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Our ref. GM:03/212

Ms Michele Bullock
Acting Head of Payments Policy
Reserve Bank of Australia
65 Martin Place
Sydney NSW 2001

8 September 2003

Dear Michele,

Re: Response to Invitation to Comment on the Reserve Bank of Australia Draft Access Regime

We are writing on behalf of the Bankcard Association of Australia (Bankcard) in response to your letter of 14 July 2003, in which you invited Bankcard to comment on the recently gazetted draft Access Regime, which is proposed to apply to Bankcard and the other schemes designated by the Reserve Bank of Australia (RBA).

We thank you for the opportunity to comment and would note that in making the observations outlined in this letter we have reviewed the draft RBA Access Regime in the context of the associated final Guidelines on Authorisation of Specialised Credit Card Institutions (SCCIs) and the Prudential Standard on Risk Management of Credit Card Activities (APS 240), both issued by the Australian Prudential Regulation Authority (APRA)[1].

1. Introduction

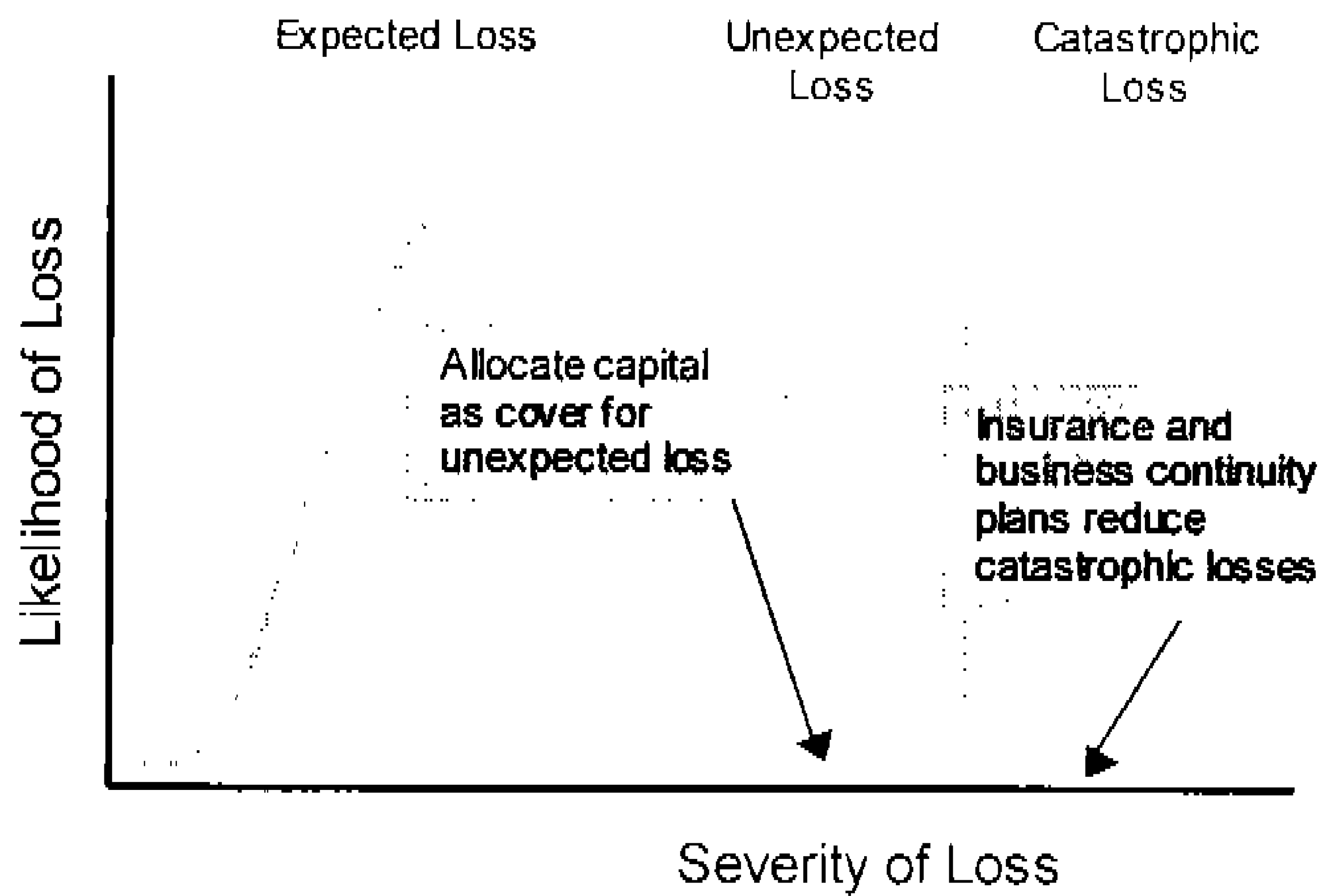
Based on our review, we have a number of observations in relation to the specific risks that might be expected to arise within Self-Acquirer Only and Acquirer Only business models, which do not appear to be specifically addressed in the SCCI provisions, which would, in our view, make to it difficult to achieve the Access Regimes' stated objectives.

