Australia and New Zealand Banking Group Limited

Submission to the
Reserve Bank of Australia

Principles for Regulation of Credit Card Systems

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Executive Summary

Principles for Regulation of Credit Card Schemes

1. Context

This is the ANZ Banking Group's submission to the inquiry that the Reserve Bank of Australia (RBA) is conducting following 'designating', under the *Payment Systems (Regulation) Act 1998* (PSRA), the MasterCard, Visa and Bankcard credit card schemes in Australia.

ANZ is committed to contributing constructively to this process, with the aim of reaching a resolution which can clearly be seen to be in the public interest. ANZ accepts that new arrangements should satisfy a public interest criterion based on efficiency and competition, as expressed in the PSRA. ANZ considers that lack of transparency is the main aspect of present arrangements that can validly be criticised — not that interchange fees are too high. In fact, interchange fees in Australia are among the lowest in the world, implying caution in considering any intervention.

2. General Principles and Issues for the Inquiry

Applying a public interest test

ANZ believes that *interchange fee* pricing principles are best dealt with as part of an *access regime* (s. 12 of the PSRA) than via regulated *standards* (s. 18), because:

- pricing principles are the core of any regulated access regime;
- the PSRA specifies a fuller set of considerations to take into account for an access regime (including the interests of current participants and access seekers); and
- in explanations accompanying the *PSR Bill*, standards were seen as covering operational matters.

Regulation designed to liberalise participation in credit card schemes should be couched in terms of access to the relevant *services* — i.e. being connected into the credit card systems and able to transact. It should not prescribe in respect of ownership of intellectual or other property, voting rights etc.

Important general considerations

Global consistency: As a global bank, ANZ is especially conscious that the main open credit schemes are global. Any regulatory framework should not segment the Australian market from the global market, deterring entry of international competitors and impeding domestic issuers from competing in overseas markets. It would also be of legitimate concern to the global open schemes (Visa and MasterCard) if Australian regulation opened access to certain categories of domestic (non-financial) organisations which, if admitted in other countries, would cause risk to those schemes.

Maintaining incentives to invest and innovate: Any new framework should allow maximum commercial flexibility and, above all, allow the commercial parties to derive reasonable economic returns on their past and prospective future investments. It is extremely important to recognise that the past investments in developing the systems were substantial, and only recently made — largely over the 1980s and 1990s. ANZ alone incurred (economic) losses running into **c-i-c**. Incentives must be maintained for making further investments (e.g. in chip cards, to improve security and reduce costs to merchants).

'Level playing field': At least one of the so-called closed schemes (American Express and Diners' Club) acts as a four party scheme in Australia (with interchange fees, which anecdotally are higher than in the open schemes, as are merchant fees and presumably costs). The PSRA would seem equally capable of regulating interchange in either 'open' or 'closed' four party schemes; to control one but not the other would be inconsistent with the efficiency and competition objectives of the PSRA public interest test.

General criteria for good regulation of credit card systems: summary

In general, any regulatory framework to be applied to credit card systems should:

(i) deal with interchange pricing principles, as well as participation, as part of an *access regime* (rather than via *standards*);

(ii) be *transparent*;

(iii) be *minimal*, lead to measurable positive *net benefit* after explicitly considering regulatory impacts; and be *sunsetted* and subject to zero-based review;

(iv) impose *criteria* or *principles*, and not prescribe their application;

(v) apply *efficient pricing principles*, taking into account all legitimate costs as well as network *externalities*;[1]

(vi) be consistent with a wide and *dynamic concept of efficiency*, including the global context, incentives to invest and innovate;

(vii) be commercially *realistic*, including allowing commercial returns to be earned, and leave maximum commercial *flexibility*;

(viii) protect intellectual property and other *property rights*;

(ix) protect the *safety, security and stability* of the schemes, in terms of payment risk, adherence to operational and technical standards and workability of scheme governance; and

(x) ensure a neutral competitive environment.

[1] Here 'network' refers to the complex of mutual inter-relationships between merchants and consumers that credit card systems mediate through issuers and acquirers — not to physical communications links.

3. Appropriate Regulation of Interchange Fees

Important considerations

Externality benefits of credit card networks: Regulation must allow for the fact that open credit card networks confer significant externality benefits on both consumers and merchants jointly. Interchange fees are the 'glue' that keeps these networks going. Credit cards distinctively offer a 'buy' now, pay later' payment functionality which relieves consumers of the need to have sufficient funds in their transactions accounts before making purchases, thus enabling them to optimise their spending patterns over time. For merchants, this means that customers can spend more, and sooner — as is widely recognised by merchants[2]; and reduced cash or cheque processing costs also benefit them.

Existing approaches to calculating interchange: Of existing (or proposed) approaches, ANZ prefers the *Visa approach,* which takes into account the demand side, i.e. revenues, as well as costs (including acquirers' as well as issuers'), and allows room for commercial judgement. In every market, that has led to fees set below full cost. However, ANZ acknowledges that market factors, commercial discretion etc may be difficult to enshrine in official regulation — given the importance of transparency and justifying the pricing arrangements to the public. This is the main argument favouring a purely cost-based approach over a more comprehensive one like Visa's.

Cost-based, issuer-focused regulatory approaches preferred: ANZ also sees it as a logical, and perhaps the simplest and most readily explained approach, to develop principles which relate the interchange fee, which is received by the issuer, to the costs of the *issuing function only*. This reflects the fact that the acquiring function is a distinct business function from issuing, and more importantly is, in open schemes, frequently provided by a different party (i.e. in 'not on us' transactions).

It would clearly be inefficient to prescribe the exclusion of some valid costs from the interchange fee calculation, as was suggested in the *Joint Study*. A key issue, then, is how to treat shared costs.

The avoidable cost methodology

The approach for dealing with shared (as well as direct) costs that ANZ favours, which is called the *avoidable cost methodology*, is fully consistent with efficient pricing principles. Under it, the costs attributed to interchange services clearly relate to benefits to merchants from the credit card payments networks. They do not include any costs unrelated to 'buy now, pay later' payment services provided by these networks.

Definition: Under the avoidable cost methodology, the cost of producing interchange services is defined as *the total costs incurred by issuers in providing all services less the costs that would be avoided if they did not provide services unrelated to payments network services.*

The issuers' costs that would be incurred by a *stand alone* operator of payment services include:

[2] E.g. Gerry Harvey of Harvey Norman recently said "If we don't provide credit, our sales will drop".

- *credit losses* and collections on those amounts related to purchases in the period just prior to the cardholder defaulting on payment (i.e. excluding costs related to default on extended credit repayments);
- the *cost of equity* capital;
- *sunk costs* (i.e. the capitalised losses associated the start up period of the credit card networks and not yet amortised); and
- *operating costs*, such as staff costs, facilities costs, systems and data processing costs.

Other implementation issues include:

- *choice of cost benchmark*. In ANZ's preliminary thinking this could involve omitting part of the cost range (e.g. the highest cost quartile) from the industry cost benchmark calculation — but avoiding affecting competition adversely by going so far as to drive out all but the largest scale issuers;
- *frequency of review*. ANZ leans to three years; and
- *setting different interchange fees* according to transaction class. While generally favouring simplicity and uniformity, ANZ supports this where there is an objective and significant cost difference (e.g. cardholder not present or 'MOTO'[3] transactions with no issuer payment guarantee).

Commercial flexibility could be maximised by allowing fees to be varied (between transaction classes or merchant categories), with regulation governing the maximum overall level — and allowing reductions from that level.

Summary of appropriate pricing principles for interchange

A methodology for interchange should be deemed appropriate under regulation if it is:

(i) *transparent* and based on a clear and *objective* methodology consistent with allocative, productive and dynamic *efficiency*, while having regard to the existence of network *externalities*;

(ii) designed to recover overall, as a maximum, no more than the *stand alone cost* (including sunk costs) of delivering the 'buy now, pay later' *payment functionality*;

(iii) designed to engender pressure for *'best practice' productive efficiency*, via choice of benchmarks, allowance for anticipated future developments etc;

(iv) consistent with dynamic efficiency, by *rewarding investment* no more than adequately, but having full regard to the risks of such investment;

(v) designed to provide *certainty*, while allowing for re-opening in response to major unforeseen developments; and

(vi) otherwise consistent with fullest exercise of *commercial flexibility* by scheme participants.

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[3] 'Mail order, telephone order'.

4. Appropriate Regulation of Access to the Designated Schemes

Membership related rules

Each of Bankcard, Visa and MasterCard has its own set of membership/access rules and policies, but they share strong common themes relating to:

- eligibility criteria;
- membership fees;
- self acquisition policies; and
- 'net issuer' requirements.

These rules are designed to efficiently protect scheme safety, which is vital to them, notably by not duplicating official prudential regulation; and also to promote scheme stability. It is clearly in the interest of all the open schemes to maximise membership, not to restrict it, so long as there is no compromise on safety.

It is important to note that each of the schemes already has liberal non-membership avenues for *effective economic participation*, and it is the latter concept of access which is most relevant in assessing whether the membership rules constitute unreasonable barriers to entry.

In each of the schemes, it is open to a non–bank to become a *co-brand partner* of a member and to have the member issue one of these schemes' cards with the partner's 'livery' predominating, under whatever terms are agreed bilaterally. The facilities provision, operation and processing functions forming part of the acquiring business are also liberally open to others. Only acquiring *per se*, i.e. carriage of settlement and merchant enforcement obligations, is prudentially restricted by the schemes.

ANZ notes that Australian banks collectively control the Bankcard Association of Australia (BAA), but Australian banks do not control the rules of the global open schemes (Visa and MasterCard).

Bankcard has already reformed its rules, which are now a benchmark for liberality in regard to access, while still protecting scheme safety and stability. The new Bankcard rules (see below) well exemplify principles which ANZ sees as also relevant for the other open schemes *in the Australian context*. However, the global open schemes, for good reason, must adopt membership rules which are broadly the same in all countries. Thus an approach to admission which produced acceptable outcomes in Australia might pose unacceptable risks if applied in, say, Russia.

Bankcard's new access rules

Under Bankcard's new access rules, membership is open to any entity that is:

- an authorised deposit-taking institution (ADI) in Australia supervised by the Australian Prudential Regulation Authority (APRA); or
- a financial institution supervised by an official prudential regulator in another country that is recognised by APRA; or

- an entity whose liabilities in respect of the BAA Scheme are guaranteed by an APRA supervised organization (or an organization supervised by a foreign prudential regulator recognised by APRA) under a guarantee that survives the commercial failure of the [guaranteed] entity.

