Australian Consumers' Association
Response to the Reserve Bank of Australia's Draft Standards and Access Regime for Credit Card Schemes

1. Introduction

The Australian Consumers' Association (ACA) supports the reforms to credit card arrangements proposed in the Reserve Bank of Australia's (RBA) Consultation Document. It is the view of ACA that Australia's credit card system is currently marred by inefficiencies and distortions which are increasing costs for all consumers.

The RBA has proposed three key reforms:

- Recalculation of the interchange fee formula;
- Abolition of the 'No Surcharge' rule; and
- Opening credit card issuing and acquiring to new entrants.

ACA views current interchange fee-setting arrangements as opaque, unaccountable, and resulting in fee levels which do not reflect the true costs of issuing and acquiring credit cards. These fees are charged to merchants, who in turn build them into pricing for goods and services, paid by all consumers. The high interchange level is justified by the banks and credit card schemes on the grounds it pays for the promotion of the credit card network through such features as loyalty programs. In ACA's view, this network has reached maturity, and no longer requires such vigorous promotion, which is being subsidised by the growing proportion of interest-paying cardholders and consumers more generally.

ACA also believes the no surcharge rule can no longer be justified. However, ACA is confident competitive pressures in the various credit-card accepting sectors (retail, bill payment) will discourage any move to direct charging for credit card transactions. This view is supported by at least one of the banks and one of the credit card schemes.

However, this reform should be accompanied by the granting of a surveillance and enforcement power to the Australian Competition and Consumer Commission (ACCC), to monitor any instances of direct charging, and take action against any merchant profiteering from the abolition of the no-surcharge rule. Double-dipping by the banks on cost recovery must not be replicated in other sectors.

Finally, ACA welcomes moves to increase competition in the credit card market by allowing new entrants to issue and acquire credit cards, subject to prudential and operational standards, to be determined by the Australian Prudential Regulation Authority (APRA).

It has been over a decade since the problems inherent in Australia's credit card market were first identified. Since that time, the credit card market has experienced such rapid growth as to outpace the growth of any other payment mechanism, eclipsing cash, cheques and debit cards in its expansion. The inefficiencies and distortions detailed in the RBA report and below have seen the costs of that expansion borne by those consumers least able to afford them, and deriving the least benefit.

The implementation of these reforms should proceed as originally set by the RBA for the end of 2002. The aims of the designation powers granted to the RBA in the wake of the Wallis reforms envisaged the broad reform of the Australian payments system to promote efficiency, security, integrity, competition and fairness. There are other payment systems equally needy of regulatory attention, and the credit card reforms should be viewed as a first step towards the achievement of this broader reform agenda.

2. Credit cards in Australia

Credit Card Uptake

Urged on by aggressive marketing and promotion efforts by the banks and credit cards schemes, Australian consumers have taken up credit cards at an unprecedented average annual growth in uptake of 25 percent over the past six years. Australia is now the sixth largest credit card market in the world, with total household debt at 83 percent of total consumer income.

The latest RBA credit card figures, to December 2001, reveal Australians now hold nearly 9.7 million credit card accounts. Their use of these accounts also continues to grow. The monthly value of credit card transactions overtook debit-card usage in 1997 and is now almost on level terms with payment by cash.

Credit Card Use

In 1999, the RBA/ACCC Joint Study found almost 70 percent of people earning less than $20,000 do not own a credit card and that this percentage falls as income rises, to only 20 percent of people on incomes of $60,000 or more not owning a credit card. Of a survey published in the Consultation Document, around 60 percent of respondents aged over 18 had a credit card.[1]

A survey of CHOICE subscribers revealed similarly high levels of credit card-holding. Of 367 respondents, 92 percent owned at least one credit card, with more than half of those owners holding more than one card. Respondents with more than one card also tend to spend more on their cards each month than those with one card. Around a third of those with more than one card spend over $2000 a month with them.[2]

Table 1.1, below, shows the across-the board increases in credit card uptake and use since November 1997. Not only are the number of accounts increasing at a steady pace, but total outstanding balances have more than doubled, as have the total value of limits.

The increase in credit limits is leading to higher spending and higher outstanding balances. In the 12 months to November 2000, these grew by 14 percent per account, compared to 10 percent per account for the previous period.[3]

More significantly, the Balance to Limits ratio has also continued to rise, indicating more cardholders are maintaining outstanding balances against their cards, and for higher amounts. This shows more and more cardholders are becoming ‘revolvers’ – using the credit facility on their card, rather than the ‘transactors’ who pay off any outstanding amount within a designated interest-free period. According to the Reserve Bank, approximately three-quarters of credit card outstandings are now interest-bearing. Mastercard figures also reveal the percentage of revolvers is increasing, from approximately 30 percent of cardholders in the early 1990s, to between 50 and 60 percent today.[4] Interestingly, it suggests this level is low compared to other countries, and offers potential for growth.

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[1] Reserve Bank of Australia *Reform of Credit Card Schemes in Australia: Consultation Document*, December 2001, p. 3.
[2] “On the cards”, *CHOICE*, December 2001, p. 16.
[3] CVC Global Consulting *Australian Credit Card Report*, November 2000, p. 9.
[4] Mastercard *Regulation of the Credit card Industry: Effects of the Reserve Bank of Australia’s Proposals on Consumers*, Lafferty Publications, 2001, p. 14.

