15 March 2002

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Per email: creditcards@rba.gov.au

Dear Dr Veale

Reform of Credit Card Schemes in Australia

I am writing in response to the Reserve Bank of Australia's (RBA) *Reform of Credit Card Schemes in Australia* (*Consultation Document*).

As you are aware, CUSCAL is the peak industry and service organisation for Australia's credit unions, representing 177 credit unions, around $20 billion in assets and 3.1 million Australians.

CUSCAL is owned by its member credit unions and provides them with a range of banking and commercial services. CUSCAL's services include treasury and funds management, transaction services (cheques, cards), wholesale and retail banking products, insurance, data processing, communications, technology, public affairs, compliance, staff training, research, and marketing.

1.0 Credit unions and the payments system

Credit unions, as a consequence of size, mutual structure and bargaining position, face a unique set of challenges in their participation in Australia's payment systems.

Credit unions have worked with particular constraints in offering competitive and viable card-based payment products. These circumstances have contributed to a high issuance of Visa Debit cards, low numbers of pure credit cards, and a position in relation to EFTPOS where credit unions face a substantial net out-flow of funds.

Credit unions, as authorised deposit-taking institutions, meet the same regulatory and prudential requirements as banks. However, while we share many features in common with banks, there are important differences in operations and services which distinguish us from our colleagues in the retail banking sector.

Credit unions:

- are mutuals, where members own the credit union in which they are customers;
- have 3.5 million members nationwide, offering a vital competitive alternative to major banks in the Australian marketplace;
- operate under a common set of principles and values, which explicitly place member benefit at the core of credit union operations;
- are not-for-profit, with a focus on delivering member benefit;
- have total combined assets of over $24 billion, with individual credit union asset sizes ranging from less than $100,000 to over $1 billion;
- work cooperatively in offering member services, with institutions such as CUSCAL operating as service providers to individual credit unions; and
- have a strong customer focus, which is reflected in the high satisfaction ratings recorded by members of credit unions.[1]

These distinguishing features are important factors in the different perspective credit unions can bring to regulatory and reform issues. The scope and size of the credit union sector, combined with a diversity of operations and a not-for-profit base, makes careful assessment of reform proposals for the sector critical.

Unlike other institutions that operate as both card acquirers and issuers, credit unions are primarily issuers. The not-for-profit and mutual nature of the sector (with limited recourse to capital markets) means that credit unions do not have significant capacity to absorb regulatory shock with large impacts on margins. This makes transitional periods for reforms with impacts on flow of funds critical. These factors further illustrate the importance of a balanced reform agenda that seeks to promote competitive neutrality in interchange arrangements.

1.1 A Snapshot of Credit Union Payment Instruments

For the 177 credit unions affiliated with CUSCAL, the aggregate figures for cards on issue at the end of February 2002 were as follows:

- MyCard Mastercard (credit card) 44,716[2]
- VISA Debit 1,183,098
- Redicard (debit card) 1,807,003

Credit unions did not start issuing credit cards until July 1999, following member demand for the product. The MyCard Mastercard product is delivered through CUSCAL for affiliated credit unions. While some credit unions also participate in AMEX/Diners Club schemes, it is clear that pure credit card issuing is a small component of credit union operations.

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[1] In 2001 a survey by Eureka Market Research, *Consumer Relationships in the Retail Financial Services Industry* found 8 out of 10 credit union members rated their satisfaction with their institution highly, compared with 3 in 10 bank customers.

[2] This compares with the 9,698,000 credit card accounts held by banks at December 2001 (RBA Bulletin Statistics, February 2002)

This data reflects the special position of credit unions in relation to credit cards. Credit unions have traditionally eschewed credit cards in favour of Visa Debit – a unique product with similarities to both credit cards and debit cards. Visa Debit is used to pay for goods and services using members' own funds, with functionality which extends beyond debit cards to include online and telephone transactions, chargeback rights, and the ability for customers who do not want or cannot afford credit cards to access the global credit card payments network. Credit unions are the largest issuers of Visa Debit cards.[3]

Visa Debit cards are attached to member accounts, which may include a line of credit (assessed using personal lending criteria) in addition to access to the members' own funds. Charges for lines of credit on Visa Debit have traditionally been lower than credit card rates, generally in the region of 10% to 13%.[4]

The adoption of Visa Debit and low numbers of credit card accounts reflect the unique challenges facing the sector:

- credit cards could not be offered by credit unions and building societies until recently, with credit unions blocked from schemes such as Bankcard;
- smaller financial institutions have not enjoyed market power parity in the cumbersome process of negotiating bilateral EFTPOS agreements and have been, traditionally, price takers with a net out-flow of funds; and
- the demographics of the customer base means that credit unions have traditionally had a proportion of members who do not want credit card products.

