REFORM OF CREDIT CARD SCHEMES IN AUSTRALIA IV

Final Reforms and Regulation Impact Statement

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RESERVE BANK OF AUSTRALIA

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1. BACKGROUND

Over the past three years, the Reserve Bank has been reviewing the operation of credit card schemes in Australia.

The original motivation was the 1997 *Final Report* of the Financial System Inquiry (the Wallis Committee), which highlighted arrangements for wholesale fees (known as "interchange" fees) and restrictions on access to credit card schemes as areas of policy concern, and recommended that these concerns be considered by a new Payments System Board in the Reserve Bank and by the Australian Competition and Consumer Commission (ACCC). In response to the Inquiry, the Payments System Board and the ACCC undertook a detailed study of debit and credit card schemes in Australia and set out their findings in the publication, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access,* which was released in October 2000 (the "Joint Study").

The Joint Study highlighted the role of private-sector regulations in the operation of "four party" credit card schemes. These regulations, which are discussed in the following Section, govern the collective setting of interchange fees, restrictions on merchant pricing and criteria for participation in the schemes. The Joint Study raised a number of public interest issues relating to competition and efficiency in credit card schemes and other payment networks, but did not contain recommendations for action by regulatory agencies.

In April 2001, following consultations with interested parties, the Reserve Bank designated the credit card schemes operated in Australia by Bankcard, MasterCard and Visa as payment systems subject to its regulation under the *Payment Systems (Regulation) Act 1998.* This Act gives the Reserve Bank power to designate a payment system and to set standards or impose an access regime on that system if the Reserve Bank believes it is in the public interest to do so.

In December 2001, following consideration of a large number of submissions and extensive consultation with interested parties, the Reserve Bank gazetted draft standards under section 18 of the *Payment Systems (Regulation) Act 1998* dealing with the setting of interchange fees and restrictions on merchant pricing in the designated credit card schemes. It also gazetted a draft access regime under section 12 of the Act dealing with eligibility for participation in these schemes. As required by the Act, the Reserve Bank invited submissions on the proposed reforms from interested parties. In a publication released at the same time, *Reform of Credit Card Schemes in Australia: A Consultation Document,* the Reserve Bank reviewed the main regulations imposed by the designated credit card schemes from the public interest viewpoint and explained the reasons for its proposed reforms.

The relevant sections of the *Payment Systems (Regulation) Act 1998* are provided in Attachment 1.

The Reserve Bank did not designate the "three party" card schemes, the American Express card system and the Diners Club card system. These schemes do not have collectively set interchange fees nor restrictions on entry enforced by existing members, and the Reserve Bank saw no case on public interest grounds to designate these schemes to deal with these issues. However, American Express and Diners Club do impose restrictions on merchant pricing and the Reserve Bank indicated in the Consultation Document that it would be consulting these schemes as to why they should not also be required to meet the standard on merchant pricing.

The Reserve Bank's reform measures deal only with the regulations of the credit card schemes governing the collective setting of interchange fees, restrictions on merchant pricing and entry to the schemes. The measures do not deal with the relationships between individual scheme members and their customers, which are not covered by scheme regulations. Hence, they do not cover the setting of credit card fees and charges to cardholders and merchants, or interest rates on credit card borrowings.

The Consultation Document also provided a description of earlier official scrutiny of credit card schemes in Australia. This is summarised in Attachment 2.

2. THE PROBLEM

Normal market mechanisms are not working effectively in the retail payments system in Australia and, overall, the community is paying a higher cost for retail payments than is necessary.

In Australia, financial institutions provide the community with a range of instruments – cash, cheques, direct entry, debit cards (EFTPOS) and credit cards – with which to make its payments. With the exception of credit cards, the prices charged by individual financial institutions to their customers for payment instruments, on a "user pays" basis, increasingly take account of the costs incurred in providing those instruments.

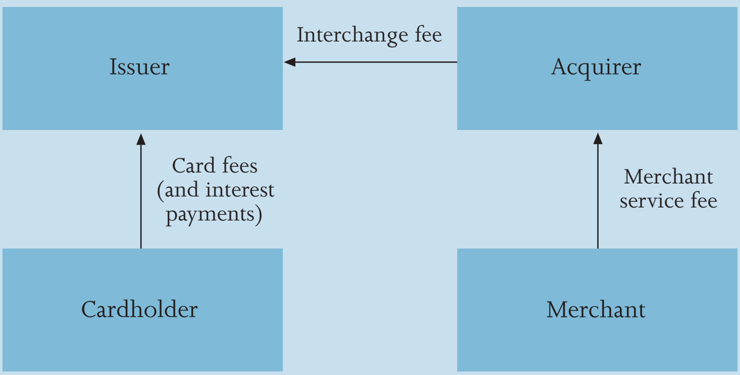
The price signals facing customers using credit cards are established on a different basis. Financial institutions in Australia provide credit card payment services as members of one or more four party credit card schemes – the two international schemes, MasterCard and Visa, and the domestic scheme, Bankcard (Box 1). These schemes have a set of regulations, which their Australian members collectively determine or agree to enforce, that have a significant influence on the prices which financial institutions charge for providing credit card payment services.

Box 1: Four party credit card schemes

The Bankcard, MasterCard and Visa credit card schemes are known as "four party" card schemes because up to four parties are typically involved in the payment process. These parties are:

- the *cardholder*;
- the *issuer*, the financial institution that issues the credit card to its customers;
- the *acquirer*, the financial institution that serves the merchant accepting the credit card for payment; and
- the *merchant*.

The flow of fees (and interest payments) in a four party scheme is shown below.



Price incentives in credit card schemes

The price signals facing consumers choosing between different payment instruments do not promote efficient resource use in Australia's retail payments system. The typical price incentives for a consumer to use a debit card (EFTPOS) or credit card, compared to the costs which financial institutions incur in providing these instruments (from information provided to the Joint Study), are shown in Table 1. In many circumstances, a debit card is a close substitute for a credit card, particularly for cardholders who do not have a cash constraint. Consumers using a debit card typically face a transaction fee of around $0.50 per transaction (beyond a fee-free threshold) for accessing their own funds; this fee is broadly in line with the average cost of providing debit card services ($0.41). Credit cardholders who settle their account in full each month (known as "transactors") pay no transaction

Table 1: Debit and credit card costs*
$ per $100 transaction

	Total cost (issuer plus acquirer)	Costs passed to cardholder
Debit card	0.41	0.50[a]
Credit card	2.01	-0.42 to -1.04[b]

a For transactions beyond the fee-free threshold.

b Includes costs of interest-free period, as defined in the Joint Study (p78), and loyalty points.

* The table excludes annual fees for credit cards and monthly account-keeping fees for deposit accounts. These are fixed costs and not relevant to the decision about which card to use for an individual transaction.

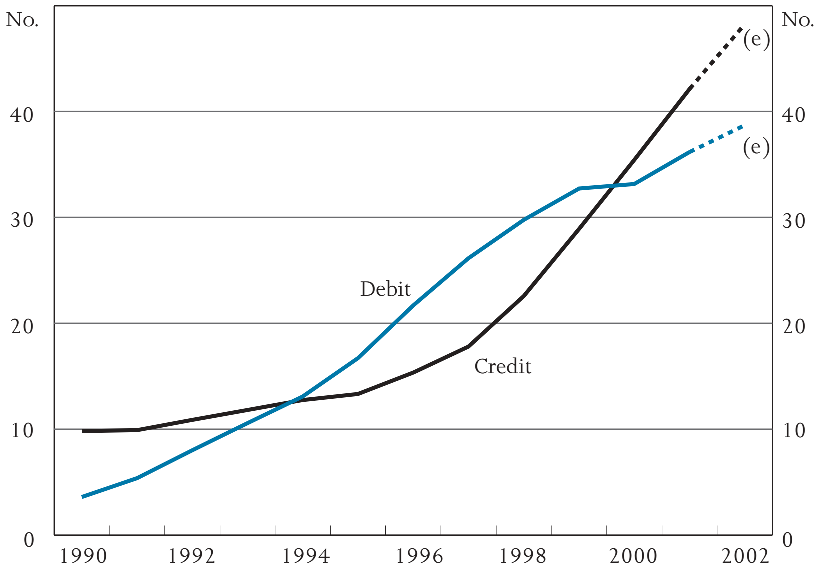
Source: Reserve Bank of Australia and Australian Competition and Consumer Commission (2000) and Reserve Bank of Australia *Bulletin*, July 2001.

fee, and may be paid in the form of loyalty points, for using the funds of their financial institution. In these cases, the benefits from using a credit card can be as much as $1.04 for an average size transaction of around $100, compared to the average cost of $2.01 to provide this transaction (excluding the cost of the revolving credit facility). In response to these price incentives, credit card usage in Australia continues to grow strongly (Figure 1).

This has occurred despite the fact that, for the community, credit cards are one of the most expensive payment instruments provided by financial institutions in terms of the resource costs involved. Merchant service fees on credit cards average 1.8 per cent of the value of each credit card transaction and can be up to four per cent for smaller merchants (Table 2). Survey data from the Australian Retailers Association show that, taking into account the average value of transactions for each payment instrument, credit card transactions in Australia cost merchants over twice as much as cash and substantially more than debit cards (Figure 2). US data show similar relative costs.

Financial institutions promote the credit card most actively because it is the payment instrument for which they receive the highest return. At the same time, it is one of the most costly instruments for financial institutions to provide and one of the most expensive for merchants to accept. Price incentives are therefore encouraging the use of a relatively high-cost payment instrument over lower cost alternatives.

Figure 1: Number of debit and credit card payments per capita
per year



(e) estimate

Source: Reserve Bank of Australia *Bulletin* and ABS Catalogue No. 3101.0.

This structure of price incentives is not the result of normal competitive processes. It is a consequence of the regulatory framework established by the credit card schemes. It is a consequence, as well, of the fact that the same group of banks and other deposit-taking institutions set the fee structures for credit cards and the other main payment instruments in Australia.

Regulations of the credit card schemes

The four party credit card schemes in Australia have regulations that have the effect of suppressing or distorting the normal market mechanisms.

First, each scheme in Australia has interchange fees which are set collectively by members that are otherwise competitors in providing credit card payment services to cardholders and merchants. The interchange fee is the fee paid to the financial institution which issues the card (the "issuer") by the financial institution which provides services to the merchant (the "acquirer") whenever the merchant accepts credit cards for payment. Acquirers pass on interchange fees to their merchants through the merchant service fee, which also includes a margin to cover the costs

Table 2: Merchant service fees on credit cards
per cent, 2000

Annual turnover ($m)	Average	Minimum	Maximum
0.10	2.53	1.36	4.00
0.25	2.30	1.25	4.00
0.50	2.10	0.90	4.00
1.00	1.75	1.00	4.00
2.50	1.68	1.00	3.00
5.00	1.53	1.19	3.25
10.00	1.51	0.90	3.00
25.00	1.47	1.00	3.00
50.00	1.38	1.25	1.50
100.00	1.35	1.25	3.00
500.00	1.30	1.00	3.00

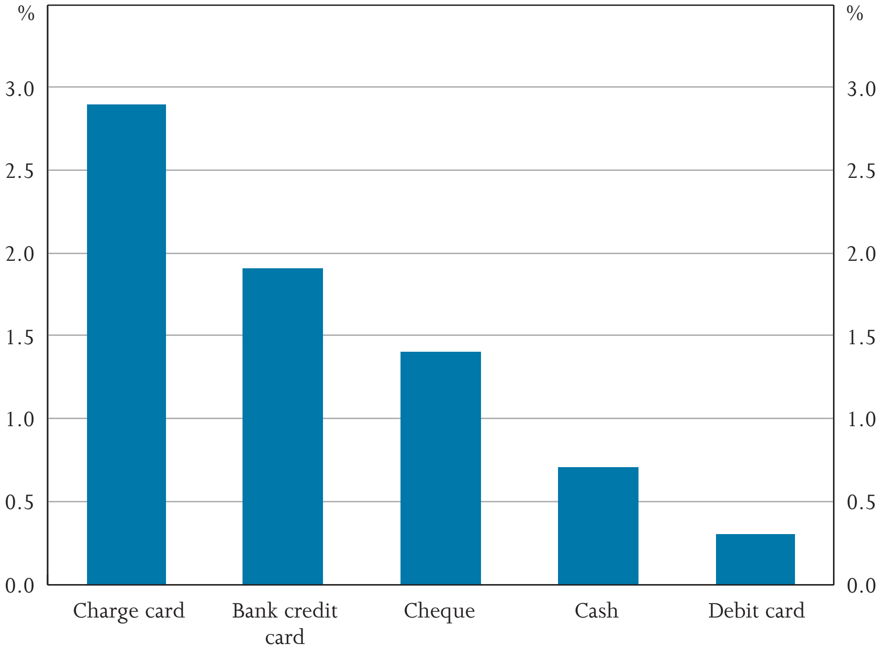
Source: Australian Retailers Association (2001a).

of providing acquiring services. Interchange fees are a type of transfer payment that enables credit card issuers to recover some of their costs from acquirers and, in turn, from merchants. Information provided to the Joint Study by card scheme members showed that the average interchange fee received by issuers in Australia was around 0.95 per cent of the value of each credit card transaction.

Secondly, MasterCard and Visa (but not Bankcard) impose restrictions on merchant pricing (so-called "no surcharge" rules) that deny merchants the freedom to set their own prices. Merchants are not free to pass on the merchant service fee to the users of credit cards. Instead, merchants face an "all or nothing" choice in accepting credit cards and have no alternative but to pass their credit card costs onto all customers, regardless of whether they are credit card users, through the prices of goods and services. Restrictions on merchant pricing constrain the ability of merchants to negotiate with the providers of credit card payment services and ensure that credit cardholders do not face the costs of the payment instruments they are choosing.

Thirdly, each scheme in Australia imposes minimum entry standards that are intended to ensure the safety of the scheme, but have the effect of unduly limiting

Figure 2: Payment costs to Australian retailers*
percentage of average transaction value



* Debit card costs include any rebates that large retailers may receive, and hence understate the processing costs to retailers of a debit card transaction. According to information from the Australian Retailers Association, the processing cost of debit cards for the sample of merchants in Figure 2, abstracting from any rebate, is around 0.4 per cent of the average transaction value.

Source: Australian Retailers Association (2001b).

competition. Generally speaking, only authorised deposit-taking institutions supervised by the Australian Prudential Regulation Authority (APRA) are eligible for participation; in Australia, participants in each scheme are all members of that scheme. Supervision by APRA is a broad-brush requirement that does not directly address the particular risks generated to the schemes by credit card issuers and acquirers. Two of the schemes prohibit their members from acting only as acquirers and two schemes have penalties for members whose business is weighted heavily towards acquiring rather than issuing. Such restrictions and penalties discourage the participation of specialist credit card acquirers which could promote competition in the acquiring market and strengthen the representation of acquiring interests in the process of setting interchange fees. The credit card market in Australia remains a highly concentrated one: the four major banks account for 90 per cent of all credit card transactions acquired by banks and 89 per cent of transactions on cards issued by banks.

Credit card interchange fees play a pivotal role in determining the incentives for consumers to use, and merchants to accept, credit cards. Revenues from interchange fees allow credit card issuers effectively to "subsidise" cardholders to use their credit cards, in the sense that they are charged less than the cost of the credit card payment services they use (or are even offered rebates in the form of loyalty points). The burden of this subsidy falls initially on merchants, but ultimately on the community as a whole.

In Australia, credit card interchange fees are not determined by a competitive market. While it is possible that a collective process may lead to interchange fees being set at an efficient level, the conditions under which this is likely to occur in practice – strong competition between credit card schemes, strong competition between credit cards and other payment instruments, and a balance of issuing and acquiring interests in the fee-setting process – do not prevail in Australia. Interchange fees have been set without any external scrutiny or accountability to the community. Interchange fees have been rigid – until late last year, rates did not change in 27 years in the Bankcard scheme and rates have changed only once in the past decade in the MasterCard and Visa schemes – and the fee-setting process has lacked transparency and any objective benchmarks against which interchange fees might be assessed.