Under Bankcard's new rules, a non-ADI only needs a guarantor — who will no doubt charge less if the merchant's businesses poses low risks. In turn the guarantor's official prudential regulator will want to be assured that it can carry the exposure. For Bankcard, this is a very efficient way of handling the prudential issue. Other possible alternatives (e.g. collateral) are not significantly effective and/or efficient.

Bankcard has also introduced lower and simpler membership related fees, and is taking a liberal approach on both self acquisition (by merchants) and specialised acquiring — matters which legitimately pose concerns for open credit card schemes. Since under Bankcard's new rules, the official regulator must be satisfied that the member or guarantor is able to settle obligations upstream, Bankcard no longer prohibits members from acting as self acquirers. It also decided that there was no need to prohibit or restrict specialised acquirers, other than to require them to make an appropriate contribution to scheme development through a (very low) 'Incentive Fee'.

Summary of appropriate principles for regulated access to the schemes

Appropriate principles governing access regimes for these schemes should require that access rules:

(i) be *transparent*;

(ii) relate to *access to relevant services*, not to ownership of scheme intellectual property or to participation in governance (e.g. voting rights);

(iii) not remove all discretion from the scheme as regards entrants, but confine discretion to substantial grounds; and otherwise be *non-discriminatory*;

(iv) be based on *objective criteria* related to legitimate *scheme objectives*, notably scheme safety and stability; and

(v) be designed to *maximise participation*, subject to those scheme objectives.

5. The 'No Surcharge' Rule

Rationale

The 'no surcharge' (or no discrimination) rule prohibits merchants from charging consumers an additional amount when using a credit card to make purchases i.e. from explicitly passing on the merchant service fee to credit card purchasers. However, nothing prevents merchants from offering discounts to consumers who pay by cash or debit card. The *Joint Study* argued that the rule distorts price signals and hence is inefficient. It also claimed that the 'no surcharge' rule provided a cross subsidy from non-credit card paying consumers to credit card card-paying consumers.

The Joint Study did not take into account the valid rationale for the 'no surcharge' rule, which is to reflect the fundamental positive externality of credit card networks. In practice removing this rule might not make practical difference, which has been the

experience in Europe. Cash discounts or, where permitted, surcharging, tend to occur only where either merchant margins are unusually thin or the unit value of purchases is low — noting that it is also costly to handle cash or cheques. It is better to deal with such areas by exception than to drop the rule altogether.

If one merchant, rationally or not, violated the 'no surcharge' rule, this would not undo the positive externality created by credit card networks. However, if many tried to 'free ride' in this way, this would tend to negate the externality benefits. Consumers would become aware that if they sought to pay by credit card they would either pay a surcharge of a known (or typical) amount or, worse, not know what might be added to advertised or posted prices until they came to pay. Hence they would tend to use credit cards less.

'No surcharge' rule does not imply cross subsidy: A service can only receive a cross subsidy if the costs saved by removing that service are greater than the revenues that would be lost. A service can only provide a cross subsidy if that service generates more revenue than the full economic cost of providing it on a stand alone basis. The Study has not demonstrated, on this accepted economic definition of cross subsidy, either that credit card paying customers receive a cross subsidy or that others provide one.

ANZ's Position

ANZ submits that the RBA has not made a convincing case that the 'no surcharge' rule is distortionary or anti-competitive or involves a cross subsidy. Given the externalities involved, the burden of proof falls on the RBA to demonstrate that this rule has negative social effects and that its regulated removal would lead to any significant net benefit to the community.

Chapter 1

Introduction

1.1 Background

This is the ANZ Banking Group's submission to the inquiry that the Reserve Bank of Australia (RBA) is conducting following 'designating', on 12 April 2001, the MasterCard, Visa and Bankcard credit card schemes under the *Payment Systems (Regulation) Act 1998*.

ANZ previously submitted to the RBA and to the Australian Competition and Consumer Commission (ACCC) a response to the RBA/ACCC joint study of debit and credit card schemes in Australia.[4] ANZ was also one of the so called 'Review Banks' whose role in setting interchange fees in the above 'open' (or 'four party') credit card schemes was challenged by the ACCC under the *Trade Practices Act 1974* (TPA), prior to the matter being passed to the RBA.

As one of the Review Banks and as a member of the Australian Bankers' Association (ABA), ANZ has been a party both to contributions on the relevant issues put forward previously by the Review Banks collectively to the ACCC and the RBA; and to the development of an industry submission to the RBA's current post-designation inquiry, which is being coordinated through the ABA.

Throughout these processes ANZ has been committed to constructive dialogue with the regulatory authorities, seeking a resolution which would both be in the public interest, and seen to be so; and allow the commercial parties maximum flexibility and commercial opportunity subject to that. In particular, ANZ acknowledges that given that interchange fee setting in open schemes must, in practical terms, be a collective process, the methodology for this should desirably be transparent and be seen to be consistent with the interests of all stakeholders, from merchants and acquirers to issuers and cardholders — effectively the public.

ANZ has already argued in its response to the Joint Study that the analysis there presented has not demonstrated that interchange fees have been set too high. Indeed in Australia interchange fees are among the lowest in the developed world. Moreover, Visa International has recently pointed out that in every market in which that scheme has comprehensively assessed the costs of running the system, interchange fees have been set by members *below* the calculated full cost of card issuing. These observations underline the fact that a convincing case that intervention will lead to positive net benefits has yet to be made out. They certainly imply a need for caution in considering any intervention. Nevertheless, ANZ does agree that it is in the interest of all parties that interchange fee setting be made transparent and be seen to be done on efficient pricing principles consistent with the public interest.

[4] RBA and ACCC, *Debit and Credit Card Schemes in Australia: Study of Interchange Fees and Access*, October 2000 ('Joint Study').

ANZ considers that the process that the RBA is conducting in pursuing its inquiries after designating the open credit card schemes is significantly more conducive to constructive exchange of information and views than was the previous process, which had more of an adversary character, overshadowed as it was by legal action. ANZ is keen to engage in the further process on a constructive and open basis, and to contribute in any way it can to a satisfactory outcome — for example by helping fill gaps in information about important aspects of the credit card systems.

This submission does not traverse in detail all of the ground that will be covered in the industry submission which is being coordinated by ABA. (The industry submission will, in particular offer a view on the specific, detailed content of an appropriate regulatory framework.) Rather this paper places ANZ's emphasis on what are seen as the most important issues for the inquiry and how they should be addressed.

1.2 Coverage of this submission

This submission focuses on the three main issues for the inquiry individually:

- the methodology for setting interchange fees in the open schemes (Chapter 2);
- scheme membership or access rules (Chapter 3); and
- the 'no surcharge' rule (Chapter 4).

General principles and issues

In this chapter (Chapter 1), Section 1.3 below canvasses at the outset general principles and issues that arise or apply in this inquiry:

- desirable general *principles or guidelines* applying to decision-making about the form, scope and degree of prescriptiveness of any resulting regulation, and the criteria or tests which any good regulation should itself meet; and
- *issues* posed by consideration of the potential consequences of regulation in this particular area — for the competitive environment, for the safety and stability of the open card schemes and for participants and users.

Contributions to filling information gaps

ANZ is also endeavouring to produce useful information on the *costs to all parties of delivering the same functionality* (as a payments mechanism) that a credit card does, but by alternative means.

An important aim is to clarify the value of the hallmark feature of credit cards as a payments mechanism: the 'buy now, pay later' feature. This feature frees cardholders from the immediate liquidity constraint — allowing them to take advantage of buying opportunities as they arise and to *separately* (and subsequently) arrange funding. The ability they have thereby to make larger purchases sooner is of course also the source of the network benefit that merchants receive by accepting cards. The work also aims to identify all costs to each party for means of transacting not involving that feature, including EFTPOS, cheque and cash (sourced at a bank branch or an ATM, or in a previous EFTPOS transaction).

ANZ notes that merchants also benefit from the *option* that a credit card holder has to fund the purchase by accessing *extended (revolving) credit* through the card — but the decision by the cardholder on whether or not to do so (or to draw funds from e.g. a housing loan) is properly seen as separate. Thus, while it is reasonable to make the 'buy now, pay later' *payment* functionality of credit cards the sole prime focus in the context of interchange fee setting, it needs to be recognised that this approach will be *conservative* in terms of assessing merchant benefits from credit card systems and the necessary costs associated with providing them.

The result of this work will be provided subsequently.

1.3 General Principles and Issues for the Inquiry

The public interest test

ANZ supports in principle the over-arching public interest criterion, and its core objectives of promoting efficiency and competition, as expressed in the *Payments Systems (Regulation) Act 1998* (PSRA). From ANZ's perspective, however, there are some particularly important considerations to be factored into the application of those criteria.

First, ANZ believes that *interchange fee* pricing principles are more appropriately dealt with as part of an *access regime* (section 12 of the PSRA) than via regulated *standards* (section 18), because:

- pricing principles are, in any regulated sector where an access regime might be applied, generally the core of that regime;
- in the case of an access regime, there is in the PSRA a fuller range of considerations specified explicitly to be taken into account in conjunction with applying the public interest test (including the interests of both current participants and access seekers); and
- the Explanatory Memorandum (EM) accompanying the *PSR Bill* characterised the application of standards as relating to the *operations* of the system (EM para 1.6).

Access means access to a service

In relation to participation in the open credit card schemes — the 'access' issue — ANZ notes that in Australian regulatory law and practice applying across other sectors, access is defined in terms of *access to a service*, not to a particular facility. In the context of the open credit card schemes and the application of the PSRA, this implies that what should be regulated in the public interest is the ability to use the services of the card systems — i.e. at the fullest, to be connected into those systems and to be able to issue cards and/or acquire merchants and carry out transactions associated with either or both.

As has been pointed out in work already done on this issue,[5] the designated schemes already offer very liberal avenues for *effective economic participation* in issuing and

[5] For example, in *Economic Review of Credit Card Scheme Membership Rules*, Report by the Allen Consulting Group Pty Ltd to the Review Banks, January 2001.

acquiring activities, short of membership. The point here, however is that regulation designed to enlarge 'full' participation should be couched in terms of access to the relevant services; it should not, and need not, prescribe in respect of *ownership* of facilities, brands and other intellectual property or in respect of participation in *governance* (including e.g. voting rights in the schemes etc).

A broad and dynamic concept of efficiency

ANZ considers that a regulatory framework applied under the PSRA should not only respect those constraints but take a broad and dynamic view of the overall public interest test — considering effects on property rights, incentives, competitive dynamics in the credit card and payments marketplace and the like (see Section 1.4 below) — and also satisfy some 'good housekeeping' criteria applicable to all regulatory intervention.