To appreciate the current position of credit unions in the payment systems, it is useful to examine the development of credit union participation.

1.2 Background to Credit Union participation in Australia's payments system

The Visa Debit card was introduced into Australia in 1982. Building societies and credit unions were early adopters of the Visa Debit card. The Visa Debit card enabled smaller institutions in the retail banking sector to:

- overcome barriers to their participation in the payments system; and
- provide members with a payment card without reliance on a credit facility - many members and customers either did not qualify for, or did not want, credit.

The innovative nature of smaller institutions in seeking to compete with major banks for retail banking market share has been acknowledged in various forums, including the Financial System Inquiry:

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[3] Over 47.5% of Visa Debit cards are issued by credit unions, with building societies and regional banks also offering cards. St George also offers Visa Debit to its customers.

[4] For example, CANNEX data for March 2002 includes examples of personal overdrafts accessed via Visa Debit at rates of 9.75% (Railways Credit Union), 12.25% (Community First Credit Union), 12.65% (StateWest Credit Society).

> "Historically, building societies and credit unions have been innovative in the provision of financial services..." [5]

Smaller institutions have needed to be innovative in the face of the significant market power held by large banks. The inability of credit unions to obtain access to the Bankcard scheme in the 1970s demonstrates the difficulty for smaller players in seeking access to payments products for customers.

The Bankcard scheme was launched by major banks in 1974. Credit unions sought access to the Bankcard scheme in 1976. By 1978, negotiations had broken down. Credit unions argued that the Bankcard agreement was anti-competitive, the banks responded with advice that credit unions could look to establish their own payments system – an undertaking clearly beyond the resources of the sector and contrary to the efficient operation of the payments system.

Credit unions and building societies turned to the Visa Debit card as the solution to providing their members and customers with a payment card with wide acceptance and suiting their members' and customers' needs. Bendigo Bank, then a building society, and credit unions issued the first Australian Visa Debit cards in 1982.

In December 1983, CUSCAL' s predecessor body became a principal member of the Visa International Card system. Credit unions in New South Wales, Queensland, Victoria, South Australia, Western Australia and the ACT gained access to a dual Redicard-Visa network (Redicard is the credit union ATM card). Work began on linking Redicard and Visa with a national ATM network and national EFT switch.

Credit unions gained access to the national EFTPOS network in late 1985, reaching an agreement with Westpac and the Commonwealth Bank on accepting Redicard at EFTPOS terminals. However, acquiring business remains tiny compared with banks.[6]

The Visa Debit card was an important means for building societies and credit unions to overcome the competitive and regulatory obstacles they faced in the 1970s and 1980s. The introduction of Visa Debit enabled credit unions to offer members:

- a debit card product that is commercially viable compared to the cumbersome process of bilaterally negotiating EFTPOS agreements;
- a card-based payment product that can be used globally;
- the ability to use a debit card payment product for mail order/telephone order and Internet transactions that cannot be made with a debit card; and
- access to a global payment method for those who otherwise do not qualify for (or want) a line of credit.

The adoption of Visa Debit by credit unions has been driven by barriers to entry to other payments instruments, and the consequences of Australia's unique EFTPOS interchange arrangements, which impose significant costs on credit unions. Visa Debit allowed credit unions to offer a competitive card-based payment product on

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[5] *Financial System Inquiry Final Repor*t, March 1997, p307.
[6] APRA data suggests that banks have combined EFTPOS terminals in excess of 68,000, compared to 557 Redipos terminals operated by CUSCAL affiliated credit unions.

commercial terms. This has been an important factor in credit unions' ability to compete effectively with larger banks.

1.3 Summary

Credit unions are in a unique position in relation to Australia's payment systems, which have traditionally been dominated by major banks. This is reflected in:

- the low issuance of credit cards by credit unions, and very low share of acquiring business compared with major banks;
- the heavy net out-flow of funds faced by credit unions on EFTPOS transactions, where credit unions do not have significant acquiring business and operate as price takers under cumbersome bilateral interchange arrangements;
- the adoption of Visa Debit cards in response to difficulties accessing payment instruments, and to offer members greater functionality and access;
- the value of Visa Debit as an access mechanism to credit union members, and the importance of balancing EFTPOS reform with review of Visa Debit interchange; and
- a lower capacity to absorb significant 'shock' from reforms involving substantial reductions in margins, leading to a potential blow to competition in retail banking if credit unions are forced from the market or price products at uncompetitive levels.