The "checks and balances" that might be expected to influence interchange fees under robust competition in the payments system have not operated in Australia. Overlapping governance arrangements mean that the four major banks dominate the credit card schemes in Australia and are also the main providers of competing payment instruments; because there are no other large credit card acquirers, merchants have not had a strong and independent voice in interchange fee setting. This environment provides no assurance that the current level of interchange fees ultimately passed onto the community is in its interest. Where the competitive environment is not robust, the risk is that collectively set interchange fees can be above an efficient level, allowing issuers to increase their subsidy to credit cardholders and resulting in price signals that encourage the use of credit cards relative to alternative payment instruments.

Summary

In summary, the pricing of credit card payment services is sending consumers a misleading signal about the cost to the community of different payment instruments, while barriers to entry are shielding the members of the credit card schemes from the competitive pressures that non-financial corporations of substance could bring to bear.

The consequence of the current structure of price incentives is that consumers using credit cards are not necessarily those who ultimately bear the costs. The community bears a significant proportion of credit card costs: because merchants have no alternative but to pass merchant service fees into the general level of prices, the costs are borne by all consumers, whether they use a credit card or not. A much larger proportion of credit card costs are borne directly by credit cardholders using the "revolving" line of credit, who pay interest rates significantly above rates on other forms of unsecured lending. Credit card transactors contribute little directly to credit card costs.

3. OBJECTIVE

The objective of the Reserve Bank's reforms is to promote efficiency in the Australian payments system and enhance community welfare by increasing competition and giving greater rein to the workings of the price mechanism.

4. OPTIONS

Three options are available to the Reserve Bank:

- (i) no regulatory action;
- (ii) regulatory action to remove credit card scheme restrictions on access and merchant pricing; or
- (iii) regulatory action to remove these scheme restrictions and to address the collective setting of interchange fees.

No regulatory action

A decision by the Reserve Bank to take no regulatory action would not necessarily mean that interchange fee arrangements in the credit card schemes would continue in their current form. However, credit card scheme restrictions on access and merchant pricing would be expected to remain unchanged.

In a development separate to the Reserve Bank's review of credit card schemes, in 2000 the ACCC instituted proceedings in the Federal Court alleging that the collective setting of interchange fees in the four party credit card schemes in Australia was a breach of the price-fixing prohibitions of the *Trade Practices Act 1974*. Following the Reserve Bank's designation of the credit card schemes, these proceedings were discontinued without any finding by the court. If the Reserve Bank were to take no regulatory action in this area, the credit card schemes and their members could remain at risk under that Act of actions by the ACCC or a third party. To remove this risk, the schemes and their members would probably consider the need to seek authorisation of their interchange fee agreements under that Act.

It is not possible to anticipate the proposals that might be made as a basis for authorisation. Members of the credit card schemes in Australia, which have delegated authority under card scheme rules to determine interchange fees for domestic transactions (ie transactions that involve two Australian members), have acknowledged that reform of the interchange fee-setting process is necessary and, through the Australian Bankers' Association, have accepted that interchange fees should be set in an open, transparent and objective manner. MasterCard and Visa, however, have not acknowledged that reform of interchange fee setting is necessary but have proposed that the methodologies they have applied in some other countries could form the basis for interchange fee setting in Australia.

Restrictions on access in the MasterCard and Visa schemes are international rules on which their Australian members have no delegated authority but which they must enforce; variations are made at the country level if required by local law or, in unusual circumstances, if the schemes decide to vary their membership criteria to encourage growth of particular markets. In Bankcard's case, decisions on membership are taken by its directors.

Neither MasterCard nor Visa has proposed changes to its membership criteria in Australia. MasterCard's rules make provision for participation by a financial institution (not necessarily an authorised deposit-taking institution) provided it is supervised by the relevant government authority. Visa's rules require that, other than in exceptional circumstances, applicants for membership must be authorised to accept demand deposits. In response to concerns raised in the Joint Study, Bankcard announced a significant liberalisation of access to its scheme, which allows non-traditional participants to enter provided their liabilities in respect of the scheme are guaranteed by a financial institution which is prudentially supervised (in Australia or overseas).

MasterCard and Visa prohibit their members from acting only as acquirers (so-called "net issuer" or "balanced portfolio" rules), but such a prohibition no longer applies in Bankcard. Visa has recently advised that it no longer enforces penalties on members whose business is concentrated on acquiring rather than issuing. Bankcard has retained such penalties despite its recent liberalisation of access to membership while MasterCard continues to defend the need for penalties in its scheme in Australia.

As with restrictions on access, restrictions on merchant pricing in the MasterCard and Visa schemes are international rules which are imposed in all countries in which these schemes operate, except in the United Kingdom, the Netherlands and Sweden where local laws prevent them doing so. Both schemes are opposed to the removal of these restrictions in Australia. Bankcard does not impose restrictions on merchant pricing.

Regulatory action on access and merchant pricing

The Reserve Bank has considered whether it could achieve effective reform of the designated credit card schemes if it confined the use of its regulatory powers to ending scheme restrictions on access and merchant pricing.

The Reserve Bank's **access regime** would liberalise access to the credit card schemes by allowing non-financial corporations of substance to become eligible to apply for participation, as either issuers or acquirers or both, through a financial subsidiary that would specialise in credit card activities. Such subsidiaries would need to be authorised and supervised by APRA. They would need to demonstrate to APRA that they have the skills, staffing and operational capacity for the scale of credit card activity proposed, and would have to meet ongoing prudential standards no less strict than those currently imposed by APRA for relevant risks.

Under the access regime, all authorised deposit-taking institutions, including the new class of specialist credit card institutions, would be eligible to apply to participate in the designated credit card schemes in Australia. In assessing applications for participation, the schemes could apply any business or operational criteria they considered appropriate, but they could not discriminate between specialist credit card institutions as a class and other authorised deposit-taking institutions as a class in relation to criteria for participation, or to rights and obligations associated with participation. The access regime would prohibit the imposition of any restrictions or form of penalties on participants seeking to specialise in acquiring; it would also require the schemes to consider on its merits any proposal by an acquirer to acquire the transactions of a related entity, such as its merchant owner.

The Reserve Bank's **standard on merchant pricing** would prohibit restrictions imposed by MasterCard and Visa on the freedom of merchants to charge according to the means of payment. Merchants would therefore be free, if they so wish, to charge a "fee for service" for accepting credit cards. At the same time, an acquirer and a merchant would be able to agree that the amount of any such fee would be limited to the fees paid by the merchant for credit card transactions. The three party card schemes, American Express and Diners Club, impose the same set of restrictions on merchants and would be required to remove these restrictions if a standard on merchant pricing came into force.

Regulatory action on access, merchant pricing and interchange fees

The Reserve Bank considered whether a standard on interchange fees would also be needed to achieve effective reform of the designated credit card schemes. While the ending of scheme restrictions on access and merchant pricing might be necessary to promote competition and market discipline, such action, on its own, might not be sufficient to ensure that the collective setting of interchange fees in Australia, by scheme members that are otherwise competitors, produces a level of interchange fees that is efficient and in the public interest. If not, a standard on interchange fees would also be needed to promote competition and the efficient pricing of credit card services to cardholders and merchants.

The Reserve Bank's **standard on interchange fees** would provide an objective, transparent and cost-based benchmark against which interchange fees in each designated credit card scheme could be assessed. The benchmark, which would be reviewed regularly, would be based on credit card payment services which are provided to merchants and for which card issuers incur costs. Each scheme would be required to publish its interchange fees determined in accordance with this standard.

5. IMPACT ANALYSIS

Parties affected

The impact of the options considered by the Reserve Bank would fall, in different ways, on the following parties:

(i) the community as a whole, including consumers who do not use credit cards;

(ii) credit cardholders;

(iii) merchants that accept credit cards for payment; and

(iv) the credit card schemes and financial institutions which are members of these schemes.

No regulatory action

In the absence of regulatory action by the Reserve Bank, credit card scheme restrictions that suppress or distort the normal market mechanisms would in all likelihood remain largely in place. Neither MasterCard nor Visa has proposed changes to its current membership criteria or to its restrictions on merchant pricing. While Bankcard has liberalised its membership criteria to allow for non-traditional participants (provided they are guaranteed by a supervised financial institution), the potential competitive impact of a new entrant to Bankcard is significantly limited if that entrant cannot also participate in the international credit card schemes. The designated credit card schemes and their members have not indicated a willingness to consider any significant reduction in interchange fees, which underpin current incentives for consumers to use, and merchants to accept, credit cards. As noted, however, it is not possible to anticipate the proposals that might be made if the schemes were to seek authorisation of their interchange fee arrangements under the *Trade Practices Act 1974.*

Under these circumstances, the price signals facing consumers choosing between different payment instruments would continue to encourage the use of credit cards, a relatively costly instrument, over less costly alternatives that provide similar transactional benefits. Merchants would continue to face the cost burden in the first instance. While individual merchants accept credit cards as part of a strategy of winning sales from, or not losing sales to, competitors, no convincing evidence has been provided – in Australia or elsewhere – that merchants as a whole gain a permanent increase in sales by accepting credit cards to offset the higher costs. As a consequence, average costs in the payments system would be higher and the resources that could be directed into other productive uses would be reduced. The Australian community would continue to pay a higher cost for its retail payments system than is necessary.

The consequences of these inefficient price signals for total payments system costs are substantial. As an illustration, Table 3 shows the costs of providing credit and debit card payment services under two different growth scenarios over the next five years. Under Scenario I, growth of credit and debit card usage is assumed to continue at the same rates as the past five calendar years, when the number of credit card transactions grew by 24 per cent per annum and the number of debit card transactions by 12 per cent per annum. Under Scenario II, growth in both payment instruments is assumed to be 18 per cent per annum, the average growth in these two instruments combined over the past five years. If current trends were to continue (Scenario I), the cost of providing the card payment system would be

Table 3: Growth in payments system costs

	Cost per $100 transaction[a] ($)	Annual cost 2001 ($b)	Annual cost 2006 ($b)	
			Scenario I	Scenario II
Credit card	2.01	1.6	4.8	3.7
Debit card	0.41	0.3	0.5	0.6
Total		1.9	5.3	4.3

a Reserve Bank of Australia and Australian Competition and Consumer Commission (2000).

around $1 billion per annum higher after five years than would be the case if growth were more evenly shared between credit and debit cards (Scenario II).

Parties bearing impact of this option

In the absence of regulatory action by the Reserve Bank, the costs of providing credit card services in Australia would continue to be borne by:

(i) credit cardholders who use the revolving line of credit;

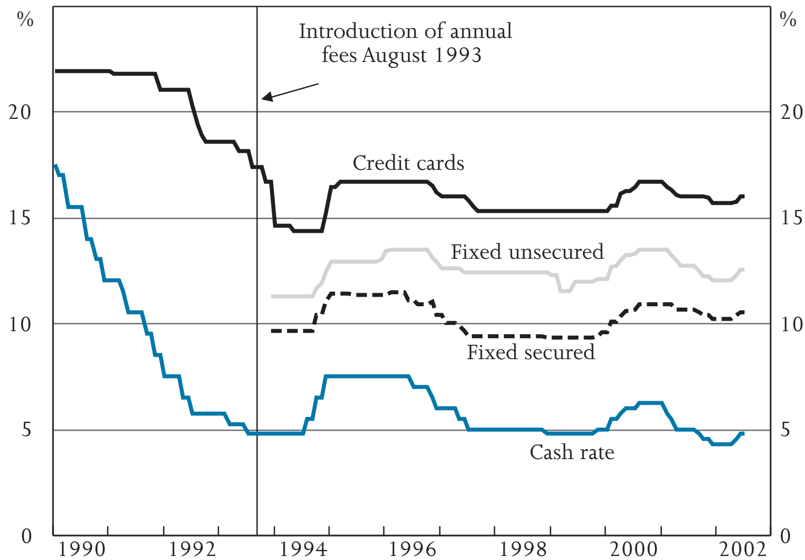
(ii) merchants that accept credit cards for payment; and

(iii) the community as a whole, including consumers who do not use credit cards.

Credit cardholders who do not settle their credit card account in full by the due date generally pay interest rates significantly above rates on other forms of lending. Credit card lending is unsecured and thus riskier than other types of personal credit provided by financial institutions. Nonetheless, interest rates on credit card lending are on average around three percentage points above the rates for other forms of unsecured personal lending (Figure 3) and are not as responsive to changes in funding costs as other retail interest rates (Table 4). In recent interest rate cycles in Australia, financial institutions have passed almost the full amount of official interest rate increases on to credit card interest rates, but only around one-half of official interest rate reductions.

The community also bears the costs of providing credit card services through higher prices for goods and services. In the first instance, the burden falls on merchants that accept credit cards, particularly smaller merchants. As noted, merchant service

Figure 3: Selected interest rates



Source: Reserve Bank of Australia *Bulletin*.

Table 4: Responsiveness of interest rates*
percentage point change

Interest rate cycle	Changes in cash rate target A	Changes in credit card rates[a] B	Changes in mortgage rates[b] C	Responsiveness of: Credit card rates (B/A)	 Mortgage rates (C/A)
Tightening phase 1994	+2.75	+2.35	+1.75	0.85	0.64
Easing phase 1996-1998	-2.75	-1.40	-4.00	0.51	1.45
Tightening phase 1999-2000	+1.50	+1.40	+1.55	0.93	1.03
Easing phase 2001	-2.00	-1.05	-2.00	0.53	1.00

* Measured from peak to trough/trough to peak in the relevant interest rates.
a Midpoint rate of major banks.
b Banks' standard variable housing loan rate; average rate of large lenders.
Source: Reserve Bank of Australia *Bulletin*.

fees on credit cards average 1.8 per cent of the value of each credit card transaction and can be up to four per cent for smaller merchants. The floor on merchant service fees is determined by interchange fees, which average 0.95 per cent per transaction. After paying these fees to issuers, the amount retained by acquirers for providing services to merchants averages around one per cent per transaction, and can be as high as three per cent in the case of smaller merchants. As discussed in the Consultation Document, there is a range of evidence to suggest that, if credit card scheme restrictions were to remain in place, competition in the credit card acquiring market would be less effective than it might be. This evidence includes the level of margins in credit card acquiring (around 67 per cent on information provided to the Joint Study); the proportion of merchant service fees retained by acquirers in Australia (around 50 per cent) compared with acquirers in the United States and Europe (around 20 per cent); and the unwillingness of acquirers in Australia to offer a flat fee for acquiring services in line with the nature of costs incurred by acquirers.

In the absence of regulatory action by the Reserve Bank, merchants would continue to pay a higher price for credit card acquiring services than if more competitive conditions prevailed. They would also be prevented by credit card scheme restrictions from passing merchant service fees onto customers who choose to use credit cards. Merchants would continue to face an "all or nothing" choice – accept credit cards and absorb the merchant service fees into their overall cost structure, or refuse to accept credit cards at all. Their ability to resist credit cards would be increasingly eroded as consumers responded to current price incentives by increasing the take-up of credit cards and demanding to make more and more use of them. Merchants would have only limited negotiating power to put pressure on merchant service fees and, indirectly, interchange fees.

In these circumstances, the community as a whole, not just those who use credit cards, would continue to bear the costs of providing credit card services, in the form of higher prices for goods and services. This burden is diffused over a wide range of markets, in which varying mixes of payment instruments may be used, and over millions of consumers undertaking a myriad of transactions. In total, however, the impact on the general level of prices is likely to be significant. Merchant service fees on credit cards currently cost merchants around $1.5 billion a year. Unless merchants as a whole gain a permanent increase in sales or other benefits from accepting credit cards, this cost is passed into price levels, depending on supply and demand conditions in each market.

Beneficiaries under this option

If credit card scheme restrictions were to remain largely unchanged, the main beneficiaries of the arrangements would continue to be:

(i) credit card transactors who settle their credit card account in full each month; and

(ii) credit card scheme members and the schemes themselves.

Credit card transactors make only a very small contribution to the revenues earned by credit card issuers (Table 5). Transactors pay, at most, an annual fee to hold a credit card but receive interest-free credit and may be eligible for loyalty points which accrue in proportion to the value spent on their credit card. Around one-quarter of credit card balances outstanding do not attract interest. Based on information provided to the Joint Study by card scheme members, revenues received from transactors from annual fees fall short of the cost of providing the interest-free period and loyalty points by around $90 million a year. That is, transactors are subsidised by this amount each year.