Good regulatory housekeeping

ANZ notes that the Commonwealth Government has for some years been an articulate advocate of *minimum necessary regulation*, requiring regulatory impact statements that set out clearly the reasons for the regulatory intervention and indeed which address the question of whether the benefit cost equation for the regulation is significantly net positive, given that all regulation has costs. These principles were indeed explicitly invoked in this specific context in the Government's response to the *Financial System Inquiry* (Wallis) Report, and in introducing the *PSR Bill* to the Parliament.

ANZ believes that it is only good regulatory practice, particularly in an area so dynamic and technology–intensive as credit cards, for the regulatory framework that may eventuate from the current process to be reviewed itself on a zero base after say five to seven years (or, say, after two regulatory review cycles of three years). Even at this stage, having designated these systems, the RBA should keep open the possibility of leaving detailed regulation of these schemes to the commercial parties — in the co-regulatory spirit of the Commonwealth Government's general approach to payment system regulation as articulated in its response to the Wallis Report.

1.4 Wider Factors for the Public Interest Test

ANZ notes that the key ingredients of the public interest test in the PSRA are promoting economic efficiency and competition. It is important, in ANZ's view that these be considered in a broad and dynamic perspective. For example, any regulatory framework that impinged adversely on the safety and stability of these systems would hardly be consistent with efficiency.

Global consistency

As a global bank, ANZ is especially conscious that the main open credit schemes are global. Any regulatory framework which aims to promote efficiency and competition must be consistent with that. For example it should not require separate compliance activities and/or business systems or in any way act to segment the Australian market from the global market. That would be inimical to the promotion of efficiency and competition — since it would tend to deter entry to the Australian market of international competitors in aspects of credit card or other payment systems. It would also raise barriers to domestic issuers competing in overseas markets. In a global

perspective, the open schemes would properly also have great difficulty with requirements e.g. to grant access to certain categories of domestic non-financial organisations which, if applied in other countries, would raise concerns about risk to the schemes.

Maintaining incentives to invest and innovate

ANZ also sees it as important that the public interest test be applied so as to produce a framework which is commercially realistic and conducive to competition and innovation. In other words, the framework should allow maximum commercial flexibility and, above all, allow the commercial parties to derive reasonable economic returns on their past and prospective future investments.

ANZ concedes that it is not easy to measure and make allowance for the sunk costs representing the large investment made in developing the credit card systems in Australia, and enlisting widespread participation in them. Nevertheless it is extremely important to recognise that these investments were substantial and only recently made — largely over the 1980s and 1990s. ANZ alone incurred (economic) losses running into **c-i-c** over the long 'ramp-up' period which ran through to the early to mid 1990s. (Details have been provided separately.)

As these schemes are highly dynamic and technology intensive, it is certain that new large investments will be required over the years immediately ahead, and beyond. For example, large investments will be required in the technology and systems needed to ensure security, particularly for transactions over the internet, and to reduce costs to merchants. Chip cards are soon to begin widely replacing magnetic stripe cards as part of this, and will require a large investment. Even without such new physical investment, ongoing expenditure is required to maintain and develop participation — of both cardholders and merchants — in these systems so ensuring continued generation of the network externalities that all participants in them enjoy. The treatment of returns on *past* investments is, in short, very important to maintenance of incentives for *future* scheme development.

'Level playing field' considerations

An extremely important consideration, in ANZ's view, is that a 'level playing field' — i.e. a neutral competitive environment — be maintained not only within and between the open schemes but between them and the so-called closed schemes, American Express and Diners' Club.

ANZ notes that the closed schemes do not collectively set interchange fees and therefore their arrangements were not open to challenge under the *Trade Practices Act 1974* as were those of the open schemes. Nevertheless, the closed schemes do have independent issuers (i.e. act as four party as well as three party schemes) and may possibly in future have independent acquirers — or e.g. enter into terminal sharing arrangements. Certainly at present they do have third party issuers and interchange fees, which anecdotally are higher than in the open schemes — as are their merchant fees, and presumably their costs. Therefore any concerns that may attach in the minds of payment systems regulators to these fees in open schemes surely apply equally to the closed schemes.

The PSRA — as distinct from the TPA — would seem equally capable of regulating the setting of interchange fees in the context of either type of four party scheme. Assuming, nevertheless, that the RBA does not proceed to draw into the set of payment systems which has been designated the comparable arrangements applying in the closed schemes, it becomes extremely important that the RBA consider the competitive implications of controls that it may impose on the one but not on the other. For example, if the interchange fees in the open schemes were forced too low by regulation, there would be the very real prospect of a loss of market share to the closed schemes which are lower in scale and probably higher cost. This would likely be reinforced via migration to those schemes of issuers, particularly of popular cards with enhanced features (which merchants would tend to accept at some increment to the merchant fees of regulated schemes); and potentially of acquirers. The consistency of such an outcome with economic efficiency and the Australian public interest would be dubious at best.

In short ANZ considers that the implications for the terms of competition among credit card schemes (as well as within them), and indeed between regulated credit card schemes and other payments mechanisms, need to be carefully weighed up in assessing the benefits and costs of whatever prospective regulation the RBA may contemplate.

1.5 Checklist of Appropriate Criteria

The foregoing discussion can be distilled into a checklist of specific criteria which should be satisfied, both in the threshold decision of whether to impose a regulatory framework and in weighing its content.

Any regulatory framework applied under the PSRA to credit card systems should:

(i) deal with interchange pricing principles, as well as participation, as part of an *access regime* (rather than via *standards*);

(ii) be *transparent*;

(iii) be *minimal*, lead to measurable positive *net benefit* after explicitly considering regulatory impacts; and be *sunsetted* and subject to zero-based review;

(iv) impose *criteria* or *principles*, and not prescribe their application;

(v) apply *efficient pricing principles*, taking into account all legitimate costs as well as network *externalities*;[6]

(vi) be consistent with a wide and *dynamic concept of efficiency*, including the global context, incentives to invest and innovate;

(vii) be commercially *realistic*, including allowing commercial returns to be earned, and leave maximum commercial *flexibility*;

(viii) protect intellectual property and other *property rights*;

(ix) protect the *safety, security and stability* of the schemes, in terms of payment risk, adherence to operational and technical standards and workability of scheme governance; and

[6] Here 'network' refers to the complex of mutual inter-relationships between merchants and consumers that credit card systems mediate through issuers and acquirers — not to physical communications links.

(x) ensure a *neutral competitive environment*.

Chapter 2

Principles and Methodology for Interchange Fees

2.1 Introduction

Purpose of this chapter

The purpose of this chapter is to outline the principles and methodology for the calculation of credit card interchange fees that ANZ considers is the most appropriate — presuming that regulation will indeed apply after the current inquiry process.

General considerations

As outlined in Chapter 1, ANZ believes that the regulatory framework to apply to the setting of interchange fees should comprise *pricing principles* that form part of an *access regime* as defined in the PSRA. The framework as a whole, and the pricing principles in particular, should satisfy all the criteria for good regulation in this area summarised just above in Section 1.5.

Externality benefits of credit card networks

It is important to keep in mind that open credit card networks confer significant benefits to both consumers and merchants jointly. Interchange fees are the 'glue' that keeps these open networks going.[7] ANZ strongly submits that a strong focus on network externalities must be maintained in considering any regulation of interchange fees, because regulation which ignored their significance could cause significant welfare losses to the community by undermining the widespread benefits of the credit card networks.

Consumer benefits

For consumers, the primary benefit of credit cards as payment mechanisms is that they ameliorate their liquidity constraints. Credit cards relieve consumers of the need to have sufficient funds in their transactions accounts before making purchases, thus enabling them to optimise their spending patterns over time.

These benefits are not available in a financially repressed environment where consumers are not free to borrow. It is generally recognised that the liberalisation of the Australian financial system, which began in the early1980s, was beneficial to consumers because it ended the rationing of credit by non-price constraints and gave consumers ample choice of mechanisms to borrow and lend. This has been recently acknowledged by the Reserve Bank of Australia itself:

[7] ANZ notes that open credit card schemes typically also have 'net issuer' rules and associated fee provisions, serving the legitimate purpose of reconciling inherent differences between issuer and acquirer interests. ANZ assumes that regulation of such provisions is not in contemplation.

> "Financial liberalisation, by opening up new sources of debt finance, has made it easier for households to smooth consumption."
>
> Marianne Gizycki and Philip Lowe, "The Australian Financial System in the 1990s" in David Gruen and Sona Shrestha (eds), *The Australian Economy in the 1990s*, 2000 RBA Conference Volume

Merchant benefits

Ernst & Young quantified the benefits of credit cards to merchants, in the United States, in a survey.[8] This study found that 83 per cent of retailers thought that accepting credit cards increased their sales while 58 per cent thought their profits were increased. In Australia, no survey is readily available, but credit card use has been increasing[9] and merchant perceptions are essentially the same. For example, Gerry Harvey of Harvey Norman recently said "If we don't provide credit, our sales will drop."[10] Further evidence of merchant benefits via cost reductions comes from the Food Marketing Institute in the United States. This suggests that the direct cost of using cash for the average FMI member is about 1.9 per cent of each transaction (i.e. probably higher than the MSF for a credit card transaction). This includes armoured car charges, bank fees, and labour costs associated with preparing and making deposits but excludes insurance costs associated with cash acceptance and theft costs.[11]

Role of interchange

Interchange fees in open credit card schemes can be said to perform one of two (arguably equivalent) roles:

- a financial adjustment that reduces the imbalance between the costs associated with issuing and acquiring (net of revenues derived by issuers from cardholders and by acquirers from merchants); or

- revenue to issuers which compensates them for the services they provide to acquirers (and through them, merchants).

The first of these interpretations is typically associated with Visa, and the latter with MasterCard (see below).

Style of regulation

ANZ thus does not believe that the regulatory framework should prescribe in detail a particular methodology for interchange fee setting; it should apply only the minimum necessary regulation. On the other hand, little will be achieved by pricing principles expressed only at the 'motherhood' level. The principles should be designed as specific enough to give rise to desired attributes that the parties subsequently reflect in the methodologies they apply, and which are consistent with *both*:

- efficient pricing principles; and

[8] Ernst & Young, "Survey of Retail Payment Systems", *Chain Store Age,* January 1996.

[9] On RBA data, credit card spending rose from approximately $20 billion in 2000.

[10] Interviewed by A Current Affair, National Nine Network, 3 May 2001.

[11] Food Marketing Institute, *A Retailer's Guide to Electronic Payment Systems Costs*, Washington DC, 1998.