In particular, we believe the move from the current level playing field, that exists within the open (four-party) payments system, to the SCCI model may lead to risk concentration, as well as a shifting of risk from the Acquirer to the Issuer and Cardholder, in Acquirer-based models.

[1] These three documents are collectively referred to in this response as the "SCCI provisions".

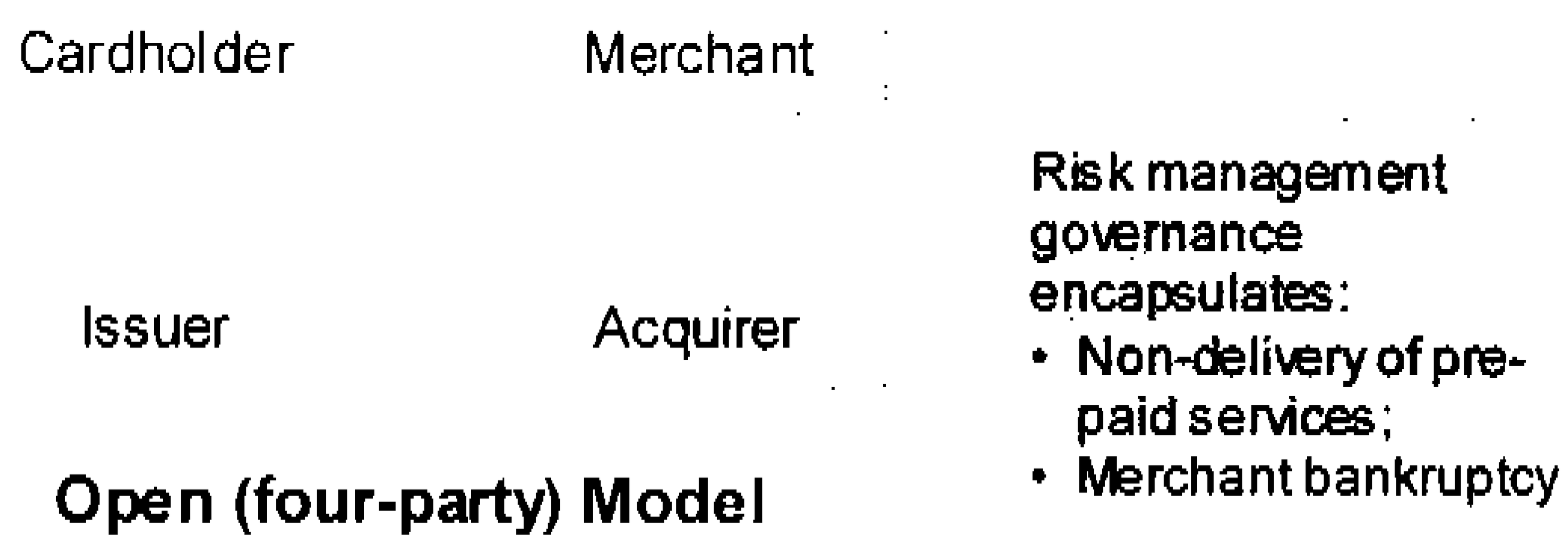
Our concern relates to our belief that in the current model, the risks outlined in a typical loss model (refer Diagram 1) are generally managed by Acquirers, whereas we are uncertain if this would be the case in an SCCI model, particularly in a Self-Acquiring Only scenario, where we are concerned that the risk would be passed onto Issuers and Cardholders as a result of the ownership of the SCCI by the parent Merchant.