A continuation of current price incentives would be expected to increase the size of the transfer from the community to credit card scheme members. Credit card issuing and acquiring are currently very profitable activities in Australia. Information provided to the Joint Study by card scheme members showed that the provision of credit card services generates revenues well above average costs, especially for

Table 5: Direct contributions to issuing revenues
per $100 transaction, 1999

	$	%
Revolvers[a]	1.64	61.2
Transactors[b]	0.10	3.5
Merchants[c]	0.95	35.3
Total revenues	**2.69**	**100.0**

a Interest payments plus 75 per cent of revenue from annual fees and other sources.

b 25 per cent of revenue from annual fees and other sources.

c Interchange fee revenue.

Source: Reserve Bank of Australia (2001).

financial institutions which are both significant card issuers and acquirers. The margins are particularly wide in credit card acquiring (Table 6). Although card scheme members were generally unable to supply suitable capital data, indicative figuring by the Reserve Bank – based on the main risks against which capital would be held – suggested that the margins in credit card issuing and acquiring were well above what would be required to provide a competitive rate of return on capital.

The designated credit card schemes would also continue to benefit from current arrangements. MasterCard and Visa earn revenue from credit card activities in Australia through their operational role in providing switching facilities to participants. The schemes typically charge their members a flat fee per transaction for processing transactions through their switch, a source of income which has risen significantly over recent years in line with the strong growth in the number of credit card transactions.

Regulatory action on access and merchant pricing

The Reserve Bank's access regime and standard on merchant pricing would remove two impediments to effective competition and improved efficiency in the Australian payments system.

Table 6: Credit card issuing and acquiring
costs and revenues per transaction
$, 1999

Issuing		Acquiring		
Revenues	2.69	Revenues		1.78
		Direct costs	0.43	
		Interchange paid	1.06	
Direct costs	1.93	Costs		1.49
Margin	0.76	Margin		0.29
(mark-up over direct costs)	(39%)	(mark-up over direct costs)		(67%)
Costs of loyalty programs	0.46			

Source: Reserve Bank of Australia and Australian Competition and Consumer Commission (2000).

The access regime would remove the current barriers to entry to the designated credit card schemes for non-financial corporations, but without compromising the safety of the schemes. Non-financial corporations of substance would become eligible to apply to participate in the schemes in their own right, through a financial subsidiary that would specialise in credit card activities. Such subsidiaries would form a new class of specialist credit card institutions, to be authorised and prudentially supervised by APRA. Competition from such non-traditional players, particularly those able to take advantage of scale economies in processing or funding, would improve the range and pricing of credit card payment services to cardholders and merchants. This is consistent with the objective of the reforms recommended by the Financial System Inquiry that non-traditional institutions be able to compete in payment technologies as a means of increasing competition and lowering costs.

The standard on merchant pricing would remove a restraint on trade imposed by MasterCard and Visa that denies merchants the freedom to set prices for customers that promote the competitiveness of their business. The standard would ensure that a merchant accepting a MasterCard or Visa credit card is free to charge according to the means of payment; if it so wished, it could charge a "fee for service" for accepting the credit cards of these schemes.

Beneficiaries under this option

The lifting of credit card scheme restrictions on access and merchant pricing through Reserve Bank regulatory action would benefit:

- (i) credit cardholders who use the revolving line of credit;
- (ii) merchants that accept credit cards for payment; and
- (iii) the community as a whole, including consumers who do not use credit cards.

Cardholders who use the revolving line of credit would benefit from stronger competitive pressure on credit card interest rates. As with the market for residential mortgages in Australia in the 1990s, when the entry of specialist mortgage originators pushed spreads between the standard mortgage rate and the cash rate from four to below two percentage points, new entrants would provide scope for greater competition in credit card issuing.

Merchants, and ultimately the community, would benefit from the participation of specialist credit card acquirers with new skills and efficiencies to bring to the designated credit card schemes. The credit card acquiring market, as noted above, is one in which more effective competition is needed to put pressure on merchant service fees and improve efficiency. So-called "net issuer" or "balanced portfolio" rules in MasterCard and Visa prohibit participants acting only as an acquirer, while the MasterCard and Bankcard schemes have financial penalties for participants whose activities are more heavily weighted towards acquiring than issuing. The access regime precludes any "net issuer" or "balanced portfolio" rules and associated financial penalties or loadings.

Freedom for merchants to charge according to the means of payment would introduce normal market disciplines into negotiations between merchants and acquirers over merchant service fees, and eliminate the "all or nothing" choice currently facing merchants deciding whether to accept credit cards. In principle, the higher are merchant service fees levied by an acquirer, the more likely is the merchant to pass the fees onto credit cardholders. Some merchants that had previously refused to accept credit cards because of their costs might decide to do so when they can pass these costs onto credit cardholders. A larger network of merchants accepting credit cards would be of benefit to all credit cardholders. Smaller merchants paying the highest merchant service fees would have a better negotiating position and would benefit, more generally, from greater competition in the credit card acquiring market.

If overseas experience is a guide, the removal of scheme restrictions on merchant pricing may not have a large impact on the pricing strategies of merchants. Many merchants may judge that it is not worth their while to charge a "fee for service" for accepting credit cards, or may be under strong competitive pressure not to do so. To the extent that merchants do charge, however, consumers choosing between different payment instruments would face price signals that were more reflective of the costs of providing these instruments; the higher costs of credit cards would not need to be built into the overall cost structure of these merchants so consumers using less costly payment instruments would gain from a lowering of prices. Overall, the community would benefit from more efficient price signals.

Parties bearing impact of this option

The Reserve Bank's regulatory actions, by promoting competition and efficiency, would be likely, over time, to reduce the size of the transfer from the community to financial institutions from credit card usage. This would have an impact on:

(i) credit card schemes and their members; and

(ii) credit cardholders.

Incumbents in the designated credit card schemes would face greater competition in both credit card issuing and acquiring, putting pressure on profit margins. If growth in the number of credit card transactions were to slow as consumers switched to other payment instruments in response to more efficient price signals, the profit projections of incumbents would need to be scaled back. The credit card schemes themselves would expect to experience a slowing in the growth of revenue from processing fees for the same reason.

The force of competition would determine how individual card issuers respond in pricing their credit card services to credit cardholders. If merchants were to charge a "fee for service" for accepting credit cards, cardholders using their credit cards at these merchants would face more of the resource costs of providing credit card payment services. They would, of course, have the option of avoiding those costs by switching to lower cost payment instruments.

Over time, the Reserve Bank's regulatory actions would also inject greater market discipline into the setting of interchange fees in the designated credit card schemes. The participation of specialist credit card acquirers would give merchants a stronger and more independent voice in the fee-setting process, while the freedom of merchants to charge according to the means of payment would strengthen the balancing forces on collective interchange fee setting. Issuers in a scheme seeking to increase interchange fees would be forced to reconsider the level of these fees if merchants passed the resulting higher merchant service fees onto cardholders, thereby discouraging credit card usage.

The time-frame for achieving greater market discipline on interchange fees is, however, uncertain. What is required is a credible threat of entry to the acquiring market by one or more non-traditional participants of substance, and effective pressure on merchant service fees from merchant freedom to charge according to the means of payment. Until such requirements are met, the collective fee-setting process in each of the designated credit card schemes would continue to be dominated by the four major banks, the main suppliers of credit card services and most other payment instruments in Australia, and there would be no assurance that interchange fees were being set at an efficient level.

Regulatory action on access, merchant pricing and interchange fees

The Reserve Bank's standard on interchange fees would provide objectivity and transparency to the process by which interchange fees are collectively set in the designated credit card schemes. By requiring that interchange fees meet a cost-based benchmark, based on credit card payment services that are principally of benefit to merchants, the standard would ensure that merchants, and the community as a whole, did not bear credit card costs that arise out of the provision of specific credit card services to cardholders.

The outcomes of the standard on interchange fees would be determined by the cost calculations to be carried out by participants in each of the designated credit card schemes. On the basis of the most recent costs provided to the Reserve Bank by each of the four major banks, the standard would be likely to result in a significant reduction in the average of interchange fees in Australia from the current level of around 0.95 per cent of the value of each credit card transaction. Since interchange fees set a floor for merchant service fees, the reduction in interchange fees would be expected to result, *pari passu*, in lower merchant service fees. Competition would be expected to ensure that these lower fees were, in turn, passed through to the final prices of goods and services.

Beneficiaries under this option

The Reserve Bank's standard on interchange fees would reinforce the impact of regulatory action on access and merchant pricing in improving competition and efficiency in the Australian payments system. Additional to the benefits accruing under option (ii), the parties benefiting from the standard on interchange fees would be:

(i) merchants that accept credit cards for payment; and

(ii) the community as a whole, including consumers who do not use credit cards.

Merchant service fees on credit cards cost merchants around $1.5 billion a year. Regulatory actions under option (iii) would strengthen competitive pressure on these fees and reduce average costs for merchants: each 0.1 percentage point reduction in merchant service fees would involve a reduction of around $100 million in the size of the transfer from the community to financial institutions. To the extent that merchants avail themselves of their freedom to charge a "fee for service" for accepting credit cards, the costs of accepting credit cards would no longer be reflected in the prices of goods and services paid by all consumers.

By requiring that the designated credit card schemes publish their interchange fees, the standard would improve transparency in the fee-setting process and ensure that merchants, and the community as a whole, know the costs that are being passed to them through interchange fees. Identifying the specific cost categories that make up the cost-based benchmark would also give card scheme members and merchants an incentive to address these costs.

Parties bearing impact of this option

Additional to the impact of option (ii), the parties bearing the impact of the standard on interchange fees would be:

(i) credit card schemes and their members; and

(ii) credit cardholders.

A significant reduction in average interchange fees would mean a reduction in interchange fee revenues for all credit card issuers. Revenues from this source account for about one-third of revenues from credit card issuing. There is no reason to expect that the reduction in interchange fee revenues would fall disproportionately on small and efficient credit card issuers, but high-cost issuers might find the reduction difficult to manage. The credit card schemes would expect to experience a slowing in the growth of revenue from processing fees if the Reserve Bank's regulatory actions, taken together, led consumers to switch to lower-cost payment instruments.

It would be a matter for individual card issuers, in competition with other issuers, to determine how they would respond to lower interchange fee revenues. Current levels of profitability are high and some issuers might absorb some or all of the reduction in revenues. Other issuers might want to wind back the subsidies received by credit card transactors by moving in the direction of the "user pays" approach they take in pricing other payment instruments that they provide. In contrast to some other countries where transaction fees and charges for payment instruments are rare, Australian consumers typically pay for their payment services. Financial

Table 7: Expected impact of reforms on financial institutions

	Revenues $b, 2001	Expected impact
Interchange fees	0.9	Downward pressure from standards on interchange fees and on merchant pricing, and from access regime
Margin on acquiring services	0.8	Downward pressure from standard on merchant pricing and access regime
Interest margin on credit card borrowings	1.6	Downward pressure from access regime
Annual fees	0.2	Downward pressure from access regime; upward pressure from standard on interchange fees

institutions have levied fees on cheque and debit card (EFTPOS) transactions for some years, and the fees are increasingly related to the costs of providing these services.

The expected impact of the Reserve Bank's regulatory actions, taken together, on the revenues earned by financial institutions from credit card activities is summarised in Table 7.

6. CONSULTATION

Throughout the reform process, the Reserve Bank has attached high priority to consultations with interested parties.

The Joint Study published in October 2000 generated considerable comment from all sections of the community, including the credit card schemes, financial institutions, merchants and consumer representatives. In the six-month period before the designation of the three credit card schemes in April 2001, the Reserve Bank received 22 written submissions containing a wide range of views on the findings of the Joint Study and recommendations both for and against regulatory action.

Following the designation, the Reserve Bank received a further 45 written submissions over the remainder of 2001. It considered all of the material provided and held numerous meetings with organisations which had made submissions to discuss their comments in detail. This consultation process culminated in the publication of the Consultation Document in December 2001. The Consultation Document reviewed the main regulations of the four party credit card schemes from the public interest viewpoint, taking into account the issues raised in the submissions. It provided extensive discussion of the purpose and effect of the Reserve Bank's proposed reform measures in promoting efficiency and competition in the Australian payments system. At the same time, the Reserve Bank published a commissioned report on the operations of credit card schemes from an international expert in network economics, as well as all of the prior public submissions it had received.

As required under the *Payment Systems (Regulation) Act 1998*, the Reserve Bank invited submissions from interested parties on its proposed reform of credit card schemes, by a date specified to be 15 March 2002. Submissions were received by that deadline from 28 organisations and a number of members of the public. The Reserve Bank has considered all of those submissions in finalising its reform measures. Comments and other material were also received after the submission deadline, which the Reserve Bank has also considered. A list of organisations that provided submissions and other material is in Attachment 3.

All organisations that made formal submissions were invited to discuss them with Reserve Bank staff. Some 52 such meetings were conducted between mid-March 2002 and August 2002; of that total, 15 separate meetings were held with the designated credit card schemes. The Reserve Bank also received extensive correspondence from these schemes regarding the Consultation Document and the proposed reforms, to which it has provided detailed written responses. Two of these schemes or their agents made a total of nine requests for information under the *Freedom of Information Act 1982* and sought three internal reviews of the Reserve Bank's decisions on those requests.

With the exception of the designated credit card schemes, the overall tone of the submissions received by the Reserve Bank is one of acceptance of the need for reform of credit card schemes in Australia, although views on what shape such reforms should take varied widely. The main views provided in the submissions and related material are summarised in this Section. Some of the submissions also provided helpful comments and suggestions on the drafting of the standards and access regime, which the Reserve Bank has accepted. This is discussed in the following Section.

Designated credit card schemes

The designated credit card schemes are opposed to the Reserve Bank's reforms. They argue that the regulations imposed by the schemes themselves are essential to ensure that credit card networks reach their optimum size and maximise community welfare.

The schemes argue that scheme regulations are needed to allow credit card services, provided in four party schemes as a "joint product", to be profitably supplied to both merchants and cardholders, with benefits for the community in the form of higher levels of consumption and lower cost payments. The schemes dispute the conclusions of the Consultation Document that there is no convincing evidence that credit cards lead to a permanent increase in aggregate consumption. They also dispute the evidence that credit cards are a relatively high-cost means of payment, claiming that credit cards generate a range of unmeasured transaction benefits to merchants and cardholders that other payment mechanisms do not provide. One card scheme provided the results of a survey on the cost of cash for a small sample of merchants in Australia, which it used to argue that the costs of cash are understated and that cash is more expensive for merchants than credit cards. More generally, the schemes claim that the Reserve Bank's proposed reforms focus on the costs of providing payment instruments and do not take sufficient account of the different benefits they offer.

None of the schemes supports the need for a standard on interchange fees. They argue that competition between credit card schemes and between credit cards and other means of payment such as debit cards and cash means that interchange fees in Australia are as close to their optimal levels as possible. They cite the consistently strong growth over recent years in the number of merchants accepting credit cards, in the number of cardholders and in the number of credit card transactions as evidence that current interchange fee arrangements are efficient and meet the demands of both merchants and cardholders. The schemes claim that interchange fees in Australia are amongst the lowest in the world.

The credit card schemes argue that, even if there were problems with current interchange fee arrangements, the Reserve Bank's proposed approach would be counterproductive. They claim that the balances to be struck are so complex that there is no reason, either in theory or practice, to expect that regulatory action could do better than a collective fee-setting process. In particular, the schemes claim that the Reserve Bank's cost-based methodology is too narrow. The draft standard on interchange fees proposed that issuers' costs eligible for inclusion in interchange fee calculations would be confined to:

- costs incurred in processing transactions; and
- costs for fraud, fraud prevention and authorisation incurred in providing any payment guarantees.

The schemes argue that, if a cost-based methodology were to be introduced, there are additional costs that should be borne by merchants, such as costs of funding the interest-free period, credit losses and the costs of credit card loyalty programs. The schemes argue that any significant reduction in interchange fees would lead to the demise of four party credit card schemes in Australia because of cardholder sensitivity to any increase in fees or reduction in current incentives such as loyalty points. On the contrary, the schemes argue that continued expansion in credit card usage afforded by interchange fees set entirely by the schemes is in the public interest because of the substantial community benefits.

MasterCard and Visa have proposed to the Reserve Bank that the methodologies they have applied in some other countries could form the basis for interchange fee setting in Australia, without the need for a standard on interchange fees. MasterCard has advised that its methodology used in some other countries treats the interchange fee as the means by which issuers recover costs for specific services provided to acquirers (and hence to merchants). In addition to the eligible costs defined in the draft standard, costs include funding the interest-free period and credit losses. Visa has advised that its methodology used in some other countries treats the interchange fee as a financial adjustment which reduces the imbalance between the costs of credit card issuing and acquiring. The methodology is treated by Visa as secret.

