

**Letterhead of the Managing Director
Commonwealth Bank of Australia**

6 April 2001

Mr I J Macfarlane
Governor
Reserve Bank of Australia
65 Martin Place
Sydney NSW 2000

Dear Governor,

DESIGNATION OF THE AUSTRALIAN CREDIT CARD SYSTEM

I refer to your letter of 21 March 2001 regarding the possible designation of "the Australian credit card system". Your letter indicated that, prior to the Payment Systems Board (**PSB**) taking a decision to designate, there would be a two-week consultation period commencing 26 March. From our perspective, discussions held as part of this consultation process have been useful in helping us understand the Reserve Bank's thinking. This letter sets out the Commonwealth Bank's views on a number of key issues that should be considered by the PSB prior to taking a decision whether to designate. In particular, please note the comments on litigation in section 3 below.

Background

At discussions with officers of the Commonwealth Bank on 26 March, Dr Laker explained that there are three characteristics of four party card schemes that have attracted the attention of regulators around the world. These are:

- (a) the collective setting of interchange fees;
- (b) restrictions on scheme membership; and
- (c) "no surcharge" rules.

Dr Laker further explained that the Reserve Bank had originally supported the ACCC's invitation to the seven "Review Banks" to apply for authorisation for the collective setting of interchange fees because it believed that authorisation would:

- provide an appropriate public process for the examination of interchange fees; and
- address the issues of membership and the "no surcharge" rules.

However, Dr Laker said, the Chairman of the ACCC had now formed the view that authorisation would not produce an appropriate outcome and had

advised the Reserve Bank to consider whether it should use its powers under the Payment Systems (Regulation) Act (**PSRA**) to designate the system. Dr Laker also advised that the PSB would only designate if it intended to impose an access regime and/or set standards in accordance with its powers under the PSRA. There would, however, be an extensive consultation process before any access regime or standards were imposed. He did not wish to set a specific timetable since the PSB was focused on the outcome rather than the timing, but the whole process was likely to take about a year.

Dr Laker noted that the PSB had not yet used its powers under the PSRA and invited the Commonwealth Bank to put forward any views it might have on processes the Reserve Bank could adopt to facilitate reaching an appropriate solution as expeditiously as possible.

Views of the Commonwealth Bank

The Commonwealth Bank's key issues for consideration by the PSB prior to a decision on designation are set out below.

1. Testing the public interest

The PSRA requires the PSB, in determining whether a particular action would, or would not, be in the public interest, to have regard to the desirability of payment systems being financially safe for use by participants, efficient, competitive and not materially causing or contributing to increased risk to the financial system.

In applying the public interest tests under the PSRA, the PSB will need to confront the following question:

Is it likely that designation and subsequent regulatory processes under the PSRA would yield greater public benefits than would be available under an alternative approach?

Unless this question can be answered in the affirmative, the public interest test will not be satisfied.

This question can be further analysed in relation to the three characteristics of interest to regulators set out in (a) – (c) above.

(a) Interchange Fees

In their letter to the ACCC of 15 March 2001, the Review Banks advised that they were willing to apply for authorisation of the setting of interchange fees using a cost based methodology consistent with the principles set out in Professor Fels' letter of 21 February 2001. While the approach put forward by the banks may have included cost components that the Commission considered inappropriate, those could easily have been dealt with, in the established manner, in the normal course of the authorisation process.

The Review Banks further advised the ACCC that they were seeking expeditious resolution of the matter and had already engaged expert consultants to undertake the necessary development of the costing methodology and accounting manual. It seems, therefore, given the powers of the ACCC to grant authorisations subject to any conditions it considers appropriate, that the authorisation process and the right of appeal to the Tribunal would have reached an outcome in relation to the setting of interchange fees.

(b) Membership Rules

In its letter to the Reserve Bank of 6 March 2001, the Bankcard Association advised that it had undertaken a major review of its membership rules. That review, which was in part a response to criticisms in the RBA/ACCC Joint Study, included a broadening of the membership eligibility criteria, the abolition of the requirement for applicants to submit a business plan, adoption of open and objective assessment of membership applications, the replacement of the large new member entry fee by a modest application fee and the abolition of the new member royalty fee.

At a meeting with the Reserve Bank on 6 March, Bankcard representatives explained that the membership eligibility criteria had been widened as far as possible, consistent with objectives of maintaining the safety of the system for participants and promoting objectivity and transparency for new member entry. In addition, the revised rules were framed so as not to discourage members from becoming pure acquirers or merchant self-acquirers. They noted that the logical route to even wider membership was in the hands of the regulators themselves – it could be achieved by widening the scope of APRA's prudential supervision activities to include non-deposit taking institutions.

The letter from Bankcard invited the Reserve Bank to provide feedback on the actions taken. Feedback was again requested by Bankcard representatives at a meeting with the Reserve Bank on 27 March.