- the specific network character of a four party open credit card scheme, viewed solely as a 'buy now, pay later' payments system.

It is useful to begin to draw out such desired attributes from a discussion of some of the main alternative approaches that have been used or proposed for credit card systems.

Existing and proposed alternative approaches

ANZ's view is that more *comprehensive methodologies* — such as the Baxter or *Visa approach* (see later), which takes into account the demand side, i.e. revenues as well as costs (including acquirers' as well as issuers'), and allowing room for commercial judgement — have much to recommend them, in principle. However, ANZ acknowledges that some of the inherent attributes of such methodologies, in particular the role of commercial discretion,[12] may be difficult to enshrine in official regulation — given the importance in that context of transparency and the ability to straightforwardly justify the pricing arrangements to the public. This is the main argument favouring a purely cost-based approach.

Nevertheless, the standards that are ultimately determined should, to the maximum extent, allow room for commercial judgement and market considerations to be taken into account in their application. For example, the standards could govern, i.e. lead to capped, average fees across all transactions or each of two or more classes of transactions, while leaving flexibility to differentiate within a transaction class by customer (merchant) segment to the commercial parties.

Cost-based approaches preferred

The foregoing discussion suggests that for the purposes of regulating maximum interchange fees, pricing principles be founded on *cost considerations* — not excluding demand or market considerations, but effectively limiting their application to the downside in terms of overall cost, with room for differentiation by market segment within that constraint.

The Visa methodology is more sophisticated than others also in looking at the costs of *both acquiring and issuing* and in effect apportioning aggregate shared costs to obtain a cost-based interchange fee designed to reimburse the issuer appropriately. Other methodologies — notably MasterCard's — are simpler and more direct, considering the costs of *the issuing function in its own right*. This is correct in principle, consistent with the very feature of four party card schemes which requires an interchange fee — the fact that the acquiring function, which is a distinct business function from issuing, is, in these open schemes, frequently provided by a different party. I.e. these schemes must, above all, set fees appropriately for 'not on us' transactions (involving unrelated parties). By contrast, in 'on us' transactions, any imbalance is internalised within a single organization (albeit that the two functions of acquiring and issuing would typically still be separate profit and cost centres) and a 'wrong' interchange fee matters less.

[12] It is worth noting again that Visa International has observed that everywhere its methodology has been applied, such discretion, weighing market and scheme development considerations, has always produced interchange fees lower than those that a cost calculation alone would have produced.

Issuer-focused approaches preferred

Hence in the context of official regulation of interchange fees in open schemes, ANZ also sees it as a logical, and perhaps the simplest and most readily explained approach, to develop principles which relate the interchange fee received by the issuer to the costs of the *issuing function only*.

Of the existing methodologies, the MasterCard approach does this but in a simplified way which arbitrarily omits some potentially important elements of cost. This may pragmatically reflect market considerations. In any event, that method seems to produce a result falling *within* the cost 'envelope' that efficient pricing principles would allow. However it would clearly be inefficient to *prescribe* the exclusion of some valid costs from the interchange fee calculation.[13]

What then is the appropriate approach to reflecting costs, including shared costs, in a pricing methodology applicable to the setting of interchange fees in this network context?

The avoidable cost methodology

The cost-based approach ANZ favours, which is called the *avoidable cost methodology*, is fully consistent with efficient pricing principles. It is also consistent with the desire expressed in the Joint Study, and in subsequent discussions, that:

- interchange fees be cost-reflective;
- the components of cost which sum to the cost of producing interchange services relate to benefits for participants (merchants and cardholders) in the payments network, and in particular that they do not include the cost of services which are unrelated to the ('buy now, pay later') payment services provided by credit card networks; and
- that the interchange fees so determined satisfy the public interest test and criteria of efficiency and promotion of competition as set out in the Payment Systems (Regulation) Act 1998 (PSRA).

The avoidable cost methodology for determining interchange is similar to the first methodology identified in the Joint Study, resembling MasterCard's, whereby the interchange fee is the means by which financial institutions recover costs from those who benefit from credit card networks (cardholders and merchants). However, unlike either methodology discussed in the Joint Study, which — in seeking arbitrarily to assign some cost elements to one side of the network rather than the other — took an inappropriately narrow view of what costs could be legitimately included, the avoidable cost methodology is rigorously grounded in economic theory. Indeed it is widely used by other regulators, and indeed is enshrined in relevant statutes in the US.[14]

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[13] This criticism can even more forcefully be levelled at the 'alternative cost recovery basis' illustrated in Table 5.3 of the Joint Study, which arbitrarily excludes further cost elements.

[14] See for example Leonard S. Goodman, *The Process of Ratemaking*, Public Utilities Reports Inc., Vienna VA, 1998, p 410.

Under the avoidable cost methodology, the cost of producing interchange services (for the benefit of network participants) by issuers is defined as *the total costs incurred by issuers in providing all services less the costs that would be avoided if they did not provide services unrelated to payments network services.*

ANZ considers that any pricing principles enshrined in a regulatory framework should, as far as they govern the treatment of costs, take the same efficiency-consistent approach as just distilled from an introductory outline of this methodology. (A further discussion of the methodology is provided later in this chapter.)

2.2 Towards Appropriate Pricing Principles

Efficient pricing

The question is how to reflect the above considerations in a set of specific pricing principles which could form part of a regulatory framework governing interchange fee setting in the designated schemes. Any such principles must above all be consistent with economic efficiency. Consideration of what that means here is an appropriate starting point.

Three concepts of economic efficiency are relevant to regulating the setting of interchange fees: allocative efficiency, productive efficiency and dynamic efficiency. These are standard concepts in economics and in regulatory settings; each is visited briefly below.

Allocative efficiency

The price of a good or service is allocatively efficient if it is equal to the cost of producing that good or service — where cost has a particular meaning (see below). In such circumstances, incentives exist in a decentralised market of buyers and sellers to produce just enough of that service so that the value placed upon the last unit purchased by buyers is equal to the value of resources used in its production.

Best practice regulation of pricing

Regulatory economists have devised alternative pricing rules which are practical and consistent with allocative efficiency. 'Best practice' regulation aims for prices that are 'subsidy free'. Credit card payment services can be thought of as being produced jointly with other credit card–related services, such as the extension of long term credit or cash advances. This means that the price of a particular credit card–related service should be at least as high as the cost of adding that service to the producer's product line, but not so high that a hypothetical alternative producer could profitably enter the market and produce that service alone.

In other words — with one caveat — interchange fees should be no higher than the *stand alone cost* of providing the 'payment functionality' (otherwise an efficient payments service provider could enter and provide the service at a lower price). Equally, interchange fees should be no lower than the *incremental cost* that would be incurred by an issuer if a credit card payment functionality was added to a range of other services it offered its customers (otherwise this service is not recovering in revenues the resource costs of its operation). For example, a bank might just offer electronic debit card services and then incrementally add credit card payment functionality to its cards. The floor for interchange fees would be the incremental cost of adding the credit card payment functionality.

It is thus very important to note that efficiency considerations point to a range, not a single figure. A regulator has no allocative efficiency basis for prescribing where the price should be set within that range or 'envelope'.

The importance of externalities

The caveat is that the above rules for allocative efficiency take no account of the positive externalities generated in credit card networks. (Higher rates of acceptance by cardholders are likely to lead to higher rates of acceptance by merchants, in turn leading to even higher acceptance by cardholders, and so on.) The externality means that the floor for interchange fees should optimally be *above* incremental cost. If interchange fees for the payment services associated with a particular credit card were set just at incremental cost, issuers would be compelled to recover all fixed costs and common costs from fees levied directly on cardholders.

In the presence of the fundamental, positive credit card network externality, this solution will not work — the outcome will not be in the public interest. High direct fees on cardholders will make holding and using the credit card unattractive to them; this in turn will make acceptance of the card less attractive to merchants. In time, both cardholders and merchants are likely to migrate to competitor schemes (such as the closed card schemes) and the credit card scheme(s) in question could fail, or at least lose significant market share.

Thus, conservatively, the ceiling for the interchange fee should be the *stand alone cost* of providing credit card payment services, *not* the *incremental cost*. The theoretical floor should indeed be an amount higher than the incremental cost of providing those services, to take account of the credit card externality. This 'cushion' reflects another important allocative efficiency issue — that (as discussed in Chapter 1) the relative competitive position of open and closed card schemes should not be distorted.[15]

The greater the competitive threat posed by alternative credit card payment schemes, the larger this 'cushion' above the floor should be. Because they are close substitutes, even a small distortion in relative prices could have large effects i.e. the closed schemes could quickly gain significant market share at the expense of the open schemes. Thus, relative prices which were distorted by regulation would distort competition in the market for credit card payment services, contrary to the stated meaning of public interest in the s. 8 of the *PSRA*.

[15] While the closed schemes do have explicit interchange fees only in respect of the (few) independent issuers that they have enlisted in recent times, conceptually such fees have always existed implicitly as internal prices within those schemes.

By contrast, setting interchange fees according to the allocative efficiency principles described above would be consistent with the public interest objectives of the *PSRA*.

Productive efficiency

Productive efficiency occurs when production takes place at minimum cost. In many regulated industries, price regulators choose to set efficiency benchmarks to avoid cost padding, or otherwise inefficient production practices, being reflected in prices. This is a reasonable objective but care should be taken to set a realistic benchmark. Following modern practice, productive efficiency should be encouraged by a system of incentive regulation. This means that, under the regulatory arrangements that emerge, interchange fees (or their path over time) would be fixed at the beginning of the regulatory period, and issuers would be encouraged to pursue production efficiency gains by allowing them to retain any gains made during the regulatory period. This would be entirely consistent with the objectives of the *PSRA*.

(Any known future developments affecting costs could in principle be factored in at the time of setting.)

Commercial flexibility could be maximised by allowing fees to be varied (within transaction or merchant categories), with regulation governing the average — and of course allowing reductions from the regulated overall level.

Dynamic efficiency

Interchange fees should not be set so low that they dampen incentives by issuers to invest and innovate. This does not mean that the way to encourage such activity is to set interchange fees significantly above costs. But it does mean that the risks inherent in undertaking innovative activity should be recognised and properly included in the cost base. If the regulatory structure cannot reward the undertaking of risky, but potentially very useful, innovation, then that innovation will not take place.

Thus, to be consistent with the public interest objectives of the *PSRA,* regulated interchange fees should set provide sufficient incentives for investment by issuers in innovative credit card services. In particular, returns on past investments (as well as future ones) should in principle be allowed for as part of costs.