The international credit card schemes oppose the Reserve Bank's proposal to remove scheme restrictions on merchant pricing (so-called "no-surcharge" rules). They argue that these restrictions are integral to credit card schemes because they ensure that cardholders are not discouraged from using their credit cards, from which both they and merchants receive benefits. One scheme provided an economic model which simulated the choice between cash and credit cards to argue that removal of the restrictions would be inconsistent with maximising community welfare. The schemes also claim that removal of the restrictions would give large merchants, or merchants in remote areas, power to exploit consumers. Conversely, the schemes claim that removal of the restrictions will be ineffective because merchants in countries where such restrictions have been abolished (the United Kingdom, the Netherlands and Sweden) have not adopted surcharging in any material way, and because merchants in Australia are already free to offer discounts for cash.

The designated credit card schemes argue that the Reserve Bank's standards on interchange fees and on merchant pricing, taken together, would confer a strong competitive advantage on the three party schemes and would encourage cardholders and financial institutions to migrate to the latter schemes. The designated credit card schemes claim that a reduction in interchange fees would mean that issuers would no longer be able to offer loyalty programs with the previous level of rewards, while the three party schemes would not be forced by competitive pressures to match the corresponding reductions in merchant service fees. The effect on competition would be accentuated, it is argued, if three party schemes were allowed to maintain their restrictions on merchant pricing. Submissions from the three party schemes, on the other hand, argue that these schemes would not be immune from competitive pressure on merchant service fees, particularly if restrictions on merchant pricing were lifted for all schemes.

The designated credit card schemes argue that the Reserve Bank's proposed access regime is not needed. The international credit card schemes interpreted the access regime as mandating that all institutions supervised by APRA be granted membership in the schemes and that schemes would not be allowed to impose their own risk management or other criteria in assessing applications for membership. The schemes also argue that there are avenues for non-traditional organisations to become involved in credit card activities through co-branding or outsourcing arrangements. If the access regime were to be introduced, however, there was support for APRA's role in authorising and prudentially supervising applicants for participation in the schemes, subject to the opportunity to assess

APRA's draft prudential standards for the new class of specialist credit card institutions.

Two card schemes oppose the prohibition on "net issuer" or "balanced portfolio" rules and two card schemes oppose the prohibition on financial penalties and loadings for participants seeking to specialise in acquiring. One card scheme argues that these prohibitions would lead financial institutions to cease issuing its cards and would reduce competition between card schemes. One card scheme expressed concerns about the elimination of the prohibition on self acquiring.

Financial institutions

The Reserve Bank received nine submissions from financial institutions which are participants in the designated credit card schemes, and their respective industry associations. Most financial institutions accept that interchange fees in these schemes should be determined on the basis of an objective, transparent and cost-based methodology, but argue that the categories of costs that the Reserve Bank proposed for inclusion in the standard on interchange fees are too restrictive. Most institutions support an interchange fee model set out in the submission by the Australian Bankers' Association, involving a wider range of cost categories which were claimed to be at the core of the credit card product.

Some financial institutions argue that the concept of an "outsourced store card" provides the appropriate analogy for considering interchange fees in four party card schemes. On this view, merchants that accept credit cards are effectively "outsourcing" the provision of a proprietary store credit card; they should therefore pay for whatever costs they would otherwise incur if they were to issue a card themselves. As a minimum, the cost of funding the interest-free period should be included in the interchange fee, on the basis that the interest-free period is a defining feature of most credit cards compared to other payment instruments. Other costs that could be included on this argument are marketing costs such as loyalty programs and advertising costs, capital costs and periodic cardholder-related costs, such as statement production and mailing and the processing of account payments; some institutions would add the cost of credit losses, including credit losses on cardholders who do not have a revolving credit balance and thus may not have paid any interest.

Some financial institutions argue that there would be no reason, in the public interest, for a standard on interchange fees if restrictions on merchant pricing were removed and access to credit card schemes liberalised. Under this scenario, which was considered as option (ii) in Section 4 above, changes in interchange fees would lead to changes in prices facing credit cardholders, and rebates to these cardholders, of the same amount and in the same direction; the interchange fee would therefore be "neutral" in that it would not affect net prices to consumers or market behaviour. This view is supported by two academic economists who commented independently on the Reserve Bank's reforms. These economists also argue that where there are different payment instruments that each benefit from larger network size, the goal of maximising the economic welfare of both merchants and customers would most likely be met by policies that aim at minimising the total cost of the payments system.

In general, financial institutions do not object to the abolition of scheme restrictions on merchant pricing or the proposed access regime. Some financial institutions strongly support elimination of "net issuer" rules and associated financial penalties and loadings.

Merchants and other non-financial corporations

The Reserve Bank received submissions from 11 retailers and other non-financial corporations, including technology companies, energy companies, small business owners and associations representing these groups; four other parties offered comments after the March 15 deadline. Most submissions support the Reserve Bank's standard on interchange fees. Some, however, dispute the view that merchants should contribute to the cost of credit card issuing and argue for the abolition of interchange fees altogether. On this view, issuers and acquirers should recoup their costs directly from their customers on a "fee for service" basis.

Most of the submissions support the abolition of restrictions on merchant pricing and the liberalisation of access to the credit card schemes, although one submission raised concerns about the potential impact of a "fee for service" for credit card acceptance on inward tourism, where many visitors use credit cards. Some smaller merchant associations claim that the Reserve Bank's reforms could benefit larger merchants at their expense, on the argument that larger merchants will charge a "fee for service" for credit card usage to encourage customers to switch to the store cards of these merchants and patronise their shops in preference.

Consumer representatives

The Reserve Bank received submissions from two consumer organisations and comments from a number of members of the public. Consumer groups support the Reserve Bank's reforms, on the basis that the current inefficiencies and distortions in credit card schemes are increasing costs for all consumers. At the same time, they recommend maintaining a watching brief on the use of a "fee for service" for credit card acceptance so that merchants do not exploit this freedom.

Of the comments from individuals, some are strongly supportive of the Reserve Bank's reforms while others are concerned that they would be charged higher fees for credit card services.

Consultation with other government agencies

The Reserve Bank has kept the ACCC informed throughout the development of its reform measures. It has worked with the Australian Securities and Investments Commission (ASIC), and will be consulting with State and Territory fair trading authorities, to ensure that the disclosure requirements imposed on merchants by fair trading legislation are clear to merchants that choose to charge according to the means of payment. The Reserve Bank has also consulted with APRA about the draft authorisation guidelines and prudential standards for the new class of specialist credit card institutions.

7. CONCLUSION AND FINAL REFORM MEASURES

The Reserve Bank has considered the views put to it in submissions from and discussions with a wide range of interested parties.

The Reserve Bank acknowledges the widespread acceptance of credit cards in Australia and the benefits that they can provide to individual cardholders and merchants. At the same time, however, it is not persuaded by arguments that allowing normal market mechanisms to operate more effectively in the Australian payments system is against the community's interest. It does not accept that continued growth in the use of credit cards at the expense of alternative payment instruments necessarily adds to the community's welfare. In particular, it remains of the view that the benefits of credit cards to cardholders and merchants as a whole – in the form of a permanent increase in sales or a reduction in transaction costs – are overstated. Other payment networks can also gain from being larger in size and the mix of payment instruments in these circumstances ought to be one for consumers to decide in a competitive market place, in response to efficient price signals. These conditions do not prevail in the retail payments system in Australia.

The Reserve Bank accepts that interchange fees can play a role in redressing imbalances between the costs and revenues of issuers and acquirers in four party credit card schemes. However, it is not convinced that community welfare would be maximised if the setting of interchange fees, which play a pivotal role in determining price incentives for cardholders and merchants, were left entirely to the schemes and their members in Australia without any external scrutiny or accountability to the community. The Reserve Bank does not accept that interchange fees are collectively set in Australia under strong competitive conditions. Such claims are not consistent with the dominant position of the four major banks in the credit card schemes, the limited ability of merchants to resist credit cards or with the rigidity, lack of transparency and common level of interchange fees in the schemes over many years.

In the absence of rigorous theoretical guidance, credit card schemes adopt different methodologies as a basis for determining interchange fees. The designated credit card schemes argue against the need for the Reserve Bank to determine a standard on interchange fees. Their members, however, have accepted that interchange fees should be set on the basis of an objective, transparent and cost-based methodology. The schemes have rejected the cost-based methodology in the Reserve Bank's standard on interchange fees, but two of the schemes have proposed alternative methodologies which are also cost-based. Bankcard has argued for the inclusion of a wide range of additional costs on the "outsourced store card" argument, which is discussed further below. MasterCard has proposed the interchange fee methodology it uses in some other countries, which includes the cost of credit losses. In Australia, cardholders using revolving credit facilities are fully covering average credit losses by paying interest rates well above rates on other unsecured personal lending. If card scheme members were to include credit losses in interchange fee calculations, card issuers would be recovering the costs of credit losses twice. The alternative cost-based methodologies would therefore have the effect of charging to merchants, and to the community as a whole, credit card costs that arise out of the provision of specific credit card services to cardholders.

Visa, on the other hand, eschews a cost-based approach in favour of a "balancing" methodology, which it treats as secret. Visa has provided the Reserve Bank with a listing of cost and revenue categories on which information is collected from Visa participants, but no details on the methodology itself or how it is applied. The methodology therefore does not meet a basic test of transparency. Both MasterCard and Visa have advised that they use their methodologies only as a guide to setting interchange fees and that they also exercise commercial judgment in determining the level of fees.

The methodologies applied by the international credit card schemes have been under official review in some other industrial countries. In the United Kingdom, the Office of Fair Trading (OFT) notified MasterCard/Europay in September 2001 that it proposed to make a decision that agreement among MasterCard/Europay members on the level of their multilateral interchange fee is in breach of UK competition law and does not qualify for exemption. The OFT considers that the agreement on this fee increases retail costs and the prices paid by consumers for goods and services. The OFT has yet to make a final decision.

Visa has made major changes to its approach in the case of its cross-border interchange fees in Europe in response to concerns about its methodology – including the lack of transparency – expressed by the European Commission. To receive an exemption under European Union competition rules, Visa proposed moving to a cost-based methodology that would be used as an objective benchmark against which its cross-border interchange fees would be assessed. This proposal was accepted by the European Commission in July 2002. Cross-border interchange fees will now be capped at the level of costs for certain specific services – transaction processing, the payment guarantee (including fraud costs and credit losses) and the interest-free period – provided by Visa card-issuing banks. The actual level of these fees will be the lower of this cap and the staged reduction in weighted average interchange fees, to 0.7 per cent in 2007, offered by Visa.

The international credit card schemes remain opposed to removal of their restrictions on merchant pricing, and have done so in other jurisdictions only when required by authorities to do so. None of the designated credit card schemes has offered to liberalise its minimum entry standards under which, broadly speaking, only authorised deposit-taking institutions supervised by APRA are eligible for membership. Two of the schemes retain "net issuer" or "balanced development" rules and two schemes impose penalties on members whose business is weighted heavily towards acquiring rather than issuing.

Overall, there is little prospect of significant change to the *status quo* if the regulations of the credit card schemes, which their Australian members collectively determine or agree to enforce, remain in place. The Reserve Bank has not been convinced by the arguments that these private-sector regulations are to be preferred, in the public interest, to the freeing up of the normal market mechanisms to promote competition and efficiency in the Australian payments system. The Reserve Bank has therefore rejected option (i) of taking no regulatory action. It believes that regulatory action is necessary to address the problem that the Australian community is paying a higher cost for its retail payments system than it would if the normal market mechanisms were working effectively.

The Reserve Bank has also rejected option (ii) under which it would confine the use of its regulatory powers to ending scheme restrictions on access and merchant pricing. Taking these steps would be consistent with the Reserve Bank's objective of giving greater rein to normal competitive processes and would, over time, inject greater market discipline into the setting of interchange fees in the designated credit card schemes. The Reserve Bank does not accept that removal of the restraint on trade imposed on merchants by the international credit card schemes is against the public interest because merchants with monopoly power might seek to exploit consumers. Even if some consumers might have little choice about where to shop, they can switch to other payment instruments if they think that any "fee for service" charged by a merchant for credit card acceptance is too high.

On its own, however, regulatory action under option (ii) is unlikely to create a strong competitive environment quickly. Such an environment requires the emergence of a credible threat of entry to the acquiring market by one or more non-traditional participants of substance, and the establishment of merchant freedom to charge according to the means of payment as an effective discipline on merchant service fees. Until there is more robust competition, the circumstances under which credit card interchange fees are collectively set in Australia create the risk that interchange fees would not be set at an efficient level, resulting in distorted price signals to cardholders and merchants.

For these reasons, the Payments System Board has decided that the Reserve Bank will introduce a package of reforms, discussed as option (iii), to promote greater competition and a more efficient allocation of resources in the Australian payments system. The reform measures, introduced under the *Payment Systems (Regulation) Act 1998*, involve:

- a standard on interchange fees that involves an objective, transparent and cost-based benchmark against which interchange fees in the designated credit card schemes can be assessed;
- a standard on merchant pricing that removes the restriction imposed by the international credit card schemes on the freedom of merchants to charge according to the means of payment; and
- an access regime that removes the restrictions on the eligibility of non-financial institutions to apply to participate in the designated credit card schemes, and removes "net issuer" and "balanced development" rules and associated financial penalties that disadvantage participants seeking to specialise in acquiring.

American Express and Diners Club have each given an undertaking to the Reserve Bank that they will remove their restrictions on merchant pricing when the standard on merchant pricing comes into force. These undertakings are set out in Attachment 4. Hence, no one credit or charge card scheme will have a competitive advantage over any other in this respect.

The Reserve Bank's reforms are consistent with the broad objectives of the Government's competition policy. They will allow normal market mechanisms to work more effectively in the Australian payments system and reduce its overall costs to the community. This will be achieved through:

- lower merchant service fees as a direct consequence of reduced interchange fees, which will pass through to consumers in the general level of prices;
- greater market discipline on merchant service fees because of the freedom of merchants to recover their credit card costs from cardholders;
- more efficient and transparent pricing of credit card services to cardholders and merchants; and
- greater competition in the provision of credit card services to cardholders and merchants from the entry of non-financial corporations of substance.

The principles that consumers should face prices that take into account the relative costs of producing goods and services, as well as demand conditions, and that resources should be free to enter a market in response to above-normal profit opportunities, have been the guiding principles for tariff reform and market deregulation in Australia. Such market reforms may impact unevenly on different groups – some gaining, some losing – but they are now the well-established route to more efficient use of resources in the Australian economy. The Reserve Bank's reforms are fully in line with these principles. The reforms will have a direct impact on credit cardholders and are likely to result in some re-pricing of credit card payment services, but such a move towards "user pays" is the means by which the price mechanism directs users of the payments system towards the most efficient choice of payment instruments.

The Reserve Bank does not accept that its reforms of the designated credit card schemes constitute a regulatory bias that favours the three party card schemes, American Express and Diners Club. Such a claim neglects the dominant market position of the four party schemes in Australia, whether measured in terms of their share of the credit and charge card market, the size of their merchant base or the number of consumers who hold cards of both types of schemes. The Reserve Bank has not been persuaded that competition in the payment card market, strengthened by its reform measures, will encourage the growth of the smaller, higher cost card schemes over the larger, lower cost schemes in Australia. On the contrary, the freedom of merchants to charge a "fee for service" for credit and charge card acceptance can be expected to put strong competitive pressure on the higher cost card schemes and ensure that these schemes also bear the impact of the Reserve Bank's reforms.

While the purpose and likely effect of the Reserve Bank's reforms are unchanged from the draft standards and access regime released in December 2001, the consultation process has been valuable in identifying the main public interest issues involved in the operation of credit card schemes in Australia and in allowing interested parties to seek further information about the proposed reforms. A number of submissions also offered suggestions for simplifying the drafting of the standards and access regime, which the Reserve Bank has incorporated in the final versions.

Standard on interchange fees

The main variations to the draft standard on interchange fees involve:

(i) application of the objective, transparent and cost-based methodology to calculate a "benchmark" for interchange fees in each designated credit card scheme rather than to calculate interchange fees for different categories of transactions; and

(ii) inclusion of additional "eligible costs" in the cost-based methodology.