Diagram 1



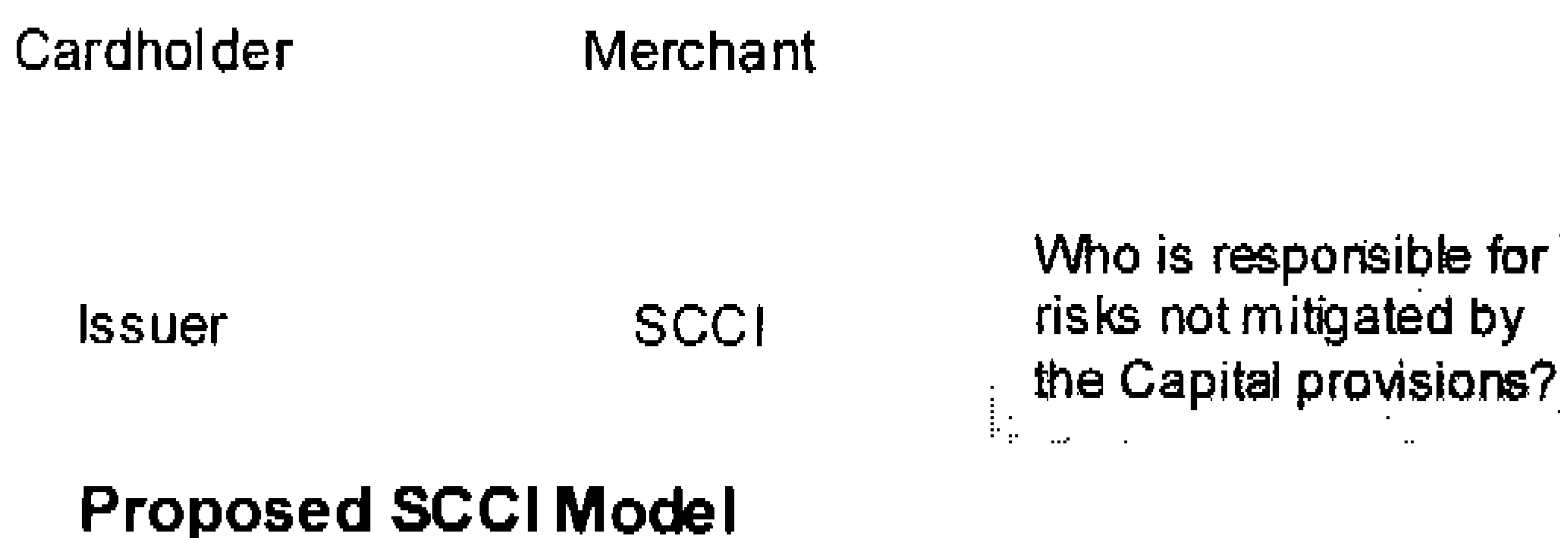
We note by way of background, that in the existing open (four-party) credit card payments system (refer Diagram 2), the Acquirer must be a bank, operating with a risk management framework that encapsulates a responsibility for expected loss (eg Merchant fraud), unexpected loss (eg major client bankruptcy) and catastrophic loss (eg building collapse), and will be supported by, and subject to, the infrastructure of the payments system.

Diagram 2



By contrast, in the model outlined in the SCCI provisions (refer Diagram 3), the Acquirer (the SCCI) is not authorised to operate as a full service bank, and as such, opens the payments system and its participants to new risks, which do not appear to be mitigated by the capital requirements outlined in the SCCI provisions.

Diagram 3



This response addresses our concerns that the concentration and shifting of risks that appears to be possible within the SCCI provisions, together with a lack of clarity in relation to the responsibility for management of these risks if in fact they are not mitigated by the provisions, may undermine a number of the stated objectives of the draft Access Regime, particularly in regard to:

- The interests of current participants;
- The public interest; and
- The financial stability of the designated credit card system.

The fundamental question therefore becomes - who will have the responsibility for the risks not mitigated by the capital provisions?

2. Executive Summary

Based on our review, we believe that under normal business conditions, the SCCI provisions have been drafted in a manner that will serve the purposes for which they are intended, as outlined in the Objectives of the draft Access Regime.

