Westpac
Australia's First Bank

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Dr John Veale
Head of Payments Policy Department
Reserve Bank of Australia
65 Martin Place
Sydney NSW 2000

Dear John,

FOLLOW-UP INTERCHANGE QUESTIONS

I refer to your letter dated 1 June 2001, and to our brief response dated 12 June 2001.

You have now received the Australian Bankers' Association ("ABA") submission "Credit Card Networks in Australia: An Appropriate Regulatory Framework". Westpac was an active participant in the formulation of that submission, and we consider that to a very large extent it sets out our current thinking on the questions posed by your letter.

Our more specific responses follow.

Standard on Setting Interchange Fees

Westpac strongly supports the view expressed in Chapter 2 of the ABA submission that the regulation of designated credit card schemes should take place via the establishment of an *access regime* rather via the setting of *standards*.

In particular, Westpac shares the belief that this regulatory mechanism would allow the Reserve Bank to define an "envelope", including the imposition of maximum level of recoverable costs, within which schemes would have some flexibility to determine their own, competitive, interchange fee setting methodologies.

Of the established methodologies that have been the subject of scrutiny in the lead up to and following designation, Westpac has determined a strong preference for the 'avoidable cost' methodology proposed by the ABA submission. We believe that the Attachment to the ABA submission sets out the appropriate starting point for recognising the elements of cost that should be recovered from acquirers (and hence merchants) by issuers.

Westpac considers a credit card is a substitute for deferred payment that may be offered by merchants. The simple concept is that retailers have 'outsourced' the operation of their debtors ledger by accepting credit and charge cards. They pay a merchant service fee (incorporating interchange) in place of bearing the costs of funding a debtors ledger and associated credit losses, fraud losses and administrative costs. The extended credit offered on credit cards is an added service not typically offered by the merchant (or indeed charge cards or store cards).

Westpac would prefer not to make further comment specifically on interchange standards until the Payments System Board resolves the question of whether they will be take the form of standards imposed under section 18 of the *Payment Systems (Regulation) Act 1998,* or be embodied within an access regime under section 12 of the Act.

Westpac believes it is appropriate that issuers recover from acquirers some proportion of the marketing costs of promoting credit card use as the use of credit confers a benefit on merchants. The attached article from *The Australian Financial Review* of Wednesday 4 July 2001 demonstrated the significance of these benefits to the US economy. The article also reported that issuers were writing-off debts an annualised rate of 6.7%. It is our understanding that these very high levels of credit loss are incorporated into the MasterCard U.S. interchange fee pricing models, which may explain the relatively high interchange rates that apply in that most competitive market.

On a specific issue, Westpac does not support a regime that differentiated interchange fees based on merchant category. Westpac's experience in New Zealand with supermarket rates suggest this will be a highly contentious issue due to the difficulty of proving the true nature of the merchant's business. Westpac supports differentiation based on the type of process involved; paper based, electronic face to face; or mail / telephone order.

Setting interchange rates too low will lead to dominance of closed schemes at greater cost to the community, as banks leave the card associations to issue Amex or Diners Cards. The market share of Amex and Diners in the corporate / purchasing card market is evidence of this potential outcome.

Risks of Self-Acquisition to Issuers

Westpac supports the comments made by the Bankcard Association of Australia on this issue in its document: 'Designation of Credit Card Payment Systems by Reserve Bank of Australia: Bankcard Association of Australia's Response to Questions Posed by RBA'. These comments are elaborated upon in Chapter 5 of the ABA submission (section 5.5 – 'Policies on Self Acquisition').

The consumer protection provisions of the credit card scheme rules provide cardholders up to six months in which to dispute a transaction appearing on their statement. If during this period a merchant suffers financial failure, then the acquirer is effectively liable for any warranty in the case of purchase of goods; and for refund of pre-paid services such as airline travel or insurance cover. Additionally, failure to have an acquirer enforce best practice card acceptance procedures at point of sale can result in excessive fraud.

Issuers of credit cards therefore need some protection from losses that could be expected to follow from a self-acquirer failing or not enforcing best practice acceptance procedures. Bankcard's concept of requiring scheme participants to procure a surviving guarantee from a qualifying guarantor is an example of how this protection could be assured to issuers.

"Double Dipping" on Credit Losses

Since formulating our November 2000 response to the Joint Study, we have participated in the ACCC sanctioned Joint Bank Review, which has led to the proposed avoidable cost methodology for the Australian market. This excludes the recognition of the costs and benefits associated with the provision of extended credit.

The relatively high credit card interest margins on extended credit currently evident in the Australian market supports the view that credit losses are recovered from the interest margins charged to cardholders. If interest margins were to fall to the point where that recovery was inadequate, then a different interchange methodology, such as the MasterCard method would be appropriate, as this recovers from acquirers losses attributable to extended credit.

In any event, some credit losses occur in the period before cardholders start paying interest on extended credit (e.g due to bankruptcy or death). As these are not recovered from interest margin it is appropriate that they be recovered from interchange. An indication of this cost could be found from the experience of charge cards (such as Amex, Diners, store cards) where extended credit is not provided.

We welcome continued discussion with you ahead of the release of the consultative document.

Yours sincerely,

Chris Smith
General Manager, Consumer Risk Management

Attach

Consumer: the last man standing in US economy

Peter Hartcher WASHINGTON

When I opened my e-mail a few days ago, I found an unsolicited offer of a Visa card from a major US company that would not know me from a hole in the ground.

If I would just fill in a few quick questions, it urged, approval for my new credit card would be flashed back to me in a maximum of 30 seconds. That's right – not 30 days, hours or minutes, but seconds.