The draft standard provided for differential interchange fees for different types of transactions (electronic vs other) and differences in the credit card payment services provided to merchants (payment guarantee vs no payment guarantee), each to be calculated on the basis of "eligible costs" as defined in the standard. One important reason for differentiating the services provided to merchants was to address the anomaly in current arrangements for "card not present" transactions in Australia, where merchants (such as Internet merchants) bear the costs of fraud – because they cannot meet scheme requirements for a payment guarantee – but nonetheless incur the higher interchange rate on such transactions. This point was highlighted in the Joint Study.

An alternative approach suggested to the Reserve Bank that would achieve the same outcome on average would be to apply the cost-based methodology to calculate a benchmark for each scheme, against which the *weighted average* of interchange fees in that scheme would be assessed; the schemes and their members would be free to determine interchange fees for different categories of credit card transactions using whatever methodologies they choose. The Reserve Bank has accepted this approach. It will provide more flexibility to the credit card schemes while ensuring that interchange fees in each scheme, on a weighted average basis, do not exceed the level determined by the cost-based benchmark, whenever that benchmark is calculated or interchange fees are changed. At the same time, the Reserve Bank expects each of the designated credit card schemes to address the anomaly in the pricing of credit card payment services to merchants that cannot, in practice, satisfy scheme conditions for receiving a guarantee against fraud.

Other drafting changes on the application of the standard involve:

- a longer implementation period for the schemes to determine interchange fees in accordance with the cost-based benchmark, and flexibility to recalculate the benchmark within the normal three-year review period if the schemes believe that changes in costs or other factors warrant;

- removal of the requirement in the draft standard that the designated credit card schemes publish their aggregate cost data, which the schemes and their members have argued is commercially sensitive. The schemes are, however, required to provide their cost data to the Reserve Bank and to publish their interchange fees; and
- addition of a requirement that the designated credit card schemes provide the Reserve Bank with an annual certification of compliance with the standard.

The Reserve Bank has considered arguments in some submissions that any methodology based on the credit card payment services provided to merchants should include costs additional to those in the draft standard. These arguments are generally founded on the "outsourced store card" concept outlined in Section 6, which claims that merchants accepting credit cards are effectively "outsourcing" the provision of a proprietary store credit card and should bear whatever costs they would incur if they were to issue a card themselves. On this basis, some submissions argued for inclusion of a wide range of additional costs – including the cost of funding the interest-free period, credit losses, statement production and mailing, and the cost of loyalty programs – while others argued for inclusion of only a portion of these costs. As a minimum, however, the submissions were strongly of the view that the cost of funding the interest-free period should be included as an eligible cost, on the argument that the interest-free period is a defining characteristic of the credit card – it lets cardholders buy now and pay later. If issuers cannot recover the cost of providing the interest-free period in the interchange fee, they will need to recover it directly from cardholders, fundamentally changing the nature of the credit card.

The "outsourced store card" argument has some conceptual appeal in understanding the historical origins of the general purpose credit card and its penetration of retail markets. However, the argument is difficult to generalise to market segments where credit card acceptance is increasing but where store cards or in-store credit have never been offered, such as utilities, educational institutions and transport. Submissions from merchants have also noted that the general purpose credit card does not provide the same loyalty benefits and has not replaced the store card or in-store credit in some retail segments; some merchants continue to offer a store card to encourage customer loyalty. Some financial institutions might also be recovering some of the cost of the interest-free period directly from cardholders, in the form of higher interest rates on cards with this facility compared with cards without an interest-free period.

The "outsourced store card" argument, in the Reserve Bank's assessment, does not provide a convincing rationale for including a wide range of additional costs in the cost-based benchmark. The Reserve Bank is prepared to include the cost of funding the interest-free period as an "eligible cost", but only as part of the transition to a lower level of credit card interchange fees in Australia. This decision will be reviewed in five years in light of market responses, and regulatory developments overseas. However, the Reserve Bank has not been persuaded that other costs of clear benefit to cardholders, such as statement production and mailing and the costs of loyalty programs, or which are already covered by cardholders, such as the cost of credit losses, should be included in the cost-based benchmark.

The Reserve Bank has also considered arguments for the inclusion of various "costs of capital" in the cost-based benchmark. The amortised costs of any investments undertaken to provide credit card payment services to merchants, such as investments in processing systems or fraud-reducing technology, are eligible costs. There would also be logic in including the cost of capital held against operational risk, to the extent that the risks arise out of the provision of services to merchants. However, the Reserve Bank has found that systems for measuring capital held against operational risk are immature compared to other costing systems, and measurements vary widely between the major banks. For these reasons, the Reserve Bank has concluded that this item is not appropriate for inclusion in the cost-based benchmark, but it will revisit this decision if, in future, operational risk capital is more clearly defined by prudential standards or otherwise. The cost of capital held against credit risk on outstanding credit card balances is, in the Reserve Bank's view, a cost that arises directly out of the provision of revolving credit facilities to cardholders and, as in other areas of bank lending, is appropriately recovered through the interest rate charged on these facilities.

Issuers' costs eligible for inclusion in the Reserve Bank's cost-based benchmark are therefore:

- costs incurred principally in processing credit card transactions;
- costs incurred principally in respect of fraud and fraud prevention;
- costs incurred principally in providing authorisation of credit card transactions; and
- costs incurred in funding the interest-free period on credit card transactions.

In broad summary, the designated credit card schemes and their members have a series of steps to undertake to conform with the standard on interchange fees. The first step will be to calculate the cost-based benchmark for each scheme. This will require the largest issuers in each scheme to provide data on eligible costs to an independent expert appointed by the scheme, who will calculate the cost-based benchmark in percentage terms. The benchmark for each scheme will normally apply for three years.

The second step will be for the participants in each scheme to determine interchange fees such that the average of these fees, weighted by the share of total transactions to which each interchange fee applies, is equal to or less than the cost-based benchmark. If a scheme wishes to change its interchange fees in the period between recalculations of the benchmark, it will need to ensure that the new set of fees conforms with the last benchmark calculated. However, it will not need to adjust interchange fees if the weighted average changes because the share of total transactions to which each interchange fee applies (ie the weights) changes over time.

The third step will be for the scheme to provide the details of its calculations of the cost-based benchmark to the Reserve Bank and to publish its interchange fees. For reasons of commercial sensitivity, the cost-based benchmark itself does not need to be published.

The Reserve Bank has also developed a Guidance Note on application of the standard, including the definition and measurement of eligible costs, and provided the designated credit card schemes an opportunity to comment on a draft of this Note. The Guidance Note is set out in Attachment 5. The Guidance Note does not impose legal obligations on the schemes and their participants, but the Reserve Bank expects adherence to it as a way of ensuring consistency in the calculation of the cost-based benchmark for each scheme.

Standard on merchant pricing

As specified in the Consultation Document, the objective of the Reserve Bank's reforms in this area is to remove restrictions imposed by the international credit card schemes on the freedom of merchants in Australia to set their own prices. The final standard addresses this objective explicitly but the Reserve Bank, in response to comments received, has made some changes to the draft standard to simplify its application.

The standard provides that neither the rules of a designated credit card scheme nor any participant in the scheme may prohibit a merchant from charging a credit cardholder any fee or surcharge for use of a credit card in a transaction. At the same time, the standard states that a merchant may voluntarily agree with its acquirer to limit the size of any "fee for service" to the fees incurred by the merchant in respect of credit card transactions. The Consultation Document had noted that such agreements would not be inconsistent with the draft standard but, in the interests of removing uncertainty, this position has now been made explicit in the standard.

Access regime

The access regime provides that any authorised deposit-taking institution in Australia, including the new class of specialist credit card institutions, is eligible to apply to participate in the designated credit card schemes in Australia. However, in response to comments received, the Reserve Bank has made some changes to the drafting to clarify the rights and obligations of the schemes and their members, and to simplify the application of the access regime.

The access regime now makes explicit that a designated credit card scheme is free to impose its own business and operational criteria in assessing applications to participate in its scheme. However, it must not discriminate between specialist credit card institutions as a class and other authorised deposit-taking institutions as a class in relation to any of these criteria, or to the rights and obligations of participants in the scheme. Each scheme must also publish the criteria it imposes in assessing applications for participation in Australia. This replaces the requirement in the draft access regime that the schemes publish their rules governing eligibility for participation and the terms of participation. The requirement that the schemes give prior notice to the Reserve Bank of any changes to the rules governing eligibility for participation has been removed.

The access regime prohibits the imposition of any restrictions or form of penalties on participants seeking to specialise in acquiring.

APRA has released its draft prudential standards on risk management of credit card activities that will apply to authorised deposit-taking institutions, including the new class of specialist credit card institutions. The draft prudential standards and authorisation guidelines for specialist credit card institutions are given in Attachment 6.

8. IMPLEMENTATION AND REVIEW

The standard on interchange fees applies to all three designated credit card schemes. To allow the schemes and their participants time to make any necessary adjustments to their costing systems, the standard will not come into force until 1 July 2003. The cost-based benchmark for each scheme must be calculated by 1 October 2003 on the basis of eligible costs for the 2002/03 financial year; if appropriate costing systems are not in place for the full year, eligible costs may be calculated for the six-month period ending 30 June 2003. The average of interchange fees for each scheme as at 31 October 2003 must not exceed the cost-based benchmark for that scheme.

The standard on merchant pricing applies to the MasterCard and Visa credit card schemes; the Bankcard scheme does not impose restrictions on merchant pricing. To allow scheme participants and merchants to make any necessary preparations, the standard will come into force on 1 January 2003. At that time, the undertakings provided by American Express and Diners Club to remove merchant restrictions in their respective schemes will also come into force.

Australian fair trading laws require the disclosure of any additional fees or charges to cardholders prior to undertaking a transaction. Merchants who fail to adequately disclose such fees or charges may be in breach of their fair trading responsibilities.

The access regime applies to all three designated credit card schemes. The Reserve Bank acknowledges that credit card schemes and their members will want to consider, and comment as necessary on, APRA's draft prudential standards on risk management of credit card activities. Hence, it will not gazette the access regime until APRA's consultation processes are complete. The access regime will come into force from the date of gazettal.

The Payments System Board will monitor the impact of the reform measures on an on-going basis and report to Parliament, in the usual way, through its Annual Reports. The Board will also undertake a major review of credit and debit card schemes in Australia after five years, updating the findings of the Joint Study. On the basis of that review, it will consider whether the standards and access regime for the designated credit card schemes remain appropriate.

Standard No. 1

The Setting of Wholesale ("Interchange") Fees

Objective

The objective of this Standard is to ensure that the setting of wholesale ("interchange") fees in the designated credit card system is transparent and promotes:

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the credit card system operated within Australia known as [ ] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to as follows as the Scheme.
3. In this Standard:

   an "acquirer" is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

   "credit card" means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

   "credit card transaction" or "transaction" means a transaction in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card;

   "financial year" is the 12 month period ending 30 June;

   an "issuer" is a participant in the Scheme in Australia that issues credit cards to the issuer's customers;

   "merchant" means a merchant in Australia that accepts a credit card for payment for goods or services;

"nominated Scheme participants" are those issuers that issued, in aggregate, credit cards which were used in at least 90 per cent of credit card transactions by value in the Scheme in Australia in the financial year prior to the date by which the applicable cost-based benchmark must be calculated, those issuers being determined by the administrator of the Scheme or the other participants in the Scheme in Australia;

"rules of the Scheme" mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. This Standard refers to wholesale fees, known as "interchange" fees, which are payable by an acquirer, directly or indirectly, to an issuer in relation to a credit card transaction.
5. Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.
8. This Standard comes into force on 1 July 2003.

Interchange fees

9. On each of the dates specified in paragraph 10, the average of interchange fees implemented in the Scheme in Australia, calculated in accordance with paragraph 15 below, must not exceed the cost-based benchmark calculated in accordance with paragraphs 11-14 below.
10. For the purposes of paragraph 9, the dates are:

    (i) the thirtieth day after the date by which the cost-based benchmark must be calculated; and

    (ii) the date any interchange fee is introduced, varied, or removed.

Methodology

11. The cost-based benchmark is calculated as the aggregate value of eligible costs of the nominated Scheme participants for the financial year prior to the date by which the cost-based benchmark must be calculated, divided by the aggregate value of credit card transactions for the same period undertaken using credit cards issued by the nominated Scheme participants, and expressed as a percentage. Eligible costs are:

    (i) issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;

    (ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;

    (iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and

    (iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the Reserve Bank of Australia over the three financial years prior to the date by which the cost-based benchmark must be calculated.

12. Data on eligible costs must be drawn from accounting records of the nominated Scheme participants, prepared in accordance with generally accepted accounting principles and Australian accounting standards.

13. Data on eligible costs of each nominated Scheme participant must be provided by that participant to an independent expert agreed to by the Reserve Bank of Australia. The expert must review the data to determine if the costs included are eligible costs and must use the data on eligible costs to calculate the cost-based benchmark.

14. The cost-based benchmark must be calculated by the end of the third month after the date this Standard comes into force and by the end of the third month of every third year after the date this Standard comes into force. If the Reserve Bank of Australia agrees in writing, a recalculation of the cost-based benchmark may be undertaken at another date if changes in eligible costs or other factors warrant. In such a case, the cost-based benchmark must be calculated by the date specified in writing by the Reserve Bank of Australia.

15. For purposes of paragraph 9, the average of interchange fees is a weighted average calculated as follows:

    (i) each interchange fee rate, net of applicable taxes, is expressed as a percentage of transaction value for the transactions to which that interchange fee rate applies for the financial year prior to the applicable date specified in paragraph 10;

    (ii) the weights to be applied to these percentages are the shares of transactions to which each such interchange fee rate applies in the total value of transactions in the Scheme in Australia for the financial year prior to the applicable date specified in paragraph 10.

Transparency

16. The administrator of the Scheme or a representative of the participants in the Scheme in Australia must publish the interchange fee rates of the Scheme in Australia on the Scheme's website or make the interchange fee rates generally available through other means.

17. The administrator of the Scheme and the nominated Scheme participants must provide to the Reserve Bank of Australia the cost-based benchmark and the data on eligible costs used by the independent expert to calculate the cost-based benchmark, by the date by which that benchmark must be calculated.

18. The administrator of the Scheme and the nominated Scheme participants must each certify annually in writing to the Reserve Bank of Australia, on or before 30 November each year, that interchange fees of the Scheme in Australia over the prior twelve months ending 31 October were in compliance with this Standard.

Transition provision

19. In reference to paragraph 11, the initial cost-based benchmark for the Scheme may be calculated using data on eligible costs for the six-month period ending 30 June 2003, rather than for the full financial year.

Standard No. 2

Merchant Pricing for Credit Card Purchases

Objective

The objective of this Standard is to promote:

(i) efficiency; and

(ii) competition

in the Australian payments system by providing merchants the freedom to charge according to the means of payment.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

2. This Standard applies to the credit card system operated within Australia known as [ ] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to as follows as the Scheme.

3. In this Standard:

   an "acquirer" is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

   "credit card" means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

   "credit card transaction" or "transaction" means a transaction in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card;

   "merchant" means a merchant in Australia that accepts a credit card for payment for goods or services;

   "rules of the Scheme" mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Standard.

5. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

6. This Standard is to be interpreted:

   - in accordance with its objective; and
   - by looking beyond form to substance.

7. This Standard comes into force on 1 January 2003.

Merchant pricing

8. Neither the rules of the Scheme nor any participant in the Scheme shall prohibit a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction.

9. Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.

Transparency

10. Each acquirer must notify, in writing, each merchant to whom the acquirer provides services of the provisions of this Standard as soon as practicable after this Standard comes into force.

Access Regime

Objective

The objective of this Access Regime is to promote efficiency and competition in the Australian payments system, having regard to:

(i) the interests of current participants;

(ii) the interests of people who, in the future, may want access to the system;

(iii) the public interest; and

(iv) the financial stability of the designated credit card system.

Application

1. This Access Regime is imposed under Section 12 of the *Payment Systems (Regulation) Act 1998*.

2. This Access Regime applies to the credit card system operated within Australia known as [ ] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to as follows as the Scheme.