However, we also believe that under certain circumstances, particularly in Self-Acquiring Only and Acquiring Only models, certain business conditions could potentially result in a shifting of risk or a concentration of risk respectively, as a result of the way in which the SCCI provisions change the balance of the current four-party payments system. Of greatest concern is the risk of bankruptcy in a Self-Acquiring Only model, resulting in a shifting of risk to the Issuer and Cardholder, who are left bearing the burden of the bankruptcy in relation to pre-paid goods and services, given that the Merchant and the Acquirer (the SCCI) are both bankrupt.

This document outlines our thoughts in relation to these risks, particularly our concern that the capital provisions of the SCCI provisions may not address aspects of these new risks.

3. Self-Acquiring Only

3.1 Background

The Self-Acquiring Only model will likely be a niche segment of the market, attracting only a limited number of participants capable of, or interested in, acquiring their own business via an SCCI subsidiary.

By its very nature, a Self-Acquiring Only SCCI will be subject to a concentration of risk arising from its reliance on a single merchant – typically it's parent company.

Furthermore, the financial stability of the parent will directly impact that of the SCCI – with the SCCI solely reliant on its parent for business.

For the purposes of considering the risks inherent in a Self-Acquiring Only business model, we would seek to distinguish two major types of Self-Acquirer:

- Those operating a pre-payment business model – including:
  - Airlines;
  - Insurance providers;
  - Mail order services / internet-base purchasers; and
  - Merchants offering lay-by purchases / gift cards;
- Those providing value for goods or services at the time of purchase – would include all businesses not operating under a pre-payment business model, eg a grocery.

3.2 Pre-payment – the Unrecognised Risk

Where an SCCI exists to acquire the business of a parent that delivers goods or services at the time of purchase, value has effectively passed to the consumer at the time of purchase, and as such, the impact of the bankruptcy of the parent (the provider of the goods or services) is limited to the parent and the SCCI, as the customer has paid for and received value and the Issuers position is neutral, subject to having received the interchange fee from the Acquirer.

In a pre-payment model the impact will likely be more complex. Consider for example, the airline industry in which cardholders effectively prepay for a service (the flight) to be rendered at some time in the future. In this model, the timing and extent of the flow of payments among the payments system participants may be different to the usual model, as holdback arrangements may be in place.

Holdback within the airline industry is a common risk management & mitigation technique, and conceptually acts to hold back payment to the Merchant (in this case, the airline) of (all or part of) the fare for each leg of a flight (depending on the risk as calculated by the Acquirer), until the individual leg of the cardholders' flight is taken. This quasi insurance acts as a protection against non-delivery, which would occur if the airline were to go bankrupt between the time of purchase of the airline ticket and the time of flight.

The Australian domestic airline market has witnessed bankruptcy twice within the last decade, and had either Compass or Ansett had SCCI subsidiaries acquiring their own business, there would have been significant financial impact within the payments system, to the extent of the value of all flights paid for, but not taken.

The important distinction to make in these circumstances is considered below.

3.2.1 Current Model

In the current open credit card system, airline tickets would have been purchased from merchants operating within the "balanced" banking system, where it is possible to price for the risks associated with such pre-purchases, and where the Acquirer will therefore have in place a performance insurance bond, or will hold back all, or some portion (depending on pricing), of the purchase price of the ticket, depending on the assessed risk.

The impact of bankruptcy of the merchant would therefore be mitigated to the extent that payment of prepaid airfares to the merchant had been held back. The current chargeback processes within the four party system would then deal with the flow-back of cash to the cardholder, in recompense for the non-receipt of services.

Arguably therefore, neither the Cardholder or Issuer would ultimately bear any of the loss associated with the bankruptcy of the merchant. and with adequate risk management practices in place, the Acquirer would minimise the losses incurred within it's business.

3.2.2 SCCI Model

Under the SCCI provisions, tickets would have been purchased from a merchant whose SCCI Acquirer does not operate as a full service bank, rather than from a traditional Acquirer. As a subsidiary of the merchant (the airline), immediate settlement of the purchase price of the airline ticket would have occurred between the SCCI and it's parent, as it would be unlikely that holdback provisions would be in place, in relation to pre-payments.