Credit unions continue to support reform of interchange fees in Australia's payment system. This submission outlines the principles that must underpin this reform in greater detail, including a recognition of diversity within the banking sector, concurrent reform and adequate transition periods.

2.0 Reform of the payments system

The release of the ACCC/RBA Joint Study in October 2000, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (*Joint Study*) marked the beginning of extensive reform of payment systems and interchange. While the approach to reform in each case has differed, there are now processes underway in respect of credit cards, EFTPOS cards, the Visa Debit card, and ATMs.

The *Consultation Document* proposes a set of principles which should underpin reform of interchange methodology, at least in relation to credit cards:

(i) provide a cost-based justification for the level of interchange fees that is transparent to merchants, cardholders, and the community in general;
(ii) be based on the credit card payment services which are provided to merchants and for which card issuers recover costs through interchange fees;
(iii) exclude from its calculations costs that are not relevant to payment network consideration, and are therefore not relevant to interchange fee calculations;
(iv) provide for different interchange fees for different types of transactions and/or differences in the credit card payment services provided to merchants;
(v) have the data independently verified; and

(vi) be subject to regular reviews.[7]

CUSCAL wholly endorses these principles as the basis for reform of credit cards, and indeed supports their use in the reform of other relevant interchange arrangements, eg. EFTPOS.

CUSCAL supports the thrust of reforms proposed by the RBA, both in relation to credit cards specifically and payment instruments generally. However, we are concerned that insufficient regard has been had to the relationship between these payment instruments and the impact of piecemeal reform upon the institutions that issue them. This is particularly the case in respect of smaller institutions, who have traditionally been disadvantaged by the behaviour and actions of larger institutions over time, but who have themselves been crucial in driving competition and choice within the marketplace.

Reform of individual payment instruments must not occur in isolation from each other. A coordinated approach is required to avoid the creation of further inefficiencies or distortions in the payments system, inconsistency in treatment of individual payment instruments, or serious damage to the viability of financial institutions (particularly smaller institutions).

CUSCAL therefore proposes a number of further principles that must underpin the RBA's reform across payment instruments:

1) uniform pricing principles must be applied across different payment products;
2) reform of different payment products must take effect concurrently; and
3) reform must take account of industry diversity.

2.1 Uniform pricing principles must be applied across different payment products

A consistent efficient pricing framework should be used for all card-based payment products. However, the underlying cost structures of the different card-based payment products will vary. This will result in different underlying interchange costs. Therefore, a consistent interchange methodology can be applied across all card-based payment products and the inherent differences in cost structures (and functionality) of these products will result in interchange fees appropriate to each card-based payment product.[8]

Card-based payment products include credit cards, signature-based card scheme payment cards, and PIN-based payment cards. A credit card has additional functionality compared to a Visa Debit card and a Visa Debit card has additional functionality compared to a PIN debit card.

For example, a Visa Debit card may have a line of credit attached to the underlying transaction account but will not feature the interest free period which distinguishes a

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[7] Reserve Bank of Australia, *Reform of Credit Card Schemes in Australia*, December 2001,Volume I, p42

[8] CUSCAL et al, *Visa Debit Australia: Discussion Paper*, September 2001, p.23

credit card. However, a Visa Debit card has the acceptability features of a typical credit card, i.e. global acceptance, telephone and internet acceptance. A PIN debit card will pose much less fraud risk than a credit card or a Visa Debit card.

These different characteristics, with their associated benefits to merchants, should be taken into account when calculating interchange fees. Current interchange arrangements are not based on such considerations.

Australia's unique EFTPOS debit card interchange arrangements are the result of powerful retailers taking control of the payments supply chain.

> "Banking relationships in Australia have been managed in such a way that the retailers are the dominant partners in the plastic card payments systems supply chain, largely thanks to their superior negotiating skills. Past absence of strategic vision among their acquirers about the increasingly card-centric delivery of financial services and the lack of recognition within bank hierarchies for the payment card managers, have provided a 'corridor of indifference' to plastic payment cards, which the large Australian retailers have been able to exploit."[9]

Australia's payments system is underpinned by a number of inconsistencies, contradictions, and anomalies. These are largely a product of the relative bargaining positions of the participants or good fortune. These inconsistencies benefit merchants along with credit card companies. Future reform must not replicate these earlier mistakes, but must be considered and underpinned by uniform pricing principles.