3. In this Access Regime:

   an "acquirer" is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

   an acquirer is a "self acquirer" if it acquires transactions for which it or a related body corporate (as that term is defined in the *Corporations Act 2001*) is the merchant;

   "authorised deposit-taking institution" has the same meaning given to that term in Section 5(1) of the *Banking Act 1959*;

   "credit card" means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

   an "issuer" is a participant in the Scheme in Australia that issues credit cards to the issuer's customers;

   "merchant" means a merchant in Australia that accepts a credit card for payment for goods or services;

"rules of the Scheme" mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

a "specialist credit card institution" is an authorised deposit-taking institution authorised by the Australian Prudential Regulation Authority as a specialist credit card institution;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Access Regime.

4. Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Access Regime.

5. If any part of this Access Regime is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Access Regime.

6. This Access Regime is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.

7. This Access Regime comes into force on [ ].

Eligibility for participation

8. Any person who is an authorised deposit-taking institution is eligible to apply to participate in the Scheme in Australia. Subject to paragraph 9, any criteria may be applied by the Scheme in assessing applications for participation in the Scheme in Australia.

9. Neither the rules of the Scheme nor any participant in the Scheme shall discriminate between specialist credit card institutions as a class and other authorised deposit-taking institutions as a class in relation to any of the criteria applied in assessing applications for participation or in relation to the rights and obligations of participants in the Scheme in Australia.

Terms of participation

10. Neither the rules of the Scheme nor any participant in the Scheme shall prevent a participant in the Scheme in Australia from being:

    (i) an issuer only; or

(ii) an acquirer only; or

(iii) both an issuer and an acquirer.

11. Neither the rules of the Scheme nor any participant in the Scheme shall impose on a participant in the Scheme in Australia any fee, charge, loading or any form of penalty as a consequence of, or which is related in any way to, that participant's activity as an acquirer relative to its activity as an issuer in the Scheme.

12. Neither the rules of the Scheme nor any participant in the Scheme shall prohibit a participant in the Scheme in Australia from being a self acquirer if the participant can reasonably establish in accordance with the rules of the Scheme that, as a self acquirer, it has the capacity to meet the obligations of an acquirer.

Transparency

13. The administrator of the Scheme or a representative of the participants in the Scheme in Australia must publish the criteria applied in assessing applications for participation in the Scheme in Australia on the Scheme's website, or make such criteria generally available through other means as soon as practicable after this Access Regime comes into force.

14. The administrator of the Scheme must provide to a person that has applied to participate in the Scheme in Australia reasons in writing if the application is rejected, as soon as practicable after such rejection.

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ATTACHMENT 1: EXTRACTS FROM *PAYMENT SYSTEMS (REGULATION) ACT 1998*

7 Definitions

In this Act:

access, in relation to a payment system, means the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable.

access regime, in relation to a designated payment system, means an access regime:

(a) that has been imposed by the Reserve Bank under section 12; and

(b) that is in force.

constitutional corporation means a corporation to which paragraph 51(xx) of the Constitution applies.

designated payment system means a payment system that is designated under section 11.

participant in a payment system means:

(a) a constitutional corporation that is a participant in the system in accordance with the rules governing the operation of the system; or

(b) a constitutional corporation that is an administrator of the system.

payment system means a funds transfer system that facilitates the circulation of money, and includes any instruments and procedures that relate to the system.

public interest has the meaning given by section 8.

Reserve Bank means the Reserve Bank of Australia.

standard means a standard in force under section 18.

8 Meaning of *public interest*

In determining, for the purposes of this Act, if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:

(a) being (in its opinion):

  (i) financially safe for use by participants; and

  (ii) efficient; and

  (iii) competitive; and

(b) not (in its opinion) materially causing or contributing to increased risk to the financial system.

The Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so.

11 Reserve Bank may designate payment systems

(1) The Reserve Bank may designate a payment system if it considers that designating the system is in the public interest. The designation is to be by notice in writing published in the *Gazette*.

(2) The designation has effect until it is revoked.

(3) The Reserve Bank may revoke the designation if it no longer considers that it is in the public interest that the system be designated. The revocation is to be by notice in writing published in the *Gazette*.

12 Imposition of access regime

(1) The Reserve Bank may impose an access regime on the participants in a designated payment system.

(2) The access regime imposed must be one that the Reserve Bank considers appropriate, having regard to:

   (a) whether imposing the access regime would be in the public interest; and

   (b) the interests of the current participants in the system; and

   (c) the interests of people who, in the future, may want access to the system; and

   (d) any other matters the Reserve Bank considers relevant.

(3) The Reserve Bank must not impose the access regime unless it has first consulted in accordance with section 28.

(4) The decision to impose the access regime is to be in writing and is to set out the access regime.

(5) As soon as practicable after imposing the access regime, the Reserve Bank must provide notification under section 29.

(6) A failure to comply with subsection (5) does not affect the validity of the access regime.

18 Reserve Bank may make standards for designated systems

(1) The Reserve Bank may, in writing, determine standards to be complied with by participants in a designated payment system if it considers that determining the standards is in the public interest.

Note: A failure to comply with a standard is not an offence, but it may lead to a direction being given under section 21.

(2) A standard:

(a) comes into force:

(i) unless subparagraph (ii) applies—on the day on which the determination of the standard is made; or

(ii) if that determination specifies a later day as the day on which the standard comes into force—on the day so specified; and

(b) continues in force until it is revoked.

(3) The Reserve Bank may, in writing, vary or revoke a standard.

(4) The Reserve Bank must not determine or vary a standard unless it has first consulted in accordance with section 28.

(5) The Reserve Bank may determine or vary a standard without complying with subsection (4) if:

(a) the Reserve Bank considers that there is an urgent need for the determination or variation of the standard; or

(b) in the case of a variation—the Reserve Bank considers that the variation is of a minor technical nature.

(6) If the Reserve Bank determines a standard, or varies or revokes a standard, it must, as soon as practicable, provide notification under section 29.

(7) A failure to comply with subsection (6) does not affect the validity of a standard or of the variation or revocation of a standard.

28 Consultation obligations

(1) Subsection (2) applies to the following actions proposed to be taken by the Reserve Bank:

(a) the proposed imposition of an access regime;

(b) the proposed variation of an access regime, other than a variation to which subsection 14(3) applies;

(c) the proposed determination of a standard, other than a determination to which subsection 18(5) applies;

(d) the proposed variation of a standard, other than a variation to which subsection 18(5) applies.

(2) If this subsection applies to a proposed action, the Reserve Bank must, before taking the action:

(a) cause a notice to be published in the *Gazette*:

(i) advising of the proposed action; and

(ii) summarising its purpose and effect; and

(iii) inviting people to make submissions within a specified time to the Reserve Bank on the proposed action; and

(b) consider any submissions that are received within that time limit.

ATTACHMENT 2: A CHRONOLOGY OF OFFICIAL SCRUTINY OF CREDIT CARD SCHEMES IN AUSTRALIA

1974	The Bankcard credit card scheme introduced by nine Australian banks.
1980	The Trade Practices Commission, the predecessor of the ACCC, authorised the Bankcard scheme under the *Trade Practices Act 1974*, on condition that scheme members not impose restrictions on the freedom of merchants to determine the prices charged to customers paying either with cash or Bankcard.
1980s (early)	The international credit card schemes, MasterCard and Visa, introduced into Australia.
1990	The Trade Practices Commission revoked Bankcard's authorisation under the *Trade Practices Act 1974*.
1991	The House of Representatives Standing Committee on Finance and Public Administration (the "Martin Committee") published *A Pocket Full of Change: Banking and Deregulation*, which concluded that differential pricing by merchants should not be prevented by financial institutions.
1992	The Prices Surveillance Authority published *Inquiry into Credit Card Interest Rates*, which recommended that the efficiency and structure of interchange fees be subject to further review, and concluded that there was an in principle case for giving merchants the freedom to set prices reflecting the methods of payment.
1993	MasterCard and Visa introduced domestic interchange fees in Australia determined collectively by their Australian members.
	Australian credit laws were amended, *inter alia*, to allow issuers to charge annual fees on credit cards and merchants to charge different prices for accepting different payment instruments.
1996	In its 1995/96 *Annual Report*, the Australian Payments System Council examined the mechanics of credit (and debit) card schemes and the rationale commonly put forward for their pricing structures.

1997 The *Final Report* of the Financial System Inquiry (the “Wallis Committee”) recommended that a Payments System Board be established in the Reserve Bank and that it investigate interchange fee arrangements for debit and credit cards, and that the ACCC monitor membership arrangements and rules of the international credit card schemes.

1998 *Payment Systems (Regulation) Act 1998* enacted.

Payments System Board established.

1999 The Reserve Bank and ACCC announced a joint study of interchange fees for debit and credit cards, and membership criteria for credit card schemes.

2000 The ACCC informed Bankcard, MasterCard, Visa and their members that it considered the collective setting of interchange fees to be a likely breach of the price-fixing provisions of the *Trade Practices Act 1974*, and advised that they seek authorisation of their interchange fee arrangements or cease the conduct.

The ACCC instituted legal proceedings against one major bank for alleged price-fixing behaviour.

The Reserve Bank and ACCC published *Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access*.

2001 After discussions with a group of banks about a possible application for authorisation of interchange fee arrangements, the ACCC recommended that the Payments System Board consider using the powers available to it under the *Payment Systems (Regulation) Act 1998* to achieve reform of credit card schemes in Australia in the public interest.

The Payments System Board designated the credit card systems operated in Australia by Bankcard, MasterCard and Visa as payment systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*.

The ACCC discontinued legal proceedings.

The Reserve Bank released *Reform of Credit Card Schemes in Australia*: *A Consultation Document* and published two draft Standards and an Access Regime for the designated credit card schemes in the *Gazette*.

ATTACHMENT 3: ORGANISATIONS THAT PROVIDED SUBMISSIONS AND OTHER MATERIAL

American Express International

Australia and New Zealand Banking Group Limited

Australian Bankers' Association

Australian Consumers' Association

Australian Retailers Association

Australian Settlements Limited

Australian United Retailers

Bank of Queensland

Bankcard Association of Australia

Caltex Australia

Citibank Limited

Coles Myer Limited

Commonwealth Bank of Australia

CoRE Research

Council of Small Business Organisations of Australia

Credit Union Services Corporation (Australia) Limited

Diners Club Australia

Financial Services Consumer Policy Centre

International Air Transport Association

Loyalty Pacific Pty Ltd

Macquarie Bank Limited

MasterCard International

National Association of Retail Grocers of Australia

National Australia Bank

Pharmacy Guild of Australia

Pure Commerce

Restaurant and Catering Association of Australia

St George Bank

Telstra

The Shell Company of Australia Limited

The Tourism Task Force

VISA International Service Association

Westpac Banking Corporation

Woolworths Limited

In addition, the Reserve Bank received submissions from a number of individuals.

ATTACHMENT 4: UNDERTAKINGS FROM THE THREE PARTY SCHEMES

UNDERTAKING

This Undertaking is made by Diners Club Pty Limited ABN 35 004 343 051 ("Diners Club") of 1193 Toorak Road, Hartwell, Victoria in favour of the Reserve Bank of Australia ("Reserve Bank") of 65 Martin Place, Sydney and dated 16th day of August 2002.

In consideration of the Reserve Bank not designating the Diners Club charge card payment system under the terms of the *Payment Systems (Regulation) Act 1998* for the purposes of determining a standard on merchant pricing pursuant to that Act, Diners Club undertakes and agrees with the Reserve Bank that:

(i) subject to the qualification in the following paragraph, Diners Club will not prohibit, or take any action that has the effect of prohibiting, a merchant in Australia from charging a Diners Club card holder any fee or surcharge for use of a Diners Club charge card in a transaction.

It would not be inconsistent with this undertaking if a merchant in Australia agrees with Diners Club that any such fee or surcharge charged to Diners Club charge card holders will be limited to the fees incurred by the merchant in respect of Diners Club charge card transactions.

(ii) Diners Club will, as soon as practicable and in writing, notify each merchant in Australia to whom it provides charge card services of the undertaking in (i) that it has given to the Reserve Bank.

This undertaking comes into force upon the date a standard on merchant pricing for the designated Bankcard, MasterCard and Visa credit card schemes comes into force.

The Reserve Bank reserves its rights to proceed with a designation of Diners Club under the *Payment Systems (Regulation) Act 1998* at any time should it consider this best serves the purposes of the Act.

Signed by Diners Club Pty Limited by its duly authorised representative

16/8/2002

Bryan Ericson
Managing Director

In the presence of

Kerry Miles
Credit & Operations Executive

16/8/2002

UNDERTAKING

This Undertaking is made by American Express International, Inc., ABN 15 000 618 208 ("American Express") of 175 Liverpool Street, Sydney in favour of the Reserve Bank of Australia ("Reserve Bank") of 65 Martin Place, Sydney and dated 21st day of August 2002.

In consideration of the Reserve Bank not designating the American Express credit card and charge card payment system under the terms of the *Payment Systems (Regulation) Act 1998* for the purposes of determining a standard on merchant pricing pursuant to that Act, American Express undertakes and agrees with the Reserve Bank that:

(i) subject to the qualification in the following paragraph, American Express will not prohibit, or take any action that has the effect of prohibiting, a merchant in Australia from charging an American Express card holder any fee or surcharge for use of an American Express credit or charge card in a transaction.

It would not be inconsistent with this undertaking if a merchant in Australia agrees with American Express that any such fee or surcharge charged to American Express credit or charge card holders will be limited to the fees incurred by the merchant in respect of American Express credit or charge card transactions.

(ii) American Express will, as soon as practicable and in writing, notify each merchant in Australia to whom it provides credit and charge card services of the undertaking in (i) that it has given to the Reserve Bank.

This undertaking comes into force upon the date a standard on merchant pricing for the designated Bankcard, MasterCard and Visa credit card schemes comes into force.

The Reserve Bank reserves its rights to proceed with a designation of American Express under the *Payment Systems (Regulation) Act 1998* at any time should it consider this best serves the purposes of the Act.

Signed by American Express International, Inc.
by its duly authorised representative

In the presence of

COLM CORIGAN

ATTACHMENT 5: GUIDANCE NOTE

Implementation of the Standard on Interchange Fees

The Reserve Bank of Australia is providing this Guidance Note to facilitate compliance with Standard No. 1 - The Setting of Wholesale ("Interchange") Fees (the Standard) which comes into force on 1 July 2003. This Guidance Note is intended to provide practical assistance to the participants in the credit card schemes designated under the *Payment Systems (Regulation) Act 1998*. This Guidance Note does not have legal effect and does not vary the Standard; however the Reserve Bank expects participants in the designated credit card schemes to use this Guidance Note to ensure consistency in the collection of cost data and to aid in the implementation of the Standard. The Reserve Bank may update the Guidance Note in future as necessary.

For each designated credit card scheme, the Standard requires the periodic calculation of a cost-based benchmark using data on "eligible costs" of certain scheme participants. A weighted average of interchange fees applied to transactions in the scheme in Australia must then be compared to this cost-based benchmark. Interchange fees in the scheme are in compliance with the Standard if this weighted average, calculated using interchange fees in effect on certain specified dates, does not exceed the cost-based benchmark. This document provides a description of the types of costs to be included in the calculation of the cost-based benchmark and other guidance on the practical operation of the Standard.

I. Measurement of Eligible Costs

Nominated scheme participants

"Eligible costs" for use in calculating the cost-based benchmark in a scheme are based on costs of certain "nominated scheme participants". The nominated scheme participants may be different for each scheme.

At a minimum, the nominated scheme participants are those issuers in the scheme whose credit card transactions together make up at least 90 per cent of the value of domestic purchase transactions in the scheme in Australia for the prior financial year. A scheme or its participants may also choose to nominate additional participants as nominated scheme participants.

It is anticipated that the nominated scheme participants will be determined by the scheme administrator, which operates or governs the credit card scheme and which would normally have access to the necessary transaction data. The Standard also provides that the participants themselves may determine the nominated scheme participants, for example, by providing data to an independent expert if the scheme administrator is unable to do so.

Time period for data collection

The cost-based benchmark must be calculated within three months after the Standard comes into effect, ie by 1 October 2003, using data for the financial year ending 30 June 2003. The benchmark must be recalculated every three years thereafter, ie by 1 October 2006 and 1 October 2009, etc. With the Reserve Bank's agreement, the cost-based benchmark may also be recalculated at an interim date. It is anticipated that the nominated scheme participants in each scheme will report their cost data to the independent expert for the scheme as soon as possible after the end of the relevant financial year in order to provide adequate time for that expert to review the data and perform the required calculations.