Against that background, the Commonwealth Bank submits that designation at this point in time is not justified on the basis of scheme membership rules and would, in fact, be contrary to the intent of Parliament in enacting the PSRA, as the following quotation from the Explanatory Memorandum to the Act shows.

“While not required by law, it is expected that designation generally will occur only ... after consideration of alternative regulatory approaches and voluntary arrangements have been exhausted.”

Bankcard has engaged in a review of its rules on an entirely voluntary basis, outside of authorisation and designation processes. An agreed set of membership rules for Bankcard could form a basis for advancing discussions

with MasterCard and Visa on expanded membership eligibility criteria in Australia. Once designated, the chance of achieving a voluntary accommodation with the international schemes will be diminished.

The Commonwealth Bank considers that until the Reserve Bank has responded to, and worked through an appropriate process in relation to, the Bankcard decisions, and the banks have been given an opportunity to take the issue up with the international card associations, the public interest in relation to scheme access will not be served by designation.

(c) "No surcharge" Rules

Bankcard has no rules prohibiting surcharging by merchants.

The European Commission recently considered the "no discrimination" rule for Visa applying in Europe. As well as prohibiting merchants from surcharging for card use, the "no discrimination" rule also prohibits merchants from giving consumers a discount for paying via other means such as, for example, cash.

On 16 October 2000, the Commission released its conclusions. Although it had originally objected to the "no discrimination" rule, it had now concluded that the abolition of the rule would not substantially increase competition. This conclusion was reached in the light of the results of market surveys carried out in Sweden and the Netherlands, where the "no discrimination" rule had been abolished by the national competition authorities.

The Commonwealth Bank considers that, at best, the empirical evidence of a public benefit resulting from abolition of "no surcharge" rules is weak, and is unlikely to outweigh the consumer detriment involved in exposing cardholders to pricing uncertainty and the actions of unscrupulous merchants. Moreover, unlike its European counterpart that was sanctioned by the European Commission, the "no surcharge" rule does not prevent price discrimination via cash discounts.

The Commonwealth Bank considers that, in the absence of evidence of a public benefit from their abolition, the "no surcharge" rules do not provide any justification for the designation of the card schemes.

(d) Conclusions of the Analysis

It is the Commonwealth Bank's view that regulation of the industry via authorisation (a voluntary process) is more desirable from a public benefit perspective than designation (an imposed process). International investors are likely to view designation as further evidence that Australia is moving towards a more interventionist approach to business issues.

Nevertheless, if it is the PSB's intention to proceed to designation, it will need to give careful consideration to several key issues, including the scope of the

designation and the processes to be adopted in moving forward to impose an access regime or set standards under the PSRA.

In considering designation it should be borne in mind that the banks were effectively constrained from entering a proper authorisation process by virtue of the ACCC initiating litigation that it had undertaken not to do.

2. Scope of Designation

The scope of any proposed designation is fundamental to the consideration of public benefits, since the scope determines the extent to which subsequent actions under the PSRA will affect the safety, efficiency and competitiveness of payment systems. Your letter of 21 March, confirmed in discussions with your officers as part of the consultation process, indicates that the PSB is considering designation of “the Australian credit card system”. This was described in discussions by Dr Laker as encompassing the Australian operations of the Bankcard, MasterCard and Visa schemes and possibly some aspects of the operations of American Express.

This raises two key issues regarding the scope of the designation. Firstly, the expression “the Australian credit card system” appears to lack clarity in relation to the requirements of the PSRA. Secondly, if the scope of the designation is largely limited to the open credit card systems, it raises questions of the efficiency and competitive effects of the designation.

(a) Definition of Payment Systems

Under the PSRA, the PSB has the power to designate payment systems. The word “system” appears to be undefined, but the definition in s.7 of the Act of a “participant” in a payment system implies that a payment system has “rules governing the operation of the system” or has a “system administrator”. There does not appear to be a set of rules governing the operation of “the Australian credit card system” nor is there a system administrator. The individual card associations do, however, have sets of rules for the operation of their schemes, and would therefore appear to be, individually, potential targets for designation. The claim that the individual card schemes form separate payment systems is reinforced by the observation that their operations utilise different processing systems, communication networks and authorisation and clearing systems.

The definition of “the Australian credit card system” encounters a further difficulty in relation to the PSRA. The PSRA defines a “payment system” to mean a “funds transfer system that facilitates the circulation of money, and includes any instruments and procedures that relate to the system”. The provision of revolving credit does not, of itself, fit the definition of a payment system. Its inclusion as part of a payment system can therefore only be as an ancillary element, and the system to which it relates must itself meet the definition of a payment system. Any definition of a payment system should therefore be framed in terms of the core system.

The difficulties that arise otherwise can be illustrated by reference to examples. Bankcard was established as a chargecard association and was authorised under the Trade Practices Act as such. There is no reference in the Bankcard rules to the provision of revolving credit – whether revolving credit is provided or not is a matter for the discretion of the individual issuer. Similar comments apply to other schemes: neither MasterCard nor Visa has rules setting all the parameters of their cards. In this respect they do not depart materially from “debit” card arrangements.