2.2 Reform of different payment products must take effect concurrently

CUSCAL has consistently argued for the concurrent reform of payment products. It is acknowledged that relative priorities and resource constraints within the RBA have prevented this from occurring however it is critical that reforms <u>take effect</u> concurrently.

Concurrent reform of card payment products (credit, EFTPOS, Visa Debit) will recognise that these products operate as close substitutes and that their relative usage is driven by sensitive pricing signals. The *Consultation Document* has noted the distorting effect of these pricing signals (as well as loyalty schemes) on the usage patterns of credit cards as against debit cards over time. Any changes to interchange arrangements must take effect concurrently to minimise distortion of pricing signals, and patterns of usage, resulting from unnecessary difference in the timing of those changes.

Concurrent reform is also necessary to avoid serious damage to the viability of smaller financial institutions, such as credit unions. If the RBA's model for credit cards were in place this financial year, CUSCAL affiliated credit unions would lose a total of $19m ($18m relates to Visa Debit interchange receipts and $1m to credit card interchange). This represents 16% of these credit unions' total net profit. This would be a major blow to competition in the retail banking sector as prices would have to

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9 "Role Reversal", *European Card Review* May/June 1996, p25

rise for credit union members. There are real risks that a shock of this magnitude could affect the prudential stability of smaller institutions; particularly credit unions which, as mutuals, are entirely dependent on retained earnings for their capital.

Credit unions will pay $15.5m in this financial year to large acquiring banks and merchants as a consequence of Australia's unique EFTPOS interchange arrangements. Under the RBA's model, this amount would fall to zero and would offset reductions in credit card interchange receipts.

Credit unions have long been acknowledged for their important contribution to competition and choice in retail financial services. It would be regrettable if the viability of these smaller institutions were threatened because of a decision by the RBA to prioritise reform of credit cards over debit cards. Reforms to these different payment instruments must take effect concurrently.

2.3 Reform must take account of industry diversity

Much has been said (ironically, often by larger players) about the need for interchange reform to safeguard the interests of smaller participants, like credit unions and building societies.

In response to this argument, the RBA has argued that "the existence of economies of scale is not an argument for keeping interchange fees high to enable smaller issuers to remain in the market. Such an argument confuses 'competition' with the number of competitors."[10]

CUSCAL does not argue for the retention of inefficiencies nor the inclusion of unjustified costs within interchange fees to account for this. Credit unions have long pursued scale through aggregation of processes as a means of driving down costs and seeking efficiencies. CUSCAL is the best example of this.

But it is not clear where the pursuit of scale in the name of cost reduction ends, nor whether the end justifies the means. Eight out of ten credit union members rate their institution as being 'excellent' or 'very good', compared to three out of ten customers of the four major banks.[11] What value do these customers place on the scale of their financial institution's activities? Many would also argue that they do not see the benefit of these cost reductions in the fees they pay to these large institutions.

CUSCAL is aware that some major banks in Australia are actively exploring options to rationalise and merge their EFTPOS and ATM switching platforms as a means of further reducing costs. Does this become the new benchmark to achieve in terms of scale? Are institutions not achieving this volume 'inefficient'?

Taken to its logical extension, the RBA's position implies that the best possible outcome for consumers would be continued aggregation until there remains one issuing financial institution, operating at lowest possible unit cost. It is not clear how this would benefit competition or consumers.

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[10] Reserve Bank of Australia, op. cit., p123
[11] Eureka Market Research, op.cit., p13

The RBA's reform of interchange must take account of industry diversity by ensuring that recoverable costs reflect justifiable costs of operating within the system by a diversity of players – not just the largest players.

Reform must also reflect the reality that not all participants within the system are both acquirers and issuers, with the capacity to offset reductions in revenue on one side of the business by concomitant increases in the other. Credit unions like most other smaller institutions have very little acquiring business.

Finally, appropriate transition periods must be provided which will enable smaller retail financial institutions (for whom interchange receipts are often a disproportionately large proportion of their revenue) sufficient time to adjust to these changes.

3. Reform of Credit Card Schemes in Australia

The *Consultation Document* proposes a standard for interchange fees, a standard for merchant pricing and an access regime for credit card schemes.

