examine relevant technology, customer disclosure and regulatory issues; for example, implication on recent authorisation of the Consumer Electronic Clearing System, prior to committing to this model.

The Study notes on page 41 that high cost locations are subsidised by low cost locations and under a direct charging model, this would provide an incentive to place more ATMs in higher cost (eg. remote) locations, offering greater convenience for consumers willing to pay. While sound economics, the equity issues require further consideration.

3.4 Understatement of Costs

While we are unable to comment on data supplied to the Study by other financial institutions, the Bank is of the view that the Study underestimated the costs of Australia’s ATM networks; eg. depreciation where the age of machines has an impact and site rental where institutions reported only explicit rental costs for off-site ATMs. Approximately 70% of the combined CBA and Colonial ATM network is branch located, and this cost was excluded from the Study’s calculations. The Study also did not factor in the impact of the additional costs of upgrading and maintaining our world class ATM network, nor rising costs associated with premium rental floor space and increased cash holding requirements as larger amounts of cash are now stocked at ATMs.

3.5 Way Forward

The Bank has agreed to explore the direct charging model with another bank mindful of the many issues that would need investigation and resolution before the industry could move in this direction.

The Bank notes that the Payment Systems Board intends to closely monitor public discussion and industry response on ATM issues over coming months. In light of the intense work taking place on credit card interchange issues, the Bank suggests that we meet with the Reserve Bank during the first quarter of 2001 to discuss possible roles in which the Reserve Bank could assist regarding ATMs.

4.0 Debit Cards

4.1 Rationale for Debit Card Interchange Flow

As noted by the Study, open debit card schemes have interchange fees which flow in the opposite direction to the credit card interchange fee; ie. debit interchange is paid by the card issuer to the merchant acquirer. The interchange fee runs in the opposite direction because merchants provide a service to bank customers to access their funds at the merchant (analogous to ATM services and interchange fee flows). As noted in the Study, larger merchants frequently enjoy a "sharing" arrangement under which the acquiring institution pays the merchant for transactions captured. This is analogous to payments to third party ATM providers.

The current structure of debit card interchange payments clearly values the benefit received by different participants and has contributed to the investment necessary to foster the world class system that we enjoy today.

Other than the minor benefits to merchants of reduced cash handling and storage costs, debit cards are not designed to enhance the welfare of merchants. Issuers offer debit cards to their customers as a convenient and inexpensive substitute for cash or cheques. The availability of a debit card is unlikely to induce a customer to make a purchase that he or she would not have otherwise made with cash. The business generation potential of credit cards is clearly superior to that of debit cards.

4.2 Debit Card Value Proposition

The debit card is a substitute payment mechanism to cash, and should be seen as a different proposition to, and with a different supporting infrastructure from, credit cards, rather than an alternative payment instrument. Debit cards provide more convenient and secure access to cash in a bank account. The value of debit cards include:

- Access to funds secured by the use of PIN and password;
- Access to funds directly from the cardholder's bank account;
- Debit cards are only used in a "card present" mode, which increases security;
- Debit cards can be used on a global basis via the Bank's membership of the Cirrus / Maestro and Visa / Plus networks; and
- Debit cards do not rely on the use of signatures.

4.3 Visa Debit Cards

The Study expressed concerns over the interchange fees applying to Visa debit card transactions. The Bank agrees that Visa debit transactions (where the consumer selects the credit option rather than the debit option) should be subject to debit card rather than credit card interchange arrangements and is reviewing the Visa debit card product that was acquired from Colonial Ltd.

4.4 Implications of Debit Card Interchange on Merchants

The direction and size of the debit card interchange rates will have significant implications on our merchant and consumer relationships. For example, in negotiating merchant service fees, a pricing structure is agreed with each merchant, which covers the total cost of servicing that merchant, given the volume and mix of debit card and credit card transactions the merchant is likely to experience.

4.5 Way Forward

In light of the bilateral nature of debit card interchange and associated merchant agreements, any change to the debit card interchange model will require considerable investigation and analysis. Issues to be addressed include the review (and possible renegotiation) of bilateral and merchant contracts, methodologies for ensuring an industry wide approach to implementing potential change and associated legal and systems issues.