In summary, the Commonwealth Bank’s view is that the use of a phrase such as “the Australian credit card system” to define a payment system for the purposes of a designation would not only lack clarity but would not meet the requirements of the PSRA. It is our view that, to minimise the potential for unintended consequences and confusion, it would be appropriate to frame designations around the sets of rules that define the individual card systems.

(b) Competition and Efficiency Considerations

Under the public benefits test in PSRA, the Reserve Bank must have regard to the competition and efficiency consequences of its actions. Indeed, the Explanatory Memorandum to the PSRA states that:

“The major objective is to achieve a regulatory framework that would best promote efficiency and competition in the payments system without compromising financial stability.”

Since designation is a prelude to the imposition of an access regime or the setting of standards for a payment system, the public benefits of designation comprehend, or at least anticipate, the competition and efficiency consequences of any subsequent access regimes and standards. Before making a decision on what to designate, therefore, the PSB must consider the overall efficiency and competition effects of the inclusion or exclusion of different payment systems.

The Joint Study acknowledged the competitive risk associated with action against the open card systems but not the closed systems:

“... 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.”

In relation to the three characteristics, set out at the beginning of this letter, on which regulators world-wide have been focusing, the closed card systems can be regarded as having a worse record than the open systems, when one looks at the substance behind the form:

- Firstly, cardholder fees and merchant service fees are set centrally in the closed systems – in the open systems these are set by individual issuers

and acquirers and are subject to market forces. It is perhaps not unrelated to this that merchant service fees are, we understand, on average around 2.8% for the closed charge card systems, compared with 1.8% for the open systems. Moreover, we understand, the cost to the store per dollar spent on store cards typically exceeds 2% - in some cases by a substantial margin where, for example, discounts are offered for purchases using the card.

- Secondly, membership of the closed card systems is, by definition, closed. Although there are some exceptions to this and various parties participate in the closed systems, performing functions such as issuing cards, capturing transactions or processing, they typically have no voice in decision making processes.
- Thirdly, the closed card systems have “no surcharge” rules or, in the case of store cards, adhere to a “no surcharge” policy.

Against that background, action against the open card systems would weaken the competitive constraints on the closed systems. This would not be in the interest of either competition or efficiency.

More fundamentally, large retailers deploy their store cards to gain an advantage over their competitors. Smaller merchants are able to offset the competitive effect of these cards, at least to a large extent, by their collective acceptance of open system cards offering comparable benefits to cardholders. Any action that significantly affects the competitiveness of open system cards relative to store cards will have a corresponding impact on the competitiveness of the smaller merchants. Under such circumstances, smaller merchants may find it difficult to resist signing up with the more expensive closed systems. Such a result, by weakening competition in retail markets, would not be in the public interest. We submit that the framing of a designation that anticipates such an outcome could therefore not be in the public interest.

3. Designation and Litigation

In making its assessment on whether designation is in the public interest, the PSB will need to have regard to the litigation which the ACCC has underway against the NAB and the cross claims that the NAB has issued against a number of other parties. Designation processes and the litigation can, in principle, run concurrently. However, while the litigation remains underway, the parties involved will be obliged to protect their legal positions. Specifically, all correspondence, and possibly oral communication, will need to be subject to legal clearance to avoid inadvertent legal damage. That will inevitably limit the ability of the Reserve Bank to build up proper working relationships between the parties and will inhibit frank exchanges of views. The most serious impact of this could be on the drafting of access regimes or standards.

Therefore, if the litigation is to continue, it could be difficult for the PSB to conclude that designation would be more efficient than authorisation in achieving an appropriate outcome. Accordingly, the Bank recommends that the Reserve Bank should not designate until the litigation is complete, either through withdrawal by the ACCC (with immunity to the banks) or the case having run its course.

4. Consultation Processes

In discussions with the Reserve Bank, Dr Laker has emphasised to us the need for payment systems reform to occur via a public process. We concur fully with this view. To this end, we would urge the Reserve Bank to adopt the following key principles in relation to its processes under the PSRA.

- Consultation should, as far as possible, but without compromising the need for flexibility, be based on written material, including consultation documents issued by the Reserve Bank and submissions from interested parties;
- All consultation documents issued by the Reserve Bank should be on the public record;
- Submissions from interested parties should automatically be put on the public record except for those parts of the submissions where the originating party can justify suppression on legitimate commercial-in-confidence grounds;
- Prior to exercising its powers under the PSRA, the PSB should publish, for public comment, a set of draft decisions, together with a summary of the key arguments put forward by interested parties and the reasons for those draft decisions; and
- The final decisions of the PSB, in exercising its powers under the PSRA, should be accompanied by a statement of reasons for the decisions.

These principles are similar to those adopted by the ACCC for consideration of applications for authorisation under the Trade Practices Act.

I would be pleased to meet with you to discuss the Commonwealth Bank's views.

Yours sincerely

D V Murray