This helps to explain one of the most puzzling features of the superpower's economy – the dogged resilience of consumer spending during the American downturn.

"The consumer," says Goldman Sachs economist Mr Jan Hatzius, "is the last man standing in this economy."

The US Commerce Department demonstrated the point powerfully yesterday when it announced that American consumers increased their spending last month by 0.5 per cent or $US32 billion ($62 billion).

Yet, their incomes in the same month rose at less than half this pace – by just 0.2 per cent, equal to an increase of $US18 billion.

How do you earn an extra $US18 billion yet manage to increase your spending by $US32 billion? You put the difference – $US14 billion – on credit. It only takes 30 seconds.

Americans are not only increasing their personal indebtedness, they are actually increasing it at a faster rate in the downturn than they did in the boom. As credit rating agency Standard & Poor's summarised in a report last week: "US consumer debt: volume heads north as economy heads south."

Consumer debt this year has been growing at a rate of more than 10 per cent, faster than the 7 per cent average clip in the years since Alan Greenspan's 1996 observation that the US markets were in the grip of "irrational exuberance".

"We weren't only living in a stockmarket bubble," Economy.com's analyst Brian Nottage told the *San Francisco Chronicle*. "It was also a lifestyle bubble."

Now that the bubble in technology stock prices has burst, Americans are seeking to perpetuate the lifestyle bubble, even if it grows ever harder to pay for it.

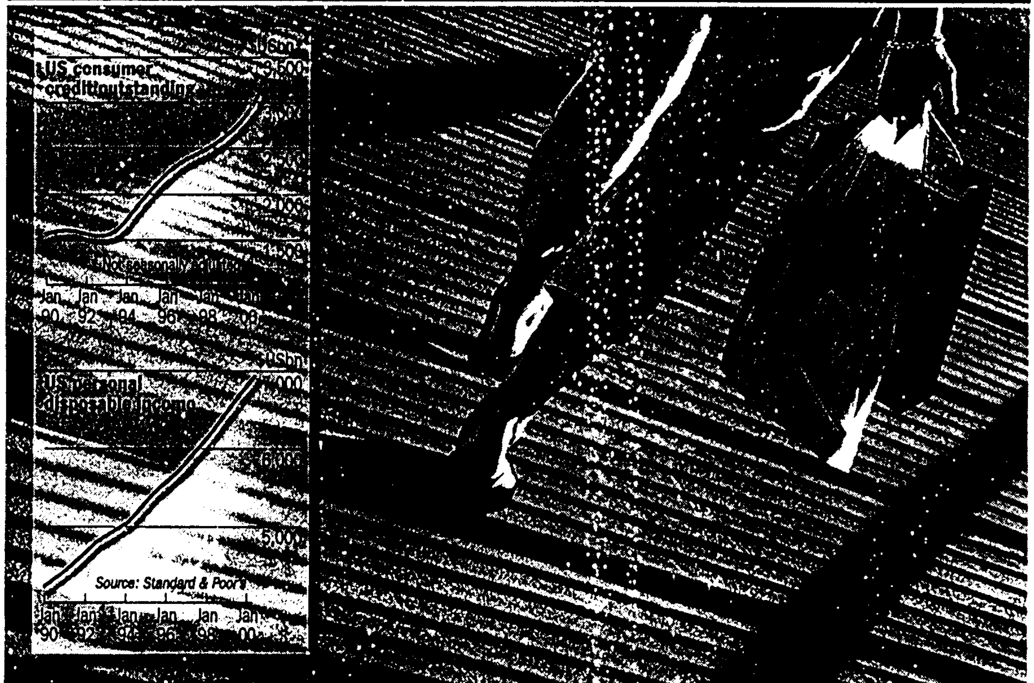
The good news is that it is helping support the US economy in its hour of need. The bad news is that it cannot continue indefinitely.

Goldman Sachs' Mr Hatzius believes the spending binge is based on a fatal combination of imprudently easy credit and irrational confidence: "The consumer confidence indices are up these last two months, but the entire rise is due to expectations of the economy's future – none of it is based on current conditions.

"People are choosing to believe in a quick recovery even though there is no actual evidence of it. People are telling themselves, 'things will be fine, this downturn doesn't matter much for the long run'. They refuse to be shaken.

"But if the labour market continues to deteriorate and unemployment goes to 5 per cent as we expect it will, then these people are living on borrowed time."

SPENDING UP BIG



Already, consumers are showing the first signs of running into increasing difficulty meeting the repayments on their debts. The total outstanding consumer debt is mountainous, at a record high of $US1.6 trillion, in addition to mortgage debt of another $US5.2 trillion, according to the Federal Reserve. As a proportion of total economic output or GDP, household indebtedness has swollen from 62 per cent to 71 per cent in the last decade.

And that debt has to be serviced. Americans now spend 14.3 per cent of their disposable incomes meeting

"We weren't only living in a stockmarket bubble. It was also a lifestyle bubble."

debt repayments, the highest in 15 years and a whisker from the all-time high. "The debt ratios that have built up in these last quarters are very troubling, and although they keep the economy afloat today, they are bills that fester away and pose an even bigger problem tomorrow," says executive director of the Financial Markets Centre Mr Tom Schlesinger.

The proportion of credit card accounts running more than 30 days overdue has crept up from 4.3 per cent a year ago to 5 per cent now.

Standard & Poor's reports that credit card companies in April wrote off unrecoverable debts at an annualised rate of 6.7 per cent, the highest rate in four years. And the number of personal bankruptcies in the first quarter of the year was running 17.5 per cent higher than in the same quarter a year earlier.

afr Westpac 6 July 2001
Chris Smith