In these circumstances, the bankruptcy of the merchant would result in the bankruptcy of the SCCI, as the parent-subsidiary relationship of the parties would likely result in the capital provisions of the SCCI provisions being ineffective, leaving no capital in the SCCI to provide the protection intended. Note that in this instance, no amount of capital will provide protection against bankruptcy. The risks of bankruptcy have therefore been shifted, with the Issuer and Cardholder left bearing the burden of the bankruptcy in relation to pre-paid tickets, as the Merchant and the Acquirer (the SCCI) are both bankrupt. The scheme impact is not considered in the SCCI provisions.

In this situation, where the risk of bankruptcy has effectively been shifted from the Acquirer to the Issuer and Cardholder, we believe that the Capital provisions of the SCCI provisions leave these payments system participants exposed to potentially significant loss, in a manner that would not occur in the current market. This impact will be exacerbated in circumstances where the Issuer is set-up as an SCCI Issuer-Only, thereby lacking the protection afforded a current "balanced market" participant.

Once again using the airline industry as an example, an analysis of past airline bankruptcies suggests that they are preceded by deep fare discounting and fare wars in an attempt to drive revenue, inevitably maximising, at the time of the bankruptcy, the number of consumers affected.

Historical global data suggests that at the time of bankruptcy, it would be common to expect anywhere between 30-40 days of average sales to be outstanding. The 15% of 3 days sales revenue that is currently proposed as the basis of the capital provisions of the SCCI provisions would likely be completely inadequate in such circumstances.

3.3 Summary

Bearing in mind the loss model outlined earlier, we do not believe that the risks transferred to the Issuer and Cardholder in the Self-Acquiring Only model are intended to be mitigated by the capital provisions of the SCCI provisions, however, we do believe that mechanisms need to be put into place to protect these previously safeguarded interests. Such mechanisms might involve:

- RBA self-insurance of the risk transferred under these circumstances;
- Lodging and quarantining of an amount with an ADI, equal to the value of forward sales, less the capital in place;
- Pricing an additional component into the Interchange fee, as a means of affording the Issuer, and in turn the Cardholder, an element of insurance protection against the shift in risk; or
- Allowing the Issuer, rather than the Acquirer, to use holdback provisions for Self-Acquired purchases, creating significant development expense that will be an additional component of the Interchange fee.

In considering the efficacy of these risk mitigation options, legal title to the holdings of capital, the holdback components or the interchange increases should be considered – in a post-bankruptcy legal analysis, would the capital of the SCCI be quarantined in the SCCI or would it be rolled up as part of the bankrupt parent entity?

In attempting to resolve these issues, it must also be recognised that the nature of the loss may well be different in the current model compared with an SCCI model – while the collapse of Ansett might have been an unexpected loss (and therefore mitigated by capital provisions) for NAB as the airlines Acquirer, the loss would have been catastrophic for the Ansett SCCI, had an SCCI model been operating.

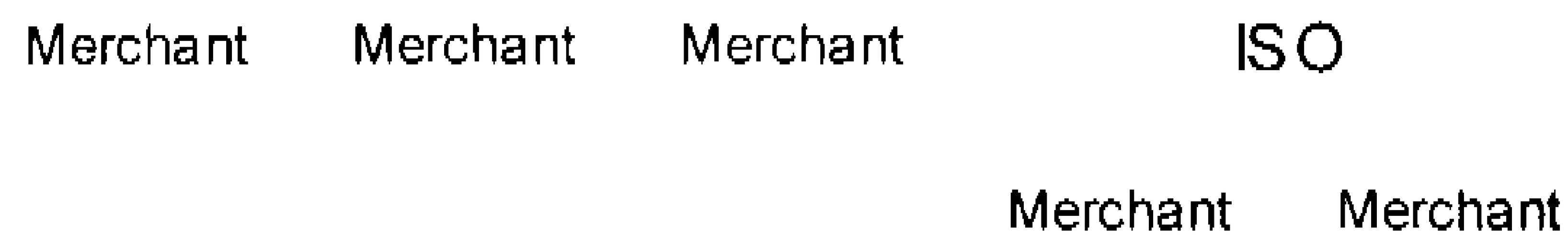
4. Acquiring Only

4.1 Background

We would expect that the Acquiring Only model that would eventuate as a result of the SCCI provisions would be similar to the long established Processor and Independent Service Organisation (ISO) model that operates in the US market (refer Diagram 4). In this model, an SCCI would be established for the purposes of acquiring the business of other merchants, possibly also including the business of an associated (ie parent) company, although the likely use of ISOs may have unintended consequences in the Australian context, based on our current understanding of the SCCI provisions.