Simplicity, transparency and certainty

The costs of applying a methodology for determining interchange fees could be significant if that methodology is complex. These costs would be high both for regulators and regulated entities. A complex methodology would also prone to error in its application.

Transparency is also important, for reasons already canvassed. The process by which interchange fees are determined should be clear and open, so that the public can be confident that the outcome is the result of an objective application of a known methodology. Merchants should likewise be able to obtain comfort from a transparent process.

ANZ expects that a set of pricing principles, once in place, will not be altered capriciously by regulators at some future time, should the regulators decide that a future

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outcome is not to their liking. This has happened in other regulated industry settings and is inimical to business planning and willingness to invest.

ANZ notes that there would need to be a relatively long phasing-in period before a new regulated regime is in place, to allow reasonable time for both system or operational and commercial adjustments to occur.

Dealing with unforeseen developments

Despite all the best intentions, at times circumstances may demand a reopening of the regulatory process part way through a scheduled regulatory period. On occasion, *force majeure* simply necessitates such flexibility, and such provisions are common in commercial contracts. The framework to be developed needs to address what kinds of circumstances would warrant reopening of the price setting process (e.g. an unforeseen requirement to implement new technology across the network, say for security purposes). Generally, however, future developments should be factored in to each review as far as they can reasonably be anticipated.

Summary of appropriate pricing principles

The principles emerging from the above discussion can be summarised as follows. A methodology for interchange fee setting adopted by the parties to one of the designated credit card schemes would be deemed appropriate if it is:

(i) *transparent* and based on a clear and *objective* methodology consistent with allocative, productive and dynamic *efficiency*, while having regard to the existence of network *externalities*;

(ii) designed to recover overall, as a maximum, no more than the *stand alone cost* (including sunk costs) of delivering the 'buy now, pay later' *payment functionality*;

(iii) designed to engender pressure for *'best practice' productive efficiency*, via choice of benchmarks, allowance for anticipated future developments etc;

(iv) consistent with dynamic efficiency, by *rewarding investment* no more than adequately, but having full regard to the risks of such investment;

(v) designed to provide *certainty*, while allowing for re-opening in response to major unforeseen developments; and

(vi) otherwise consistent with fullest exercise of *commercial flexibility* by scheme participants.

ANZ notes that these are suggested as the main kinds of principles that should govern the adoption and application of an interchange fee setting methodology *by a scheme*. A larger set of principles — already articulated in Section 1.5 above — applies to the setting and application of the governing regulatory framework *by the regulator*.

2.3 Alternative Approaches vis-à-vis the Principles

Specific Cost Recovery (or MasterCard) methodology

The Specific Cost Recovery methodology (also known as the MasterCard methodology) is based on the issuer recovering certain specific costs incurred in conjunction with the issuer making a payment guarantee to the acquirer and immediate settlement (even though payment from the cardholder is deferred).

Costs that are included in the interchange cost calculation are *(1) risk costs* related to credit losses and fraud losses; *(2) funding costs* for funding the transaction from the purchase date until the payment due date; and *(3) transaction processing* costs related to presentment of the transaction for payment.

Interchange costs are determined by (a) calculating the risk and funding costs for the Issuers, stated as a percentage of transaction value and (b) calculating the processing costs on a per transaction basis ..

This methodology has the advantage of being conceptually simple. However, it encompasses only a subset of relevant costs and does not have a clear philosophy, based on efficiency principles, for distinguishing between which of those of the issuers' costs that should (as a matter of economic efficiency) be recoverable in the interchange fee, and those which should be recovered from cardholders.

'Baxter' (or Visa) methodology

The 'Baxter' methodology (also known as the Visa methodology) is based on the issuers recovering that portion of their actual costs that are in excess of their 'fair share' of the total network costs.

Costs that are included in the interchange cost calculation are the total issuers' and acquirers' costs that are attributed to the payment functionality of the credit card. The end-to-end purchase functionality costs of the issuers and acquirers are calculated, with costs allocated between the issuer and the acquirer based on cardholder and merchant demand for the product functionality. Interchange costs are the difference between the issuer's actual costs and their allocated portion of total network costs.

ANZ believes that there is much to recommend this methodology, because it takes account of demand-side factors (acquirers' and issuers' revenues) and explicitly recognises the network characteristics of a credit card system. However, ANZ acknowledges that it is relatively complex to implement and incorporates commercial judgement (and discretion). That is, it may be difficult to reconcile with the criteria of transparency, simplicity etc.

Residual Cost Recovery methodology

The Residual Cost Recovery Methodology is based on the issuers recovering their costs that are not recovered from other revenue sources. Costs that are included are total issuers' costs. The revenues included are total issuer revenues.

This methodology relies on competition in all aspects of issuing, including revolving credit. I.e. it is not confined to the payments functionality of credit cards.

In this context the relevant payment service is the ability of the cardholder to transact with the merchant on a 'buy now, pay later basis' — i.e. to make immediate payment to the merchant but to have some reasonable time afterwards to arrange the funding of the payment. As noted earlier, this feature is the distinctive hallmark of this payment system (as also of equivalents such as plain charge cards and store cards), is separable from other features — notably the option of revolving (extended) credit — and should be the sole focus of regulated interchange fee setting.

ANZ's favoured interchange fee methodology:
The Avoidable Cost methodology

While all of the methodologies described above have their advantages, none is completely satisfactory. ANZ favours a methodology for calculating the interchange fee which precisely meets the efficiency-based principles summarised above — the 'avoidable cost' model.

The *avoidable cost* model asks the question: *"what costs would issuers avoid if they were no longer to provide the services that are not necessary for the operation, maintenance and growth of the credit card system as a payments system?"*

Advantages of the model

This model is closely related to the Specific Cost Recovery (MasterCard) Methodology which was discussed above and formed the initial basis of the indicative interchange fee in the Joint Study. However, unlike the Specific Cost Recovery Methodology, the avoidable cost model has a clear guiding philosophy grounded firmly in regulatory economics. The outcomes from the model can be confidently predicted to be efficient, as required by the *Payment Systems (Regulation) Act 1998*.

Under the avoidable cost model, costs that are common to services provided to both cardholders and merchants would be counted in the calculus for determining (maximum) interchange fees, because they would not be avoided if 'ancillary' services (such as extended credit) were discontinued. Such an outcome would be consistent with efficient resource allocation, because the maximum interchange fee would equal to the stand alone cost of providing credit card payment services, as required in the principles summarised in the previous section.

The minimum interchange fee should be the incremental cost to a card issuer of providing credit card payments services (adjusted upward to take account of the credit card network externality), but there would be no need to regulate that boundary of the efficient range or 'envelope'.

A further, but related, consideration is that the interchange fee so determined should not distort merchant decisions on whether to accept particular types of credit cards e.g. open system versus closed system cards. Indeed, it should not distort merchants' decisions about accepting credit cards in general. Likewise, consumer decisions about which cards to hold and which to use, should not be distorted.

The avoidable cost model has the following advantages:

- it largely, if not entirely, obviates the need to make arbitrary and subjective cost allocations and so should be relatively easy to implement; and

- it is consistent with economic efficiency, a key concern of the RBA/ACCC Joint Study and the *PSRA*.

Some specific aspects of how it would applied in practice are discussed in the next section.

2.4 Measurement and Implementation Issues

The distinct features or functionalities of credit cards

A credit card typically has three distinct functionalities already alluded to. More specifically they are as follows:

Payment functionality allows a cardholder to make a purchase and defer payment until his or her bank (or other issuer) sends a statement and requests payment.

The payment functionality of a credit card is similar to the payment functionality of a charge card that is issued by three party card scheme such as American Express or Diners' Club.

Extended (revolving) credit allows a cardholders to defer payment beyond the payment due date (subject to minimum monthly payments). This is not a functionality in which the merchant participates.

Cash advance functionality allows the cardholder to withdraw cash from an ATM or over-the-counter at a bank and charge the amount to his or her credit card. This is also not a functionality in which the merchant participates. (It does involve credit etc costs.)

Relating cost elements to functionalities

The application of the Avoidable Cost Methodology focuses on which of the issuers' costs are related to the payment functionality i.e. the service which is of benefit to merchants. Costs related to the extended credit and the cash advance functionality that would be avoided if those functionalities were not offered are excluded form interchange costs. The costs related to the payment functionality are the starting point for the calculation of the interchange fee.

As noted above, the efficient interchange fee lies in a range bounded by (somewhat more than) the incremental costs and the stand alone costs of providing a buy now, pay later functionality.

The categories of issuers' costs that would be incurred by a *stand alone* operator of payment services would include:

- *credit losses* and collections on those amounts related to purchases in the period just prior to the cardholder defaulting on payment (i.e. excluding costs related to default on extended credit repayments);
- the *cost of equity* capital;
- *sunk costs* (i.e. the capitalised losses associated the start up period of the credit card networks and not yet amortised);

- *operating costs*, such as staff costs, facilities costs, systems and data processing costs.

ANZ believes that costs incurred in promoting the holding and use of cards are legitimately part of stand alone costs — and are certainly relevant to the generation of network benefits. ANZ believes that, notwithstanding the fact that they are a feature at the discretion of the particular issuer, loyalty points undoubtedly do generate network benefits to merchants. A survey reported in a recent article in a business journal stated that the proportion of those interviewed who said that their decision on where to shop was often based on the reward points offered rose from 26 per cent in 1997 to 42 per cent in 2000, easing back to 38 per cent in 2001.[16] The article stated that the appeal of reward schemes was waning for low-income earners, targeted mainly by mass-market reward schemes, but not for white-collar professionals targeted by "some of the more lucrative niche co-branded credit card offers". It is of course the latter type of consumer that merchants most seek to attract by accepting credit cards.

The *incremental* costs for the buy now, pay later payment functionality are those costs that would be incurred if that functionality (with all of its essential elements, e.g. universal acceptance, charge-back rights etc) was added to an existing card product not offering that feature. For practical purposes that would be the inclusion of the functionality to a transaction account access / EFTPOS card. It is likely that a large part of the costs associated with a stand alone facility would also be associated with the feature incrementally, apart from card production and delivery and some corporate overheads.

Implementation issues

A number of implementation issues would need to be resolved especially if the implied interchange fees flowing from a new regulated system were significantly different from those currently in existence. If so, ANZ recommends that the new system be implemented with a phase-in period to give issuers time to adjust.

