21 December 2000

Hon Joe Hockey MP
Minister for Financial Services and Regulation
Parliament House
CANBERRA ACT 2600

Dear Minister

Thank you for your letter seeking our response to issues raised in the October 2000 joint study by the Reserve Bank and ACCC of Debit and Credit Card Schemes in Australia.

Credit Union Services Corporation (Australia) Limited (CUSCAL) is the peak industry group for credit unions. CUSCAL is owned by credit unions and provides a wide range of banking and other commercial services to 188 affiliated credit unions. These services include access to debit and credit card and ATM networks for members of affiliated credit unions.

Issues surrounding credit card interchange have been examined by consultant economists *Frontier Economics* in a review commissioned by the major banks. We have not seen the review's findings. We understand further work commissioned by the banks is under way reviewing card scheme access and participation rules.

Credit unions, even collectively, have little market power in the debit and credit card and ATM networks.

"Large institutions", the RBA/ACCC joint study found, "have the dominant influence on interchange fee setting; however, since they are both issuers and acquirers and benefit from the revenue generated, they have little incentive to press for lower interchange fees."

The Credit Union Movement is a relatively large issuer of cards but is not a large acquirer. Credit unions own the Rediteller ATM network which comprises around 10 per cent of the national ATM network.

"A large financial institution", says the joint study, "that is both a significant issuer and acquirer is a microcosm of the industry." Credit unions do not fit this template.

Having made these important preliminary points, our responses to the major policy issues raised by the joint study are:

- CUSCAL supports the removal of barriers to competition in the issuing and acquiring card and ATM networks.

- CUSCAL supports the removal of rules in card schemes and ATM networks which prevent pricing transparency or the development of new pricing mechanisms.

- CUSCAL supports industry self-regulation and cautions again piecemeal intervention into payments system arrangements. Any attempt at partial regulation of payment mechanisms or payment pricing is likely to create distortions and inefficiencies elsewhere in the payments system.

It must be recognised that there will be winners and losers whatever changes are made to existing arrangements.

For example, according to the joint study "cardholders are effectively being paid by card issuers to use credit card" and "much of this higher cost is borne by consumers who do not use credit cards."

In relation to ATMs, the joint study says high-cost ATM locations are subsidised by low-cost ATMs. "Under a direct charging regime, in contrast, ATM owners could vary the transaction fee according to the per unit cost of individual machines." This means that ATMs in remote locations may cost more to use than ATMs in metropolitan areas. ATMs may cost more late at night than at high traffic times during business hours.

Accommodating declined transactions (10-15 per cent of Rediteller transactions) and balance inquiries in an ATM direct charging regime raises a number of technical and practical cost issues.

Existing Structures
The joint study's Executive Summary says "financial institutions have no clear incentives to negotiate lower ATM interchange fees." This is not the case for many smaller institutions and institutions which do not have their own large ATM network. This financial year credit union card issuers will pay around $53 million to other financial institution ATM acquirers. Credit union ATM acquirers will receive around $32 million from other financial institution card issuers.

The joint study has focused on interchange fees rather than merchant service fees. Merchant service fees imposed on retailers by American Express or Diners Club are not covered in the study. However, these fees - like fees imposed by Visa or Mastercard scheme members - are "built into the prices of goods and services and are recovered from all customers, whether or not they use credit cards."

Cost Estimates
The joint study estimates that the cost of providing ATM cash withdrawals averages $0.49 per transaction. This is not the case for credit unions. Due to smaller volumes, the average transaction cost for credit union ATM acquirers is around $0.65.

The study says 'foreign ATM fees' average around $1.35 while ATM interchange fees average around $1.03 and that "there are normally no fee-free transactions if customers use ATMs owned by other institutions." This is not the case with credit unions. Credit unions generally include ‘foreign’ ATM transactions in monthly free transaction allowances.

While it is certainly true that bilateral ATM interchange fee rates have not fallen in nominal terms over time, the fact they have not increased means they have declined in real terms.

The joint study estimates that costs for credit card issuers average $1.93 while revenues average $2.69, a mark-up over costs of 39 per cent. The cost figure excludes the cost of loyalty schemes - “because they are not a resource cost” - even though the study estimates the cost of loyalty schemes per transaction is $0.46. If this component is added back in, the average cost becomes $2.39, a mark-up of 12.5 per cent. Loyalty schemes are an important aspect of marketing and are increasingly seen by consumers as a core element of the product.

‘No surcharge’ rule

According to the study, “Australia has a higher cost retail payments system than necessary and much of this higher cost is borne by consumers who do not use credit cards.”

Who does not use credit cards? According to the study, almost 70 per cent of people earning less than $20,000 do not own a credit card. This percentage falls as income rises. Only 20 per cent for people on incomes of $60,000 or more do not own a credit card.

The consumers who don’t use credit cards and are therefore bearing the higher than necessary cost of the retail payments system tend to be lower income consumers.

In pursuit of a fairer retail payments system, CUSCAL supports the study’s view that merchants “should not be prevented by the credit card schemes from passing on some or all of the merchant service fee through surcharges.”

We note that until recently credit laws prevented differential pricing.

Of course, merchants may choose for their own commercial reasons not to impose such a transaction fee on their customers.

As the study recognises, the arguments against ‘no surcharge’ rules also apply in relation to charge card schemes.

‘Card not present’

The study “can see no logical basis” for ‘card not present’ transactions attracting the higher 1.2 per cent interchange fee.

It is the case that fraud risk in these cases generally falls back on the merchant. However, there may be a case for the higher interchange fee based on costs for the issuer in handling cardholder complaints.

Telephone and Internet credit card transactions show a relatively high incidence of fraud and disputed transactions. Chargebacks involve significant costs for staff, postage, telephone and card scheme fees.

Visa debit card
The study singles out for comment the Visa branded debit card, a product widely issued by credit unions and also by some banks.

The study questions the use of these cards as credit cards. "In practice, these cards are simply debit cards; whichever button is selected, the funds are drawn from the customer's deposit account," the study says.

In our view, this conclusion is unjustified.

Some 70 per cent of credit union Visa debit cards have overdrafts attached and therefore are subject to the same risk of bad debts as any other credit card. The risk of fraud with a Visa debit card is the same as with any credit card. The Visa debit card does not have an interest-free credit period, but neither do many other credit cards.

Visa debit cards clearly meet the characteristics usually associated with credit cards.

(Credit unions earned $20 million last financial year from Visa credit card interchange fees. The study says there is no need for a debit card interchange fee, paid by issuer to acquirer. Credit unions paid $14 million last financial year in EFTPOS debit card interchange fees.)

Conclusion
Our position is that we favour the removal of barriers to competition and the removal of barriers to particular pricing mechanisms and price signals.

Retail banking, currently and historically, is characterised by bundling and cross-subsidies across payments, loan and deposit products. Unwinding these cross subsidies, whether driven by regulators or by market forces, inevitably creates winners and losers.

The Reserve Bank reported in June 1999 that the gains in income that banks have made from increases in fees have not been sufficient to offset the decline in margins. "Thus, on average, customers are better off, although those with small balances and a lot of transactions could be worse off."

Customer resistance to rising transaction fees is prominently covered in the media and is firmly on the political agenda. Change to pricing of payment mechanisms may have merits from a purely economic perspective, but customer attitudes should not be ignored.

If you would like any further information on these issues, please contact Luke Lawler on 02 6232 6666.

Yours sincerely

STEVE LAUE
Chief Executive