As we stated in our response[12] to the *Joint Study*, CUSCAL supports:
- the removal of barriers to competition in card issuing and acquiring;
- the removal of rules in card schemes which prevent pricing transparency or the development of new pricing mechanisms; and
- industry self-regulation and cautions again piecemeal intervention into payments system arrangements.

CUSCAL has no objection to the standard on merchant pricing or the access regime. Our major concern with the RBA's proposed reform agenda is the interchange fee standard.

We agree that interchange fees should be based on a transparent and objective methodology, and that the fee setting process should be open to public scrutiny and subject to periodic review. This methodology should be based on sound economic principles and consistently applied across all card-based payment products - credit cards, signature-based card scheme payment cards, and PIN-based payment cards.

The existence of credit card schemes provides benefits to cardholders and merchants. Credit card scheme services can be divided between those that are provided to cardholders, those that are provided to merchants, and those that are shared between the two parties. Benefits to merchants include reduced cash handling costs, reduced transaction costs, the payment guarantee, and higher sales or brought-forward sales due to cardholders buying on credit or "impulse".

In our view, the RBA's proposed standard on interchange fees far too narrowly defines services provided to merchants. As a consequence, many legitimate costs have been ruled out of the proposed methodology.

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[12] Letter to Hon Joe Hockey MP, 21 Dec 2000

3.1 Eligible costs

A credit card is defined by its 'buy now, pay later' functionality. Our key disagreement with the proposed standard is the RBA's argument that there is no benefit to merchants arising from the key feature underpinning this functionality, i.e. the interest free period.

Although the RBA argues that evidence has not been provided that credit card usage leads to a permanent increase in sales for merchants as a whole, there is no doubt that credit cards allow consumers to spend more than they otherwise would. This benefits merchants and they should bear some proportion of this cost.

Merchants, as beneficiaries of card schemes, should also bear a proportion of issuers' operational costs and capital and sunk costs. Operational costs include application management, card production and distribution, statement production, chargeback processing, customer service and account maintenance, product strategy and development, and marketing (excluding loyalty schemes).

Product strategy and development includes work on new anti-fraud measures with the potential to further lower payment system costs.

These are unavoidable costs for card issuers and are implicit in providing card scheme benefits to merchants. Merchants should bear some proportion of these costs. We agree that the cost of loyalty schemes should be excluded because loyalty schemes are a discretionary cost for card issuers and a number of issuers have chosen not to offer such programs.

We also accept the exclusion of the cost of revolving credit.

The case for including some proportion of the cost of capital and sunk costs as 'eligible' costs in calculating interchange is particularly relevant for new entrants. Smaller players wanting to enter the card issuing business should be able to recover some of their entry costs through interchange fees in order to facilitate a contestable market.

We note that the RBA concedes "that there would be logic in individual issuers seeking from merchants a return on the capital committed to providing payment services to merchants."[13]

3.2 Summary

The RBA's Draft Standard for the setting of interchange fees excludes too many issuer costs which relate, at least in part, to benefits provided to merchants. The effect of this proposed standard will be punitive to card issuers without any guarantee that it will benefit consumers.

The RBA states that:

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[13] Reserve Bank of Australia, op.cit., p52.

> "Since interchange fees effectively set a floor for merchant services fees, the reduction in interchange fees would be expected to result, *pari passu*, in lower merchant service fees. Competition should ensure that these lower fees are passed through to the final prices of goods and services."[14]

In other words, for the RBA's reforms to take effect, acquirers and merchants in turn will both have to resist the temptation to pocket the benefits for themselves. This scenario relies on fierce competition firstly among the big acquirers and secondly among the big retailers.

It is highly questionable whether this is the case. The *Joint Study* found that 93 per cent of credit card transactions are acquired by the big four banks.[15]

The Australian Consumers' Association has enough doubts about competitiveness in the retail market to call for the ACCC to be given price monitoring power to ensure that pricing for goods and services is lowered accordingly.[16]

CUSCAL's conclusion is that, if implemented, the RBA's interchange fee standard will punish card issuers and possibly drive some small issuers out of the card issuing business.

This would be a blow to competition in the retail banking sector in exchange for a reform outcome which can't be guaranteed and may not be achieved. This would be a hollow victory for consumers.

Thank you for the opportunity to respond to the *Consultation Document*.

Yours sincerely

ADRIAN LOVNEY
General Manager – Public Affairs and Compliance

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[14] Ibid., p116.
[15] Reserve Bank of Australia*, Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access,* October 2000 p17
[16] "Consumers would win from card reform", *AFR* 21 Feb 2002.