Some other implementation issues include:

- *choice of cost benchmark*. In ANZ's preliminary thinking this could involve omitting part of the cost range (e.g. the highest cost quartile) from the benchmark calculation — but avoiding affecting competition adversely by going so far as to drive out all but the largest scale issuers;

- *frequency of review*. ANZ leans to three years; and

- *setting different interchange fees* according to transaction class. While generally favouring simplicity and uniformity, ANZ supports this where there is an objective and significant cost difference (e.g. cardholder not present or 'MOTO'[17] transactions where — as is almost always now the case — the issuer provides no payment guarantee to the acquirer).

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[16] Simon Lloyd, "Retail: Happy Shopping", *Business Review Weekly*, 8 June 2001, p 56.

[17] 'Mail order, telephone order'.

Again while generally preferring simplicity and uniformity, ANZ also supports allowing schemes to implement differential interchange fees by customer (merchant) segment (within a class); this would allow demand factors to be incorporated (by the commercial parties) in an otherwise cost-based methodology. For example, in accordance with standard Ramsey pricing principles, higher interchange fees could set in situations where the elasticity of demand (by consumers) is lowest, and *vice versa.* Examples of special segments include supermarkets, petrol outlets, bill payments. Within a framework that constrains regulated revenues not to exceed the total of all relevant stand alone costs, this flexibility would enhance economic efficiency while permitting greater commercial flexibility.

Chapter 3

Access to the Designated Credit Card Schemes

3.1 Context and General Principles

Context

Bankcard, Visa and MasterCard each have a set of membership/access rules and policies which govern the terms of entry to these schemes. The schemes' membership/access-related rules and policies differ in details but have strong common themes relating to:

- eligibility criteria;
- membership fees;
- self acquisition policies; and
- net issuer requirements.

These categories of rules and policies have been subject to the scrutiny of both the ACCC and the RBA recently, with:

- the Joint Study expressing particular concerns about the restrictions on participation in the international credit card schemes (i.e. Visa and MasterCard), while being "particularly concerned about the lack of transparency and objectivity in the membership procedures for Bankcard;".[18] and
- the RBA in its 12 April 2001 designation statement repeating the Joint Study conclusion that "restrictions by credit card systems on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed".[19]

The RBA also directly expressed in its statement of 12 April 2001 the view that the current rules may be more restrictive than necessary, at least in the international open schemes (as distinct from Bankcard, given its recent decisions);

> "membership of the international card systems (MasterCard and VISA), either for credit card issuing or acquiring, is restricted in Australia to authorised deposit-taking institutions. Such membership rules based on institutional status may be more restrictive than necessary to protect the safety and integrity of the systems. Bankcard is currently review its membership rules."
>
> Reserve Bank of Australia, 'Designation of Credit Card Schemes in Australia', *Media Release – 2001-09,* 12 April 2001.

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[18] Australian Competition and Consumer Commission (ACCC) and Reserve Bank of Australia (RBA), Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access, October 2000.

[19] Reserve Bank of Australia, 'Designation of Credit Card Schemes in Australia', Media Release — 2001-09, 12 April 2001, p 2.

ANZ notes that a number of Australian banks do collectively control the Bankcard Association of Australia (BAA), whose former membership rules drew particular criticism, but Australian banks do not control the rules of the global open schemes (Visa and MasterCard).[20]

The main criticisms of Bankcard concerned:

(a) an excessive entry fee (around $1 million); and

(b) lack of transparent and objective eligibility criteria.

ANZ agrees that those criticisms were well taken, noting however that BAA has already taken decisions which fully respond to them. Indeed the Bankcard rules are now a benchmark for liberality in regard to access, while still protecting scheme safety and stability. In short, the new Bankcard rules on access well exemplify principles which ANZ sees as also relevant for the other open schemes *in the Australian context*. ANZ notes that the global open schemes, for good reason, must adopt membership rules which are broadly the same in all countries. Thus an approach to admission which produced acceptable outcomes in Australia might pose unacceptable risks if applied in, say, Russia or Sri Lanka.

ANZ notes that it is clearly in the interest of all the open schemes to maximise membership, not to restrict it[21], so long as there is no compromise on maintaining a high degree of assurance that parties obliged to make payments will do so. That assurance is fundamental to the safety and stability of the schemes, and public confidence in them. Basically on efficiency grounds, the schemes rely primarily on official prudential regulation in this regard rather than expensively duplicate it. The onus is on any proponent of an alternative to demonstrate that it will produce net benefits when costs are taken into account as well as expected increased participation and any consumer benefits it might bring.

Principles

The broad considerations flagged in the discussion can be readily distilled into some principles governing appropriate access regimes for these schemes. Such regimes:

(i) be transparent;

(ii) relate to access to relevant services, not to ownership of scheme intellectual property or to participation in governance (e.g. voting rights);

(iii) not remove all discretion from the scheme as regards entrants, but confine discretion to substantial grounds; and otherwise be non-discriminatory;

(iv) be based on objective criteria related to legitimate scheme objectives, notably scheme safety and stability; and

[20] Some examples of the international nature of these schemes rules are as follows:

- In relation to the MasterCard scheme in Australia, the decision as to whether a new entrant may become a member of the scheme is determined by the Asia Pacific Board of Directors on which Australian members have only two Directors (out of a dozen or so). There is also a process of appeal to the global Board. Therefore, incumbent Australian members of this scheme have little ability to prevent the entry of new members in Australia.
- Visa's net issuer rule was introduced on a regional basis — that is, it is a rule which applies within Visa's Asia Pacific region, which encompasses Australia. Such regional organisation, and a degree of devolution of rule-making, allows the system to adapt to differing circumstances, but at the level of the region, not of a country such as Australia alone.

[21] E.g. in the United States, the open schemes have literally thousands of competing issuers.

(v) be designed to maximise participation, subject to those scheme objectives.

3.2 Rationale for Schemes' Eligibility Criteria

General philosophy: maximum access subject to safety

At a superficial level it could be argued that the schemes' membership criteria do act to restrict competition, by limiting entry to those prospective members that satisfy the entry criteria. However this does not automatically mean that the membership rules are anti-competitive. As noted already, the schemes have no interest in anything but promoting participation, as long as they are not exposed to unacceptable risk to their safety or stability.

While the schemes have somewhat different eligibility criteria, focusing on prudential supervision status, the primary rationale (or motivation) for each scheme's set of criteria is essentially the same. It is to maintain a high degree of confidence that each party to a credit card transaction will be paid the amount owing to it. One of the most important assets owned by each scheme is its brand name and the confidence that goes with it. These eligibility criteria are fundamentally designed to protect the scheme brands (recognised worldwide in the case of Visa and MasterCard and domestically in the case of the Bankcard Association of Australia Scheme) and all they represent.

In addition, ANZ considers it to be highly efficient for the credit card schemes' eligibility criteria to avoid costly duplication of what official prudential regulators already do in providing a high degree of assurance as to an institution's ability to settle. Nevertheless, this stance does not preclude non-ADI's from becoming members, as recognised by the recent BAA reforms, discussed in Section 3.3 below.

Non-membership avenues for participation

It is important to note that each of the schemes already has liberal non-membership avenues for *effective economic participation*, and it is the latter concept of access which is most relevant in assessing whether the membership rules constitute unreasonable barriers to entry.

(Existing liberality of access is also highlighted by the fact that many current issuers are non-banks, including credit unions, building societies and finance companies; currently, the Credit Union Services Corporation (CUSCAL) is an issuer for both the Visa and MasterCard schemes.)

Issuing and co-branding

In the schemes, it is open to a non–bank to become a *co-brand partner* of a member and to have the member issue one of these schemes' cards with the partner's 'livery' predominating, the partner having a major influence over features, promotion avenues, the application process etc — and the partner sharing the revenues and/or profits under whatever terms are agreed bilaterally. The schemes (in particular, the Visa and MasterCard Schemes) allow great flexibility in these respects. The member still carries the formal obligations of issuance and owns the receivables, but even this may be transparent to the cardholder.

A good example of issuing and co-branding is the Qantas-Telstra-ANZ Visa card which has proved to be very popular in the marketplace. As the partner which is the scheme member, ANZ is the issuer, owns the receivables and is responsible for settlement. But in the public eye, the card may appear to be issued not by ANZ but by either Qantas or Telstra (depending upon the version of the card). Competition is generated by the marketing of the card as either a Qantas (or Telstra) card. Clearly, organizations such as Qantas or Telstra (or indeed smaller organizations) have been able to find scheme members with whom to partner on competitive terms.

The only possible constraint on co-branding is the ability of potential co–branders to find willing partners among the schemes' members. This has not proven to be a problem so far, as supported by the evidence that overall there are over sixty participant issuers in the Australian marketplace, issuing over two hundred different credit card products, of which many involve co–branding partnerships.

Acquiring and associated functions

The primary obligations of acquirers include:

- delivering payment to merchants; and
- monitoring and enforcement of merchant standards (including their delivery of paid–for goods and services to cardholders, as well as precautions against fraud etc).

In this regard, merchant acquirers carry initial responsibility for charge-backs (generally speaking).

However, the facilities provision, operation and processing functions associated with acquiring and forming part of the acquiring business are liberally open to others. In fact, there really is no barrier to non-acquirer ownership and operation of the physical terminals (e.g. by a merchant, as in the case of Coles Myer). Furthermore, First Data Resources Australia is a significant third-party processor but not an acquirer in the Australian market, and its US parent is a major player in virtually all aspects of acquisition although it is understood not to be a scheme member itself. The terms on which non-banks can participate in functions within the acquisition process are set bilaterally in a competitive environment.

3.3 The Bankcard Association of Australia's Recent Reforms and Position

In light of the RBA's expressed concerns and designation of the schemes, the Bankcard Board of Managements recently undertook a review of its membership/access requirements and fees.

In our capacity as a member, ANZ supported the changes which are designed to liberalise the BAA Scheme's membership/access rules so as to facilitate entry in a transparent and objective manner as possible, while preserving the financial integrity and stability of the Scheme. The changes are consistent with, indeed exemplify the principles articulated in Section 3.1 above.

Membership Criteria

In relation to the BAA Scheme's *eligibility criteria*, the following reforms were introduced:

- membership to be open to any entity that is:
  - an authorised deposit-taking institution (ADI) in Australia supervised by the Australian Prudential Regulation Authority (APRA); or
  - a financial institution supervised by an official prudential regulator in another country that is recognised by APRA; or
  - an entity whose liabilities in respect of the BAA Scheme are guaranteed by an APRA supervised organization (or an organization supervised by a foreign prudential regulator recognised by APRA) under a guarantee that survives the commercial failure of the [guaranteed] entity;
- replacement of the previous two-tiered voting requirements with special rights for Founding Members with a single voting structure with voting weighted in accordance with BAA total turnover; and
- abolition of the requirement that prospective BAA members submit a business plan upon membership application.