Processor (SCCI)

Diagram 4



In many respects, the Acquiring Only model is similar to the Self Acquiring Only model, in the sense that the use of an SCCI changes the relationship between the Acquirer and the other payments system participants. However, it should not result in a potential transfer of risk from the Acquirer to the Issuer and Cardholder, as the Self Acquiring Only model may.

Nonetheless, we believe that the model may introduce new risks into the payments system in the form of risk concentration, should an SCCI business model be predicated on the provision of services to a narrow market segment. Accordingly, we support the flexibility that has been built into the capital provisions of the SCCI provisions, with their references to potential variations in the capital charge for start-up SCCIs, different business plans and risk profiles.

4.2 Likely Impact

However, we do wish to draw on the experience of the US market in distinguishing between the role of the sponsoring bank, the processor (SCCI) and the ISO, noting that the development of processor business plans has inevitably led to the creation of ISOs in a role that sits between the processors and the Merchants. Our analysis suggests that the nature of their business plans, together with the associated concentration of risks that has tended to develop in the ISO models has been the greatest source of risk in the payments chain.

In the SCCI provisions, we are uncertain whether the proposed capital charge would be expected to cover the risk of bankruptcy of the SCCI or the ISO, nor is it clear what sort of mechanisms would be required to minimise business interruption, by physically restoring merchant operational functionality, if SCCI or ISO bankruptcy occurred.

In the US market such mechanisms are well established, irrespective of the operational model driving the interaction of the participants (ie sponsoring bank, processor, ISO and Merchant), as the parties are fully integrated into the banking system, while at the same time being protected by a series of scheme and other fees that act as a form of insurance against the risk of bankruptcy of each of the participants.

An additional consideration in the Australian context is the possible shift from a Self-Acquiring Only to an Acquiring Only model, which could arise if for example, a merchant such as ColesMyer operated an SCCI to acquire its own transactions, and later also began acquire the business of other retail merchants, for example IGA stores. This would potentially give rise to risk concentration issues that had not previously existed, in addition to the risks associated with Self-Acquiring Only.

Lastly, consideration should be given to the impact of chargebacks in the Acquiring Only context. The credit cards schemes typically impose fines on Acquirers for excessive levels of chargeback, and it is foreseeable that the impact of fines in relation to the chargeback tail could be more severe in the SCCI model than in the current four-party model, especially where the SCCI operates in a narrow business segment.

4.3 Summary

In Australia, the SCCIs are not authorised as full service banks, and while SCCI bankruptcy in an unlikely event, it would foreseeably result in the ultimate transfer of risk to the Merchants, as it is clear that the capital provisions of the SCCI provisions would be expected to cover such a risk.

Furthermore, Bankcard, with no material level of scheme fees, would probably be exposed in these circumstances, should they be pursued in relation to such failures.

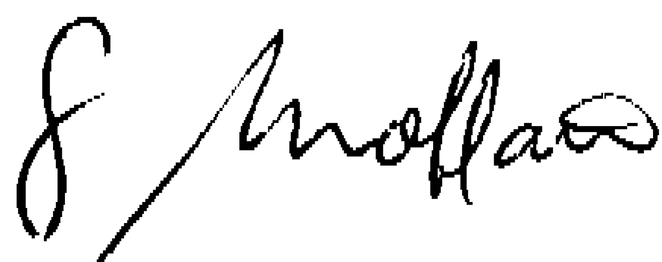
5. Closing Observations

We believe that in general, under normal business conditions, the way in which the SCCI provisions have been drafted will serve the purposes for which they are intended, as outlined in the Objectives of the draft Access Regime. However, as we have attempted to demonstrate in this response, we believe that under certain circumstances, particularly in Self-Acquiring Only and Acquiring Only models, there is a potential for a shifting of risk or a concentration of risk respectively, due to the way in which the SCCI provisions change the balance of the current four-party payments system. Our concern is that the capital provisions of the SCCI provisions will not address these new risks.

We would welcome the opportunity to further discuss any aspects of our response and to consider with you, potential mechanisms for mitigating these perceived additional risks. Please feel free to contact me on 02 9281 6633.

Thank you again for the opportunity to comment on the draft Access Regime.

Yours sincerely



Garry Moffatt

General Manager