The Bank notes the Payment Systems Board's willingness to work with industry participants to bring about more efficient pricing arrangements for debit card payments. As with ATMs, the Bank suggests that we meet with the Reserve Bank during the first quarter of 2001 to discuss a process and timeframe for investigating debit card interchange issues.

5.0 Other Issues

A number of other issues are presented below.

5.1 Payment Transaction Fees

The Study does not mention the impact that government payment transaction taxes have on consumers' choices of efficient payment instruments. The current FID tax of $0.06 per $100 deposited to an account and the Debits Tax of $0.70 for a $100 withdrawal on an account that has cheque access distorts consumer choices.

The imposition of debits tax no doubt helps explain the shift from cheque instruments to alternatives such as the card-based mechanisms. Debits tax is an active deterrent to writing cheques, or even having a debit card on an account with cheque access. This, we believe, contributes to the relative attraction of credit cards.

Similar considerations apply to the Northern Territory Electronic Debits Duty and the Queensland Credit Card Business Duty.

The abolition of payment transaction taxes, which distort consumer's payment preferences, should be brought forward.

5.2 Low Take-Up in Direct Debit

The Bank actively promotes the use of Direct Debit but is mindful that the use of direct debit brings with it a perceived loss of consumer control over "how" to pay (ie, from which account), "when" to pay, and even "if" to pay (notwithstanding provisions contained in the Charter for Direct Debit Customers). Alternative bill payment practices such as using BPAY, credit card "over the phone direct to the biller", or even over the counter (such as at Australia Post) enjoy a higher "acceptance" as they allow the customer to remain in control of these key factors – and without perceived security concerns of giving a biller effective access to a customer's account.

5.3 Bankcard Association

The Bank notes the Study's specific concerns with regard to the membership criteria for the Bankcard Association. Prior to the release of the PSB / ACCC report, the Bankcard Association had commenced a review of its entry requirements.

5.4 Incentive for Investment

As a general comment, the Bank is concerned that the nature of the changes being canvassed in the Study, together with the suggested returns on investment, will result in reduced incentive for future investment in these networks and emerging payment technologies. In response to increased customer demands, the Bank is planning a multi-million dollar investment programme to maintain, upgrade and expand our ATM and EFTPOS networks (which are already the largest in Australia) and is planning considerable investments in emerging payment technologies. The Bank is concerned that the changes intimated in the Study will reduce our shareholders' appetite for such investments, to the detriment of our customers.

6.0 Way Forward

In summary-

6.1 Credit Cards

The most appropriate way in which credit card interchange issues can be addressed is for the work program agreed with the ACCC to proceed to completion.

6.2 ATMs

The Bank has agreed to explore the direct charging model with another bank mindful of the many issues that would need investigation and resolution before the industry could move in this direction.

The Bank suggests that we meet with the Reserve Bank during the first quarter of 2001 to discuss possible roles in which the Reserve Bank could assist regarding ATMs.

6.3 Debit Cards

The Bank is reviewing the Visa debit card product that was acquired from Colonial Ltd.

As with ATMs, the Bank suggests that we meet with the Reserve Bank during the first quarter of 2001 to discuss a process and timeframe for investigating debit card interchange issues.

6.4 Reduction in Payment Transaction Taxes

The abolition of payment transaction taxes, which distort consumer's payment preferences, should be brought forward. While this was not addressed by the Study, this issue could be championed in the context of the Study.

7.0 Conclusion

In conclusion, the Bank appreciates the opportunity to comment on the issues raised in the Study. While the Bank disagrees with a number of the conclusions reached by the Study, we intend working collaboratively with RBA / ACCC to determine outcomes that meet our customers' needs while satisfying our business imperatives.

The Study acknowledged Australia's world class card and ATM systems. This is the result of the significant and collective investment by all participating financial institutions over many years yielding innovative developments to the benefit of our customers – both consumers and merchants. As a leading participant in these systems, we are justifiably proud of this achievement.

However, technology does not, of course, stand still. Financial institutions are now planning for further substantial investment in emerging payment technologies, for example, secure Internet payments, smart cards, which will need to be designed to maintain the system stability and interoperability that we enjoy today from our more traditional payment instruments.

Government and regulators need to ensure that the financial institutions continue to have the incentive to develop innovative payment instruments that meet the future needs of all Australians.

Commonwealth Bank of Australia
Sydney

20 December 2000