Rationale for and implications of new eligibility criteria

The above reforms are designed as open and transparent eligibility criteria which can be applied in a simple and cost-effective manner, while providing a high degree of financial assurance to all scheme participants.

Particularly for a relatively small domestic scheme like Bankcard, relying on official prudential supervision is a highly efficient way to ensure that members have sufficient capital and are otherwise financially sound — i.e. to ensure the financial stability of the scheme while avoiding the duplication of APRA's supervisory activities. The reforms retain that efficiency feature while offering a liberal opportunity to non-ADI's to become members (i.e. to access the services required for full participation in issuing and/or acquiring). The non-ADI must only find an ADI, or equivalently supervised overseas institution as guarantor.

The Joint Study focused particularly on entry to *acquiring*, by contrast with issuing, arguing that acquirers pose negligible settlement risk.[22]

For many types of transactions, the settlement risks that acquirers pose to other parties (cardholders via their issuers for charge-backs, as well as merchants) may be small, but *they are not zero and in some cases are significant*. For example,

- acquirers sometimes do have to settle issuers e.g. when merchants collapse or do not otherwise deliver goods or services for which consumers have pre-paid;
- acquirers do have to pay merchants. This occurs with a lag of up to a couple of days, depending on whether the merchant banks with its acquirer. Failure of an acquirer to pay could leave merchants in significant financial distress, especially if it occurred at a time of significant retail sales; and

[22] ACCC and RBA, *Debit and Credit Card Schemes in Australia — A Study of Interchange Fees and Access,* October 2000, p 39.

- failure by an acquirer would leave all of its merchants unable to make credit card sales, which in itself would cause significant merchant distress.

It must be noted again, however, that the restrictions in question refer only to the types of institutions that can take final settlement responsibility for merchant acquiring, and enforce merchant compliance with scheme obligations. There *need not be (and are not)* any significant restrictions in the open schemes on who can undertake many of the functions associated with acquiring, apart from the (important) ability to meet technical standards and not affect the technical reliability of the network, etc. This distinction again relates to the need to consider effective *access*, as opposed to simply membership *per se.*

In any case, ANZ considers that BAA's new eligibility criteria clearly allow non-ADIs to become members on as liberal a basis as possible consistent with the overriding objectives of scheme safety and stability.

In addition to the guarantee approach, the BAA Board of Management considered other alternatives for non-ADI eligibility, including the holding of an Exchange Settlement Account (ESA) with the RBA. However, this option was not considered to be practical or sufficient (without accompanying onerous requirements on prospective members) to minimise and manage the potential for settlement risk. Similarly, it was felt that BAA was too small a scheme to administer such alternatives as posting collateral direct with the scheme. In short, the alternatives are not sufficiently effective and/or efficient.

In any case, ANZ does believe that any access regime should not prescribe any *specific* mechanism for non-ADI entry, such as guarantees or collateral. That should be a matter for each scheme.

Additional eligibility criteria

The BAA Scheme also recently resolved to dispense with its two tiered voting requirements, entailing special rights for its Foundation members, and replace it with a single tiered voting structure with voting weighted according to a member's BAA total turnover. Furthermore, the BAA Scheme also resolved to abolish the requirement that prospective members submit a business plan upon application for membership. It can be seen that these reforms are consistent with the principles articulated in Section 3.1 above.

Membership-Related Fees

Entry Fee

The BAA Board of Management recently reduced its entry fee to a flat $66,000 (GST inclusive) in response to the concerns expressed in the *Joint Study*,[23] comparable with the other open schemes' entry fees.

ANZ considers that the current basis for levying an entry fee is appropriate, is comparable to the actual costs of bringing in a new member, and would not on its current basis constitute an additional barrier to entry to the Scheme (over and above the actual costs of entry). It too well exemplifies the principles articulated in Section 3.1.

23 ACCC and RBA, *Debit and Credit Card Schemes in Australia — A Study of Interchange Fees and Access,* October 2000, p 58.

Annual Membership Fee

The purpose of the annual membership fees imposed by open credit card schemes is to reimburse the schemes for the costs of administering and operating the scheme.

Recently, the BAA Board of Management decided to retain the annual membership fee based on a fixed component of $33,000 (GST inclusive), with the balance required to cover operating costs levied on members in proportion to their total Bankcard turnover (i.e. issuing plus acquiring). The current level of the BAA Scheme's annual membership fees is comparable to that charged by other open credit card schemes operating in Australia, and is considered reasonable for a domestically focused credit card scheme.

ANZ considers that the current basis for levying such an annual membership fee is appropriate, and would not on its current basis constitute an additional barrier to entry to the BAA Scheme. I.e. again it exemplifies the principles above.

Annual Royalty and Multi-Badging Rights Fee

The BAA Board of Management also recently resolved to abolish its annual royalty and multi-badging rights fees since no other competing schemes levy such fees and their imposition is considered to inhibit, and be contrary to, the desired expansion of the BAA Scheme's issuing base. ANZ supports these liberalising reforms to the BAA Scheme.

Self acquisition, 'net issuer' rules and the 'Incentive Fee'

Before the recent BAA Board of Management decision, the BAA Scheme had a policy against self acquisition, consistent with the other open schemes' policies.

Self Acquisition

The rationale for the policies against self acquisition is to manage and minimise the risks associated with the classical principal-agent problem arising where self acquisition is allowed. That is, if a member were to be a significant acquirer and merchant, a classical principal-agent conflict of interest risk arises because the acquirer must enforce merchant compliance with obligations while itself being responsible for paying issuers in some circumstances (i.e. charge-backs, non-delivery of prepaid goods and services etc).

However, the BAA Board of Management reasoned that the residual risks associated with self acquisition are likely to be small in the context of the reformed eligibility criteria. The reforms are based on the official regulator being satisfied that the supervised financial institution entity (member or guarantor) is able to settle obligations upstream, effectively transferring to other competent bodies the responsibility to minimise and/or offset the risk.

Therefore, the BAA Board of Management decided that there was no longer the need for the scheme to prohibit members from acting as self acquirers. It also decided that there was no need to prohibit or restrict pure acquirers, other than to ensure that they make an appropriate contribution to the development of the scheme through the 'Incentive Fee' (see below).

'Net issuer' restrictions

Similar to the other open credit card schemes, the BAA Scheme has a 'net issuer' rule. Members of the schemes face a financial loading where their issuing activity is low relative to their acquiring activity. In the case of the BAA Scheme, an 'Incentive Fee' is imposed on the member where there is a disparity ratio of two between acquirer and cardholder volumes.

The rationale for the open schemes' 'net issuer' rules and associated fees is to promote the manageability and effective governance of the schemes, given that the interests of acquirers and issuers (the latter bearing much of the scheme development burden) would otherwise not be as well aligned as desirable for the stability and growth of the schemes.

In an open credit card scheme, the role of the interchange fee is important in internalising such network externalities. Therefore it could be argued that with an appropriately set interchange fee and the necessary incentives in place for members to issue cards, it is not necessary to introduce related net issuer restrictions. However, establishing the 'right' interchange fee so as to create all of the necessary incentives is problematic, due to the existence of the difference in sunk costs incurred by issuers and acquirers, which is at the source of the asymmetry between the interests of acquirers and issuers.

The BAA Board resolved that the Bankcard Incentive Fee would not be applied until the second full financial year of an entity's BAA membership. Since as well, the fee is only 3 basis points — providing some resources that can be deployed in promotion efforts at scheme level — the resulting regime is clearly very liberal towards participation on the acquiring side.

Insofar as the rule nevertheless seeks to balance incentives to members, in respect of issuing and acquiring efforts, such a fee is helpful to the scheme's stability. This in turn helps maintain effective competition within the scheme and between schemes. ANZ therefore considers the BAA Scheme's approach here to be a desirable and liberal approach.

3.4 Summary of ANZ's Position on Access Issues

ANZ considers that the new BAA membership rules are no more than reasonable prudential measures, maximising opportunities to participate and placing minimal restriction on the pattern of participation, while efficiently protecting scheme safety and stability.

This view is further reinforced by considering the wider avenues for effective economic participation already available. On the issuing side, co-brand partnering is open to non-financial institutions on a virtually unrestricted basis. Non-ADIs can also participate in merchant acquiring by providing terminals, communications and processing services to merchants, on behalf of member acquirers.

The Schemes do seek to attract members who will issue as well as acquire, but generally the membership rules do not preclude would-be members intending to focus on acquiring. Instead, as outlined above, the schemes impose moderate financial loadings on those scheme members whose volume of acquiring business exceeds a pre-determined ratio of their volume of issuing business. The BAA Scheme's recent reforms, which as a member ANZ supported, explicitly allow members to act as pure acquirers and/or self acquirers, although the BAA Scheme does still have a mild 'net issuer' bias and an associated 'incentive' fee, albeit a very small fee — contributing to the effective governance and stability of the scheme and to its efforts to grow.

Access to the global open schemes

It should be noted again in concluding this chapter that the Australian members of the open credit card schemes (MasterCard and Visa) have little influence over the schemes' membership rules. The Australian members of these schemes are rule–takers, not rule-makers. In the Australian context, ANZ would favour improvements to access by these schemes of similar character to those applied by Bankcard — consistent with the principles articulated in Section 3.1. ANZ stresses, however, that the very global dimension of these schemes raises some particular important issues for these schemes. It would be very difficult for the global open schemes to accept rules governing access in Australia which if applied elsewhere would lead to unacceptable risks.

Chapter 4

The 'No Surcharge' Rule

4.1 Rationale

The 'no surcharge' (or no discrimination) rule prohibits merchants from charging consumers an additional amount when using a credit card to make purchases i.e. from explicitly passing on the merchant service fee to credit card purchasers. However, nothing prevents merchants from offering discounts to consumers who pay by cash or debit card (though relatively few merchants — e.g. computer stores — choose to do so).

The Joint Study was critical of the 'no surcharge' rule, arguing that it distorts price signals (i.e. the relative price of purchases made by credit card and made by other means) and hence is inefficient. The Joint Study also claimed that the no surcharge rule provided a cross subsidy from non-credit card paying consumers to credit card card-paying consumers.

In making these claims, the Joint Study did not take into account the rationale for the no surcharge rule, which is to reflect the fundamental positive externality of credit card networks (see below). There is a valid rationale for the 'no surcharge' rule when that externality is considered. Although in practice removing this rule might not make practical difference, which has been the experience in Europe, ANZ's view is that the burden of proof should fall on the RBA to demonstrate that the 'no surcharge' rule is harmful to competition and welfare, and that removing it would lead to tangible benefits. In ANZ's view, the RBA has not done this, and unless it does, under the principles of good regulation articulated in Section 1.5, then there is no case for regulatory intervention here.