Except where otherwise noted, eligible costs are actual costs incurred as recorded in the general ledger or other appropriate accounting records and systems of the nominated scheme participants for the entire relevant financial year ending 30 June. Estimated or anticipated costs should not be included.

The Reserve Bank recognises that scheme participants may need to make initial system or procedural changes to their accounting systems to accurately measure the eligible costs as defined in the Standard. As a result, the Standard includes a Transition Provision that allows a scheme to determine the cost-based benchmark using eligible cost data only for the six months ended June 30, 2003. In such a case, the cost data should be annualised (if necessary) such that it is consistent with the transaction data used to calculate the cost-based benchmark.

Definition of eligible costs

Under the Standard, eligible costs for inclusion in the calculation of the cost-based benchmark are limited to:

(i) issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;

(ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;

(iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and

(iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the

Reserve Bank over the three financial years prior to the date by which the cost-based benchmark must be calculated.

Costs to be included for each scheme are limited to those arising from domestic credit card purchase transactions for credit cards issued by each nominated scheme participant under the rules of that scheme. Costs associated with cash advances, balance transfers, international transactions or transactions for cards of other card schemes are not included in eligible costs.

All cost and transaction value amounts described in this Guidance Note refer to Australian dollars.

Measurement of eligible costs

Eligible costs (with the exception of the interest-free period which is purely a funding cost) includes the following types of costs to the extent they arise out of the relevant activities:

(i) direct internal staff costs (including for example salaries, benefits, recruitment, travel and related costs, where charged directly to the credit card issuing business), and direct ongoing costs of systems, materials, premises and equipment;

(ii) direct software, hardware and other capital expenditures, amortised according to accounting requirements for the relevant time period;

(iii) external charges for services from third-party providers. These could include, for example, switching and stand-in authorisation processing costs and insurance premiums paid for operational or fraud-related coverage; and

(iv) internal charges or allocations from other business units where costs have been identified through appropriate activity-based methods. These could include, for example, the share of call centre, branch and other processing staff and related costs incurred in responding to authorisation or retrieval requests, chargebacks, lost/stolen card reports and customer enquiries on suspect transactions. The allocation of telecommunication costs in respect of processing and authorisation activities are also included. Other indirect costs that are not specifically related to the eligible cost categories, such as general corporate overheads, are not included in eligible costs.

Activities and costs for inclusion in eligible costs

Transaction processing and authorisation

Eligible costs for processing and authorisation are those related to the following activities and costs:

(i) receiving, posting to cardholder accounts and other processing of data for domestic credit card transactions;

(ii) receiving and processing authorisation requests for domestic credit card transactions;

(iii) receiving and processing retrieval requests;

(iv) receiving and responding to referral enquiries;

(v) investigating and processing exception transactions;

(vi) maintaining and updating card authorisation files;

(vii) clearing and settlement of domestic credit card transactions;

(viii) receiving and processing chargebacks and representments;

(ix) net chargeback write-offs;

(x) scheme fees for processing and authorisation, clearing and settlement, retrievals and chargebacks; and

(xi) compliance with scheme requirements related to processing and authorisation, clearing and settlement.

Fraud and fraud prevention

Eligible costs for domestic fraud investigation and fraud prevention are those related to the following activities and costs:

(i) investigation of suspect credit card transactions;

(ii) processing fraud files;

(iii) developing and maintaining fraud management systems, including detection and prevention systems;

(iv) developing and implementing measures to monitor cardholder usage for potential fraud;

(v) developing and operating fraud detection measures in cardholder application processing and the opening of new accounts;

(vi) development and production of card security features where such features are implemented principally for the purposes of fraud prevention;

(vii) compliance with scheme fraud mitigation measures, such as fraud reporting, blocking accounts, logging lost/stolen cards, paying card capture rewards and maintaining hot card files and card recovery bulletins;

(viii) assisting and liaising with other members, schemes, law enforcement and other relevant parties for fraud investigations and prosecution;

(ix) secure delivery of cards where such delivery is employed principally to prevent fraud;

(x) scheme fees related to fraud prevention and investigation, such as for recovered cards, bulletin and file updates and payments to other members for captured or recovered cards under scheme rules; and

(xi) total domestic fraud losses net of recoveries.

Costs that are not principally related to fraud prevention, such as routine card production and delivery, statement production and credit assessment on new accounts, are not included in eligible costs. Costs incurred from scheme fines and penalties from failure to comply with scheme rules are also not included in eligible costs.

Interest-free period

An interest-free period on some credit cards is available to cardholders who pay off their entire balance by the required date or, in some cases, prior to the date on which interest begins to accrue on unpaid balances. The cost of funding the interest-free period is calculated by applying a cost of funds rate (the daily cash rate) over the prior three years, in order to take into account cyclical fluctuations in interest rates, to the average daily balances outstanding on credit cards that are attributable to the interest-free period.

Eligible costs for funding the interest-free period are calculated as follows:

(i) the value of any advances outstanding on credit card accounts that did not accrue interest is determined for each day in the prior financial year. The value of cash advances, international transactions, fees and any other transactions other than domestic credit card purchase transactions that may be reflected in those advances are subtracted from these advances;

(ii) the average daily value of advances not accruing interest is determined by summing the daily value of these advances calculated in (i) and dividing by the applicable number of days in the year;

(iii) the average daily cash rate for the prior three financial years is determined using the cash rate for each business day published monthly in the Reserve Bank of Australia *Bulletin*. For example, for the initial cost-based benchmark that must be determined by 1 October 2003, the daily cash rate would be averaged for the three years between 1 July 2000 and 30 June 2003; and

(iv) the average daily value of advances calculated in (ii) is multiplied by the average daily cash rate to obtain the total cost of funding the interest-free period.

II. Calculation of the Cost-based Benchmark

The cost-based benchmark for each scheme is calculated by summing all of the reported and verified eligible costs of the nominated scheme members, and dividing that amount by the aggregate value of credit card transactions for the prior financial year on credit cards of that scheme issued by the nominated scheme participants. For example, for the initial cost-based benchmark that must be calculated by 1 October 2003, the independent expert for each scheme must obtain the transaction value of all domestic purchase transactions on credit cards issued by each nominated scheme participant for that scheme, for the period 1 July 2002 to 30 June 2003.

For ease and consistency of implementation, the Standard requires the cost-based benchmark to be expressed as a percentage of transaction value, eg 0.52 per cent. However, as discussed below, this does not require that interchange fees must be set only as percentages of transaction values. The cost-based benchmark, expressed as a percentage, should be calculated to at least two decimal places.

III. Application of the Benchmark to Weighted Average Interchange Fees

The Standard requires that the cost-based benchmark for each scheme be compared to a weighted average of all domestic interchange fee rates in the scheme, where the weights are the respective shares of transaction value for each interchange fee rate. (An interchange fee *rate* is the percentage of transaction value, per-transaction amount or other formula that determines the dollar amount of interchange fees paid on a particular transaction, eg 0.6 per cent, 20 cents per transaction, etc.)

Calculation of weighted average

If there is only one interchange fee rate in a scheme in Australia, no weighted average calculation is necessary. This rate is simply compared to the cost-based benchmark. If there are multiple interchange fee rates applicable to different types of transactions, each of these rates must be weighted by their respective transaction shares, by value, to arrive at a weighted average that is compared to the cost-based benchmark. The weighted average, expressed as a percentage, should be calculated to at least two decimal places.

Where an interchange fee rate includes a flat fee or other fee formula, the rate must be converted to a percentage of transaction value. This can be done by dividing the amount of the interchange fee applicable to the average transaction amount by the average transaction size for transactions to which that fee rate applies or, equivalently, by summing all interchange fee revenue paid for a particular transaction type and dividing this amount by the aggregate value of transactions to which that interchange fee rate applies. This is illustrated in the following calculation.

Example

(i) A card scheme applies three interchange fee rates to domestic purchase transactions: (1) a rate of \$0.25 + 0.3% of transaction value for electronic transactions at hotels, (2) a rate of 0.5% for all other electronic transactions, and (3) a rate of 0.7% for non-electronic transactions;

(ii) the respective shares of transaction value in the financial year ending 30 June 2003 for these transaction categories were: (1) 10% for electronic transactions at hotels; (2) 60% for all other electronic transactions; and (3) 30% for non-electronic transactions;

(iii) for electronic transactions at hotels, where a blended flat and *ad valorem* rate is applied, the average transaction size for the year ended 30 June 2003 is equal to the total value of transactions in this category divided by the number of those transactions. Assume this average transaction size amounts to \$200. The interchange fee rate expressed as a percentage of average transaction size for this category is therefore: $(0.25 + 0.3\% \times 200)/200 = 0.425\%$; and

(iv) the weighted average of interchange fees, which must be equal to or less than the cost-based benchmark, is equal to:

$$10\% \times 0.425\% + 60\% \times 0.5\% + 30\% \times 0.7\% = 0.55\%.$$

Timing of compliance

The Reserve Bank recognises that, due to trends in different types of transactions, the weighted average of interchange fees may change over time, even though interchange fee rates themselves have not changed. Adjusting interchange fee rates on an ongoing basis to ensure that the weighted average remains at or below the benchmark would be unduly cumbersome. For this reason, the requirement that the weighted average of interchange fees be equal to or less than the cost-based benchmark does not apply at all times, but at certain times only.

First, the requirement applies to the interchange fees in effect thirty days after the date by which the cost-based benchmark must be calculated or, in future, recalculated. Thus, the initial compliance date is 31 October 2003.

Secondly, the requirement applies at the time any new or modified interchange fee rates are implemented. For example, if an interchange fee rate is being modified (whether it is being raised, lowered or a different formula applied) on 1 February

2005, the weighted average of all interchange fees, calculated according to the Standard, must be based on the interchange fee rates that will be in effect on 1 February 2005 and the transaction shares, by value, for these interchange fee rate categories for the financial year ending 30 June 2004. This weighted average must not exceed the cost-based benchmark that was previously calculated as at 1 October 2003.

If a scheme introduces a new interchange fee category for existing transactions (eg an interchange fee for Internet transactions), the transaction share to be used is the share of transactions to which that fee rate *would have* applied had it been in effect during the previous financial year. If a scheme introduces an interchange fee category for a new type of transaction or product that did not previously exist, the relevant share to be used is zero until the next time the weighted average is calculated.

Reserve Bank of Australia
SYDNEY
27 August 2002

ATTACHMENT 6: APRA's GUIDELINES ON AUTHORISATION OF SCCIs AND DRAFT PRUDENTIAL STANDARD FOR ADIs

GUIDELINES ON AUTHORISATION OF SCCIS

Overview

1. These guidelines are for prospective applicants seeking an authority to carry on credit card issuing and/or acquiring business in Australia as a "specialist credit card institution" (SCCI). Credit card issuing and acquiring activities in "four-party" credit card schemes are considered banking business, as defined in Section 5 of the *Banking Act 1959*.
2. SCCIs are locally incorporated authorised deposit-taking institutions (ADIs) that are authorised to perform a limited range of banking activities. SCCIs may only perform credit card issuing and/or acquiring business and any other services directly related to credit card issuing or acquiring. SCCIs are not permitted to accept deposits (other than incidental credit balances on credit card accounts), unless specifically permitted to do so by APRA. SCCIs that are acquirers are not permitted to hold deposit accounts for their merchants which must be held at an ADI authorised to hold deposits. Any subsidiary of an SCCI is allowed to perform only those activities directly related to credit card issuing or acquiring.
3. As ADIs, SCCIs are subject to the requirements of the Banking Act and any other Acts applicable to ADIs such as the *Financial Sector (Shareholdings) Act 1998* and the *Financial Sector (Transfers of Business) Act 1999*. Regulations and prudential standards applicable to ADIs also apply to SCCIs, unless provided otherwise by APRA.
4. Section 7 of the Banking Act stipulates that only bodies corporate can be authorised as ADIs in Australia. Prospective SCCI applicants may refer to the Australian Securities & Investments Commission (ASIC) website (www.asic.gov.au) for information with regard to the requirements and procedures for registration of a body corporate in Australia.
5. A body corporate seeking to become an SCCI in Australia should apply in writing to APRA, in accordance with Section 9 of the Banking Act.
6. APRA may refuse an application for authority to become an SCCI in Australia where an applicant is a subsidiary of a non-operating holding company

(NOHC) that does not hold a NOHC authority under the Banking Act. Where relevant, an applicant should submit to APRA a written application by its NOHC for a NOHC authority under Section 11AA of the Banking Act concurrently with its application for authority to carry on credit card issuing and/or acquiring business.

7. ADIs, foreign banking organisations and other foreign or domestic non-financial corporations may apply to establish wholly owned SCCI subsidiaries.

Use of Restricted Words and Expressions

8. An authority to act as an SCCI does not entitle the SCCI to call itself a "bank". Applicants should note Section 66 of the Banking Act which restricts the use of certain words or expressions, without explicit APRA consent (refer Section 66 Guidelines available on the APRA website www.apra.gov.au).

9. An SCCI is entitled to use or assume the restricted expressions (determined by APRA under Section 66(5) of the Banking Act) "specialist credit card institution" and "SCCI" in relation to its financial business upon authorisation, pursuant to a class consent made by APRA under Section 66(1B) of the Banking Act. However, an SCCI is prohibited from representing that it is authorised to carry on the general business of taking deposits. Whenever an SCCI holds out to a member of the public that it is an "ADI" or "authorised deposit-taking institution" or in possession of a banking authority, it must qualify that with a clear statement that it is only authorised to carry on credit card issuing and/or acquiring business and is not authorised to carry on the general business of taking deposits.

Authorisation Criteria for SCCIs

10. Unless otherwise indicated, the authorisation criteria set out below are applicable to all applicants, including foreign-owned applicants intending to establish locally incorporated SCCI subsidiaries. These criteria represent the *minimum* requirements that an applicant will need to meet for authorisation under the Banking Act and should not be taken as an exhaustive list. Depending on the circumstances, APRA may refuse an application on other prudential grounds not covered in this Guideline.

11. APRA will only authorise suitable applicants with the capacity and commitment to conduct credit card issuing and/or acquiring business with integrity, prudence and competence on a continuing basis.

12. APRA expects all applicants to be able to comply with its prudential requirements, as set out in the various ADI Prudential Standards, from the commencement of their credit card issuing and/or acquiring operations. (Note: Where appropriate, APRA may exempt a wholly owned SCCI from some of these requirements e.g. NOHC structure and consolidated supervision at parent company level where the SCCI is the only "ADI" in a non-financial or commercial group, recognising the lower risks in its non-deposit taking function.) Prospective applicants should familiarise themselves with these Prudential Standards. It should be noted that higher prudential requirements may be set on a case-by-case basis, e.g. for newly authorised SCCIs in their formative years.

Capital

13. No set minimum amount of initial capital is required for an authority to carry on credit card issuing and/or acquiring business. APRA will assess the adequacy of start-up capital for an SCCI applicant on a case-by-case basis, based on the nature and scale of the operations as proposed in the business plan.

14. At a minimum, SCCI applicants must satisfy APRA that they are able to comply with the Capital Adequacy Standards for ADIs from the commencement of their credit card issuing and/or acquiring operations. Given their specialised nature which may concentrate certain types of risks, SCCIs will normally be subject to a minimum capital ratio above the 8 per cent benchmark. In addition, newly established SCCIs will also be subject to a higher minimum capital requirement in their formative years, depending on the risk profile of the proposed operations.

Ownership

15. Ownership in SCCIs is governed by the Financial Sector (Shareholdings) Act ("the FSSA"). The FSSA limits shareholdings of an individual shareholder or a group of associated shareholders in an SCCI, whether held directly or through another entity or entities, to 15 per cent of the SCCI's voting shares. The Treasurer, or in some cases APRA under delegated authority from the Treasurer, may approve a higher shareholding limit for specific institutions on national interest grounds.

16. SCCI applicants must satisfy the requirements specified in the FSSA in respect of ownership interests or, where relevant, have exemptions granted under the FSSA. Applicants wishing to obtain an exemption from the FSSA must

submit with their application an explanation and supporting evidence of how an exemption would serve the public interest.