The Joint Study also erred in claiming that the 'no surcharge' rule leads to a cross-subsidy.

4.2 The Rule in Practice

What would happen without it?

The Joint Study assumes that, in the absence of the 'no surcharge' rule, merchants would pass on the merchant service fee to credit card users, enabling them to face price signals that "reflect the costs of providing credit card services".

It is not at all obvious that merchants would pass on the merchant service fee, even if they were permitted to under the card scheme rules. If only some merchants did so, consumers would switch their purchases to merchants who did not. In many areas of sale of goods and services merchants would risk the near-certain reaction they would face from consumers if they attempted to charge more than posted prices for credit card transactions on their own — especially given that merchants can resort to cash discounts in particular cases, although they rarely do. Cash discounts or, where permitted, surcharging tend to occur only where either merchant margins are unusually

thin[24] or the unit value of purchases is low. Such areas aside, why would a rational merchant deter the very consumers whose ‘prospectivity’ as purchasers (of more expensive items, sooner) is enhanced by the ‘buy now, pay later’ functionality? In other words, merchants sense the externality and typically reflect this by *not* surcharging.

Merchants would be further reluctant to pass on the merchant service fee for credit card transactions because these transactions reduce cash handling and cheque processing costs. Evidence from the Food Marketing Institute in the United States suggests that the direct cost of using cash for the average FMI member is about 1.9 per cent of each transaction.[25] This excludes theft costs.

Aside from the adverse commercial implications for merchants who charge more for credit card users, the Joint Study appears to assume that economic efficiency would be enhanced if merchants obtained the same profit margin from sales to all classes of customers (specifically credit card users and others). As a matter of economics, this is not correct. Optimum economic efficiency (e.g. through Ramsey pricing) is often obtained when, for identical costs, different prices are charged to different consumers, or equivalently, when the same prices are charged to different consumers with different costs.

In the case of credit card networks, which generate positive network externalities, this conclusion is reinforced. No merchant is obliged to accept credit cards. The ‘no surcharge’ rule binds those merchants who choose to do so to pricing behaviour that creates positive spillovers for the schemes as a whole by preventing merchants from free-riding on the benefits of credit cards. A merchant who — rationally or otherwise (in self interest terms) — charged a surcharge would share in the benefits of accepting cards (a population of cardholders) without also sharing the associated costs of card use. Indeed, if surcharging were allowed, the cost of providing credit card services would be passed back to cardholders, who would reduce their card usage below socially desirable (i.e. efficient) levels. If a merchant, individually, violated the ‘no surcharge’ rule, this would not undo the positive externality created by credit card networks. However, if they all violated the rule, this would have a negative social effect by negating the positive externality.

In essence, the Joint Study ignores the important role that the no surcharge rule plays in (implicitly) pricing the positive externalities from credit card use and acceptance.

Benefits of voluntary non-discrimination: European experience

Furthermore, the fact that few merchants offer discounts for cash (which is allowed under card scheme rules) indicates that for most merchants, the transactions costs of doing so exceed the benefits of any extra sales that might result.

[24] Examples are discount computer stores — whose pricing is evidently low enough relative to ‘full service’ outlets to attract sufficient cash customers, even though they might prefer to use credit cards — and cheaper restaurants and cafes in parts of Europe where the ‘no surcharge’ rule is not enforced.

[25] Food Marketing Institute, *EPS Costs: A Retailer’s Guide to Electronic Payment Systems Costs,* 1998.

Evidence for this comes from Europe, where the no surcharge rule has in fact been abolished in the Netherlands and Sweden. Research conducted by the European Commission on the effects of this abolition found that merchants in these two countries did not surcharge for credit card transactions even though they can.

> "The main conclusions of the market studies are that most merchants do not use their right to surcharge cardholders for the use of the card. It is not established that the abolition of the [no surcharge rule] substantially improved the negotiating position of merchants, in particular not that it lead [*sic*] to decreased merchant fees. Cardholder's reaction to surcharging is in general negative."
>
> http://www.europa.eu.int/comm/competition/antitrust/cases/29373/studies/

As a result these studies, the EC has decided that the no surcharge rule is not anti-competitive.

> "After a thorough investigation, the Commission believes that it can take a favourable view with regard to certain provisions in the Visa International payment card scheme, which has been notified for formal clearance. One of these provisions is the so-called no-discrimination rule, a rule which prohibits merchants from charging customers an additional fee for paying with a Visa card. The Commission will publish shortly a notice in the Official Journal of the European Union, inviting interested third parties to submit their observations within a month, before reaching a final conclusion.
>
> ***Although it had originally objected to this rule, the Commission has now concluded that its abolition would not substantially increase competition.*** This conclusion has been reached in the light of the results of market surveys carried out in Sweden and in the Netherlands, where the no-discrimination rule has been abolished following the intervention of national competition authorities."
>
> www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/00/1164|0|RAPID&lg=EN [italics added]

Surcharging is also permitted in Britain, but it rarely occurs there also, indicating that merchants do not want to create ill-will amongst their card paying customers, including possibly losing the business of cash-constrained customers who would chose to shop at a non-surcharging merchant if faced with the prospect of paying more when they pay by credit card.

In summary, the rationale for the no surcharge rule is as follows. As argued above, it is unlikely in practice that merchants would charge extra for credit card purchases, even if they were allowed to, because this would be bad business for them. But suppose that individual merchants could charge extra without generating hostility from their own customers. Individually, no single merchant, by charging extra, would negate the positive externalities of the credit card network. Thus, no individual merchant would take this negative effect into account and so would not be restrained from charging more for credit card purchases.

However, collectively, if a sufficiently large number of merchants did charge extra, this would create a negative effect. Consumers would know that if they sought to pay by credit card they would either pay a surcharge of a known (or typical) amount or, worse, not know what (if anything) might be added to advertised or posted prices until they came to pay. Hence they would tend to use credit cards less, and to some extent the benefit of the 'buy now, pay later' feature would be lost to both consumers and merchants — a socially sub-optimal outcome.

Hence, there is a valid rationale for these schemes having a rule which constrains all merchants from charging consumers more if they pay by credit card. These kinds of rules, motivated by the same concerns, are commonplace in other settings. For example, quotas are set for individual fishermen (especially professionals) which constrain the number of fish they can catch. Without such quotas, fish stocks would be depleted, to the detriment of all. Regulations are necessary because individual fishermen will not affect the aggregate stock, and so each lacks the incentive not to catch too many fish. These regulations are not considered to be distortionary or anti-competitive; on the contrary, they are market-enabling.

No surcharge rule does not imply cross subsidy

Furthermore, the no surcharge rule does not imply cross subsidisation, contrary to the claim made in the Joint Study. A clear definition of cross subsidy was given by Faulhaber (1975.)[26] On this definition, a service can only receive a cross subsidy if the costs saved by removing it are greater than the revenues that would be lost. A service can only provide a cross subsidy if that service generates more revenue than the cost of providing it on a stand alone basis. The Joint Study has not demonstrated, on this accepted economic definition of cross-subsidy, either that non-credit card paying customers provide a cross subsidy or that credit card paying consumers receive one.

The test of whether non-credit card paying customers generate a cross subsidy would be the presence of businesses who do not accept any credit cards. Since these are uncommon in the Australian retail sector, it would appear that the revenues generated by such hypothetical businesses would be less than their stand alone costs i.e. this test is not passed.

The test of whether credit card paying customers receive a cross subsidy would be to ask what would happen to merchants who stopped accepting credit cards. In all likelihood these merchants would lose far more in revenue than they would save in costs (as the statement by Gerry Harvey quoted earlier implied),[27] in which case this test would not be passed either.

Summary

International evidence suggests that if the 'no surcharge' rule were abolished, merchants would not surcharge their credit card–paying customers, because the transactions costs and business risks of doing so would be high. But even if this were not the case, the 'no surcharge rule' serves the important purpose of helping to 'price' the positive externalities (i.e. by aligning marginal network costs and benefits) generated by credit card use and acceptance.

[26] G. R. Faulhaber, "Cross Subsidization: Pricing in Public Enterprise", 65, *American Economic Review*, 1975.

[27] Merchants of course have the option of offering non-revolving credit by other means e.g. store cards or 'private label' cards, but only for some large scale merchants is this economic c.f. widely issued credit cards. The existence of those alternatives nevertheless helps demonstrate the benefit to merchants from offering a 'buy now, pay later' facility; and the fact that surcharging appears to be non-existent with merchant-provided facilities of this type again reinforces the central argument of this chapter.

4.3 ANZ Position

ANZ submits that, contrary to the claims made in the Joint Study, there is a valid rationale for the 'no surcharge' rule and the onus is *not* on the industry to demonstrate why it should stay. Rather the onus is one the RBA to demonstrate the contrary (as the European Commission concluded it could not).

This rule stops merchants from 'free riding' on the externality benefits created by the credit card schemes i.e. the schemes create a large class of customers who would not otherwise shop with merchants and the rule stops merchants from 'free riding' on the benefits created by the schemes. Indeed, if it were widespread, such 'free riding' could endanger the schemes by undoing the positive network externalities that the schemes create — in particular by tending to deter consumers from using credit cards to 'buy now, pay later' (especially if consumers were uncertain about whether they would face discrimination).

When the externalities involved are considered, the 'no surcharge' rule does not distort relative prices and create cross subsidies. On the contrary, the 'no surcharge' rule enforces the important positive externality created by credit card networks.

ANZ submits that the RBA has not made a convincing case that the 'no surcharge' rule is distortionary or anti-competitive. Given the clear existence of the externality benefits which it reflects, the burden of proof falls on the RBA to demonstrate that this rule has negative social effects and that its removal via government regulation would lead to significant improvements to social welfare. Until and unless the RBA can do so, their case for regulatory intervention has not been made.

International evidence suggests that, in practice, merchants will typically not charge more to their customers for credit card purchases even if they are permitted to do so, Thus, abolishing by regulation the 'no surcharge' rule is unlikely in most areas to have the effect that the Reserve Bank is apparently seeking i.e. consumers who make credit card purchases pay more than consumers who pay by other means. In respect of those limited areas where the rule may unduly constrain merchants — i.e. areas where merchant margins are very thin and the unit value of purchases is low, it would be preferable for the schemes to make well demarcated exceptions or to adopt other solutions (as one open scheme does in respect of taxis) rather than to prohibit the rule altogether.