17. All substantial shareholders of an SCCI applicant are required to demonstrate to APRA that they are "fit and proper" in the sense of being well-established and financially sound entities of standing and substance. In the case of a wholly owned SCCI, the substantial shareholders of the parent company must also be "fit and proper". APRA requires all substantial shareholders of an SCCI to be able to demonstrate that their involvement in the SCCI will be a long-term commitment and that they will be able to contribute additional capital if required.

Management

18. SCCI applicants must satisfy the requirements set out in the (draft) ADI Prudential Standard on "Board Composition". Specifically:

    (a) SCCIs must have a Board with at least 5 directors, a majority of whom (including the Chairman of the Board) must be non-executives i.e. they must not be executives of the SCCI, its parent corporation or any member of the corporate group to which the SCCI belongs. However, non-executive directors of the parent may sit on the Board of the subsidiary SCCI as non-executive directors. In addition, non-executive directors should have at least proportionate representation on all Board committees. Other than a wholly owned subsidiary SCCI, individual shareholders (or any group of associated shareholders) of an SCCI should have broadly proportionate representation on the Board, based on their shareholdings. As a guide, holdings under 15 per cent of an SCCI's voting shares should have a representation of no more than one on a Board of six or less, and no more than two on a Board of seven or more. Holdings over 15 per cent may have greater representation but not more than is broadly proportionate to the relevant shareholding.

    (b) in the case of a foreign-owned subsidiary SCCI, non-executive directors (including the Chairman) of the Board could be executives of the foreign parent. However, at least two directors must be Australian residents, one of whom must be a non-executive.

19. Directors and senior management of the proposed SCCI must satisfy APRA that they are fit and proper to hold the relevant position. APRA may consult other regulators (domestic and overseas) regarding the suitability of personnel for the proposed SCCI. Where necessary, applicants should provide APRA with the authority to seek details in this regard.

20. In reaching its view on the fitness or propriety of any director or manager, APRA will have regard to factors such as:
    (a) the experience and expertise of the person relative to the duties involved;
    (b) demonstrated competence in business in the past and/or in the conduct of current duties;
    (c) integrity in business activities; and
    (d) reputation within the business and financial community.

Risk Management and Internal Control Systems

21. SCCI applicants must satisfy APRA that their proposed (or existing) risk management and internal control systems are adequate and appropriate for monitoring and limiting risk exposures arising from their credit card issuing and/or acquiring business from the commencement of their operations. This includes, in particular, the maintenance of adequate and appropriate policies and procedures for monitoring and managing:
    (a) credit risk (including credit risk arising from merchant chargebacks) such as underwriting standards for cardholders and merchants, policy on large exposures and policy on monitoring asset quality (e.g. loan classification and provisioning policy) – refer Prudential Standards on "Risk Management of Credit Card Activities", "Large Exposures" and "Credit Quality";
    (b) liquidity risk (refer Prudential Standards on "Risk Management of Credit Card Activities" and "Liquidity"); and
    (c) operational risk such as fraud or systems failure (refer Prudential Standards on "Risk Management of Credit Card Activities" and "Outsourcing").
22. SCCI applicants that are subsidiaries of a parent company must demonstrate that arrangements for reporting to parent companies are adequate.
23. In assessing whether the policies and procedures proposed for managing and controlling risk are adequate and appropriate for the applicant's operations, APRA will take account of the nature and scale of the operations, the volume of transactions undertaken and the proposed organisational structure as set out in the business plan.

Information and Accounting Systems

24. SCCI applicants must satisfy APRA that their proposed (or existing) information and accounting systems are adequate for maintaining up-to-date records of all transactions and commitments undertaken by the SCCI, so as to keep management continuously and accurately informed of the SCCI's condition and the risks to which it is exposed. Applicants are required to demonstrate to APRA that the proposed systems will be capable of producing all required statutory and prudential information in an accurate and timely manner from the commencement of their credit card issuing and/or acquiring operations.

25. In assessing the overall adequacy of the proposed information and accounting systems, APRA will have regard to the integrity and security of the systems, including associated backup facilities and disaster recovery arrangements. Any proposed (or existing) outsourcing of data processing (and any other back office) functions must satisfy APRA's outsourcing requirements (refer Prudential Standard on "Outsourcing").

External and Internal Audit Arrangements

26. SCCI applicants must demonstrate to APRA that arrangements have been established with external auditors in accordance with the requirements set out in the Prudential Standard on "Audit and Related Arrangements for Prudential Reporting". This includes, in particular, arrangements for an external auditor to report annually to APRA on:

    (a) the SCCI's observance of APRA's prudential standards and requirements;

    (b) the SCCI's compliance with statutory banking requirements and the conditions on the SCCI authority (including restrictions on deposit-taking activities);

    (c) the reliability of information supplied to APRA for prudential supervision purposes;

    (d) any other matters agreed between the SCCI, its external auditor and APRA under the tripartite arrangements.

27. SCCI applicants are also required to satisfy APRA that the proposed (or existing) internal audit arrangements (including establishment and composition of an audit committee) are in accordance with the requirements set out in the Prudential Standard on "Audit and Related Arrangements for Prudential Reporting".

Supervision by Home Supervisor

28. Foreign banking organisations wishing to establish a subsidiary SCCI in Australia must have received consent from their home supervisor.

29. Foreign bank parents of SCCIs must satisfy APRA that they are subject to adequate prudential supervision in their home country. In considering the standard of supervision exercised by the home supervisor, APRA will have regard to the Core Principles of Banking Supervision promulgated by the Basel Committee on Banking Supervision. This includes whether the home supervisor supervises the foreign banking organisation on a consolidated basis in accordance with the principles contained in the Basel Concordat, and is prepared to co-operate (in terms of the Concordat) with APRA in the supervision of the SCCI in Australia.

Dual Operation

30. Where an ADI has dual authorisation to operate as an ordinary ADI and to conduct its credit card business in a subsidiary SCCI, each operation is required to conduct its business in Australia in a way which recognises, and makes clear to others, its separate authorisation.

31. The ADI and its subsidiary SCCI will need to have:
    (a) separate books of accounts;
    (b) separate statistical (including prudential) reporting to APRA;
    (c) separate internal control systems for monitoring and managing risks (including systems for controlling credit, liquidity and operational risk); and
    (d) as part of the control systems, separate systems of delegations (although these could comprise the same people in some cases).

Information Required to be Submitted on Application

32. A list of information and supporting documents required to be submitted by an SCCI applicant on application for an authority to carry on the banking business of credit card issuing and/or acquiring in Australia is set out in Attachment A.

33. APRA may seek such additional information from an applicant as is necessary to assess the application.

Application Procedures

Preliminary Consultation

34. Prospective SCCI applicants are encouraged to contact APRA at an early stage to discuss their plans prior to submitting a formal application. This assists APRA in identifying any matters which might adversely impact on the proposal and to advise on the format and content required of an application. APRA will review drafts of an application through various stages of its development.

Submission of Application

35. Two copies of the final application, including all the required information and supporting documents set out in the Attachment (as appropriate) should be submitted to APRA.

Processing and Notification

36. All applications will be promptly processed. However, the time required to process an application will depend on the particular circumstances of each application, including the completeness of information and documents submitted to APRA by the applicant.
37. An authority may be granted to take effect on delivery or from some nominated date.

Attachment A

Supporting Information Required for an Application to Establish a Specialist Credit Card Institution (SCCI)

1. Ownership, Board and Management

(a) Name of the proposed SCCI.

(b) A brief history of the applicant and an outline of the existing operations of any related entities in Australia.

(c) Proposed initial capital (authorised, paid-up, classes of shares, etc).

(d) Names of substantial shareholders (direct and ultimate) and their respective shareholdings.

(e) An undertaking by substantial shareholders to provide additional capital, if required, and that their investment in the SCCI represents a long-term commitment.

(f) Board structure, including names of directors, their principal business associations and curriculum vitae.

(g) An outline of the proposed organisational framework, with names of senior management, their responsibilities and curriculum vitae.

2. Three-Year Business Plan

The business plan submitted should incorporate the goals or milestones of the first three years of operations of the SCCI. The plan should include:

Structure of Business

(a) An outline of the current and proposed activities and the scale of operations.

(b) For issuers, current and targeted cardholder demographic composition.

(c) For acquirers, a list of existing merchants and details of the targeted client base.

(d) The location of head office and any envisaged network of other offices or operation centres and the timeframe over which the network will be established.

(e) A description of operations and technology.

(f) An estimate of total staff complement envisaged.

(g) Descriptions of any marketing or similar alliances with third parties.

(h) The proposed date for commencement of operations.

Financial Data

(i) The most recent audited financial statements.

(j) The size and composition of loan portfolio, if any (including for example number of cardholders' accounts, details of delinquencies and provisions made).

(k) Projections (including sensitivity analysis covering expected, up-side and down-side scenarios) of the following:

- (i) detailed balance sheet, cashflow and earnings (including assumptions used);
- (ii) key financial and prudential ratios (e.g. capital ratios, liquidity ratios, prescribed provisioning amounts, etc) for the proposed SCCI; and
- (iii) key financial and prudential ratios for the proposed SCCI and its subsidiaries (if any) on a consolidated basis.

3. Systems and Controls

(a) Details of the risk management systems and procedures to be used to control and monitor risks in relation to the operations of the SCCI (and its subsidiaries), including:

- (i) credit underwriting and scoring policies;
- (ii) credit policy on loans to shareholders, directors and associated interests;
- (iii) large exposures policy;
- (iv) policy on measuring, reporting and monitoring credit quality across credit card accounts and provisioning policy for doubtful loans;
- (v) merchant screening policy (including subsequent ongoing review procedures) and chargebacks risk management policy;
- (vi) liquidity management policy; and
- (vii) policies and procedures for control of operational risk (e.g. systems failure and fraud monitoring).

(b) Description of information and accounting systems (including a list of internal reports generated for risk management purposes).

(c) Description of information security policies, procedures and systems controls.

(d) Evidence that, from the commencement of operations, information and other systems will be capable of producing all required statutory and prudential returns in an accurate and timely manner.

(e) Description of any existing or proposed material outsourcing arrangements.

(f) Description of business continuity (including disaster recovery and system reliability) arrangements.

(g) Description of the audit program covering internal controls and systems.

4. Subsidiaries

(a) Details of existing or proposed subsidiaries and associates, the nature and scale of their business, and their proposed business relationship with the proposed SCCI.

(b) Any plans to transfer assets from subsidiaries and associates to the proposed SCCI.

5. Other

(a) Certificate of incorporation of the corporate vehicle to hold the SCCI authority (refer Section 10 of the Banking Act).

(b) Certified copies of Memorandum and Articles of Association (refer Section 10 of the Banking Act).

(c) External auditor's certificates verifying the level of capital and, where applicable, capital ratios of the applicant.

6. Additional Information Requirements for Wholly Owned SCCI Applicants

(a) The parent company (intermediate and ultimate) of an SCCI applicant should provide:

(i) a brief history and an outline of its operations, substantial shareholders (direct and ultimate) and directors (including principal business associations);

(ii) balance sheet, profit and loss and off-balance sheet data for the last three years (plus any available current year data), and in the case of ADI or foreign bank parents, information on impaired loans and capital ratios;

(iii) an outline of the proposed reporting arrangements from the subsidiary SCCI to the parent company;

(iv) an undertaking to co-operate in the supervision of the proposed subsidiary SCCI, including the provision of information required by APRA to supervise the proposed subsidiary SCCI;

(v) an undertaking to keep APRA informed of any significant developments adversely affecting its financial soundness and/or reputation, and to provide promptly to APRA copies of its published financial accounts and any significant media releases (with translations where appropriate); and

(vi) an outline of the supervisory arrangements to which it is subject in its home country, if applicable.

(b) Foreign bank parents of SCCI applicants should provide APRA with a statement from their home supervisor confirming that:

(i) the foreign bank parent is of good financial standing and has the supervisor's consent to establish an SCCI subsidiary in Australia;

(ii) it supervises the parent bank and its subsidiaries on a consolidated basis in accordance with the principles contained in the Basel Concordat; and

(iii) it is willing to co-operate in the supervision of the proposed subsidiary in terms of the Concordat.

7. Prudential Supervision by APRA

(a) A written undertaking by the applicant to:

(i) adhere to APRA's prudential requirements at all times;

(ii) consult APRA and be guided by it on prudential matters and in respect of new business initiatives; and

(iii) provide APRA with any information which it may require for the prudential supervision of the proposed ADI (and its consolidated group).

(b) An acknowledgement by the applicant that APRA may discuss the applicant's conduct and status with its parent and, where applicable, its parent's supervisor(s).

(c) Evidence that arrangements have been established for the prospective SCCI's external auditors to report to APRA.

PRUDENTIAL STANDARD

APS XXX – Risk Management of Credit Card Activities

Objective

This standard aims to ensure that ADIs (including SCCIs) implement proper measures to monitor and control the risks associated with their credit card activities.

Principles

Board and Management Supervision

1. The Board of an ADI must ensure that the ADI has established a comprehensive risk management process for managing and monitoring the risks associated with its credit card activities. This should include policies, systems and procedures for approving new merchants and credit card applicants, ongoing monitoring of their credit quality and fraud control.
2. The Board and senior management of an ADI should receive and review regular reports which detail risk management information on its credit card operations such as the number of new merchants and cardholders, account attrition, portfolio compositions, sales volumes, credit quality, chargebacks and frauds.

Credit Risk

3. The primary risk to credit card issuers is credit risk. Card issuers reimburse card acquirers for transactions on behalf of their cardholders and undertake the associated risk that the cardholder will not make payment as expected. As a result, credit risk management is critical for credit card issuers.
4. Issuing ADIs must establish prudent credit policies and procedures for approving new cardholders and determining credit line size (including policies and procedures for approval of overlimits). Where credit scoring models are used, the methodology and experience with these models must be kept under continual review.
5. Issuing ADIs must have adequate systems and procedures in place for measuring, monitoring and provisioning for delinquent accounts and bad and doubtful loans (see APS 220 – Credit Quality).
6. Credit risk also arises for credit card acquirers where merchants fail to reimburse them for chargebacks (reversed transactions due to the return of faulty goods by cardholders, non-delivery of goods and services by merchants

or merchant fraud). To manage and monitor such risk, acquiring ADIs must establish prudent underwriting standards and procedures for approving new merchants as well as ongoing review processes for assessing the operational and financial condition of merchant customers. There must be adequate systems and procedures in place for monitoring merchant chargebacks. Acquiring ADIs must monitor trends in chargebacks and merchant capacity to repay these chargebacks, and take appropriate risk management measures (e.g. posting of collateral, pre-funding, performance guarantees, etc) where risk concerns exist with particular merchants.

7. Issuing and acquiring ADIs must establish policies, systems and controls for monitoring credit concentrations to particular customers (see draft APS 221 – Large Exposures). For the purposes of APS 221, aggregate exposure to individual cardholders or merchants includes both on- and off-balance sheet exposure (i.e. any credit card advances and unused credit lines for a cardholder or any advances to a merchant arising from chargebacks and potential chargeback exposure to the merchant).

Liquidity Risk

8. Both credit card issuers and acquirers are exposed to liquidity risk. Card issuers are obliged to settle payments with card acquirers for transactions on behalf of their cardholders within a short period of time (one or two days) regardless of when payments are received from cardholders (which might be spread across several months). Liquidity risk also arises for credit card acquirers where chargebacks or refunds to cardholders reach a level that cannot be covered by the merchant's transactional processing volume. Issuing and acquiring ADIs must establish policies, systems and procedures for measuring, managing and reporting liquidity (see APS 210 – Liquidity).

9. Issuing SCCIs must hold highly liquid assets (cash or cash equivalents) sufficient at all times to fully cover any incidental credit balances on credit card accounts.

10. Acquiring SCCIs must separate funds awaiting settlement to merchants in a trust or escrow account with an ADI authorised to accept deposits.

Operational Risk

11. Both credit card issuers and acquirers are exposed to operational risk arising from systems failure, outsourcing arrangements and fraudulent transactions. Issuing and acquiring ADIs must implement policies, systems and procedures with respect to:

(a) integrity of transaction data and timely processing of transactions;

(b) appropriate back-up and disaster recovery plans and facilities, including real-time fail-over capacity of critical processing systems;

(c) controls against information security and physical security risks;

(d) outsourcing risk management for any third-party service providers (see APS 231 – Outsourcing); and

(e) fraud risk management.