These limit increases and higher spending have been fuelled by aggressive promotion by the banks. A recent unsolicited card offer forwarded to ACA targeted consumers earning $45,000 per annum for a card with a limit of up to $25,000. It is difficult to see how that amount could be repaid within the 55 days interest-free period offered on the card, yet the 17.2 percent interest charged on the card after the 9 month honeymoon period is well in excess of comparable no-frills card or personal loan rates.[5]

Indebtedness

Levels of credit card debt have grown strongly in recent years, and certainly warrant closer examination with regard to impact on insolvency levels, household savings and the impact on the daily lives and choices of Australians. However, this is a separate issue to the setting of interchange fees, and the operation of the credit card payments system. Concerns over the setting and level of interchange fees in Australia were raised a decade ago, in the context of the 1991 Martin Committee report into banking, *Pocketful of Change*,[6] and in a 1993 Prices Surveillance Authority report, long before personal debt levels began their growth to the levels concerning the consumer movement today.

Contrary to recent comments, the RBA reforms cannot be viewed as harbouring a 'secret agenda' to address indebtedness via regulation of the payments system.[7] ACA would welcome any *open* agenda to address indebtedness by the RBA, in conjunction with such State Government initiatives as the current NSW Department of Fair Trading investigation into levels and causes of indebtedness, but sees no such agenda inherent in the reforms proposed as part of its current review.

The practices which appear to encourage cardholders to take on potentially unsustainable levels of debt on their credit cards are those which promote ownership of more than one card, and which promote credit limits well in excess of what the holder can afford. These practices have developed separately to the setting of the interchange fee. There is scope for concern that the debt provisioning to cover the greater risk associated with lending on these grounds is contributing to higher costs being built into the interchange fee, but this is hardly the 'secret agenda' the RBA has been accused of.

Table 1.1 Credit card use in Australia over the past 5 years.

Year	*Total Accounts ('000)*	*No of cash advances ('000)*	*Value of cash advances ($m)*	*No of other transactions ('000)*	*Value of other transactions ($m)*	*Total amounts outstanding ($m)*	*Total value of limits ($m)*
Nov 1997	7818	2363	531	26812	2585	8582	28111
Nov 2001	9648	3128	861	66050	7297	19379	57910
	+ 1830	+ 765	+ 330	+ 39238	+ 4712	+ 10797	+29799
	+ 23%	+ 32%	+ 62%	+ 59%	+ 182%	+ 126%	+106%

Source: Reserve Bank Bulletin Statistical Tables, January 2002.

[5] Citibank Gold Master Card offer, 22 /2/2002. See Appendix 2.
[6] House of Representatives Standing Committee on Finance and Regulation *Pocketful of Change*, November 1991.
[7]Mr Frank Cicutto, address to the Australian Institute of Banking and Finance, 14/3/2002, as reported in Bruce Brammall "NAB chief ramps up fees fight" *Daily Telegraph* 15/3/2002, p. 99: "If there is a need to debate the level of credit card debt within the context of overall household debt in Australia, then let's do so. But we shouldn't bury that debate in the merits of how interchange is determined."

Credit Card Spending Patterns

The RBA has estimated spending on bank credit cards equals $79.3 billion per year. ARA figures show that across the retail sector, cash is used for 39.7 percent of transactions, cheques for 9 percent, Visa and MasterCard for 29.4 percent, American Express and Diners 6.5 percent and debit cards 15.4 percent.

In department stores (including store cards), non-bank credit cards account for 38 percent of sales and bank credit cards 31 percent, while cash accounts for just 56 percent of food store sales, debit cards 27 percent and credit cards just 14.5 percent.

Credit Card Products and Features

Available bank-issued credit card products tend to fall into two categories – those with loyalty schemes, high interest rates, and interest-free periods, and the 'no-frills', cheaper cards. Most standard credit cards have interest rates between 14.5 percent and 17.5 percent. Cards with loyalty schemes which offer rewards charge between 14.9 percent and 17.7 percent, and 'no frills' cards between 10.9 percent and 13.5 percent.

While these figures indicate a range of interest rate charges across different products, in reality, competition in the credit card market has largely been on other features, notably loyalty schemes. These were first introduced in the mid-1990s, and have been a strong factor in the expansion of the credit card network.

More recently, banks have also used other methods to encourage uptake and use of credit cards, including unsolicited offers of pre-approved credit cards to consumers, unsolicited offers of limit increases and offers of credit cards in lieu of personal loans to applicants.

Credit Card Market

This market growth is delivering significant profits to the four main issuing banks, and the two major credit card schemes.

Despite its size, Australia's credit card market remains highly concentrated, with the four major banks, ANZ, Westpac, Commonwealth and National Australia Bank, sharing more than 80 percent of the issuing and acquiring markets between them, with Visa and Mastercard holding approximately 53 and 23 percent of the credit card market respectively.

These profits are built on a range of fees and charges, from the direct interest rate and annual fees levied on cardholders, to the indirect interchange fee levied for transaction processing.

All four banks highlighted credit card earnings in their most recent results releases as a growing contributor to overall earnings and growth. The ANZ Bank reported total outstanding amounts on credit cards rose from $2.837 billion in September 2000 to $3.352 billion in September 2001, an increase of just over 18 percent. Of this, interchange revenue currently delivers approximately $775 million to issuing banks.

The incentive for banks to promote the growth of the credit card network through increased uptake and use by consumers is clear. As revenues from other banking activity decline due to increased competition in areas such as mortgage lending or lower investment returns, generating new sources of revenue to maintain the double digit growth the banking sector has enjoyed over recent years is a priority for the banks. But the methods used to promote this growth have also generated an inefficient, inequitable system.

The banks have created a system whereby normal pricing and incentive signals are suppressed by cross-subsidisations and bribes, largely in the form of loyalty points, aimed at encouraging cardholders to use credit cards to the exclusion of other payment methods.

This is not to discount the attractions of credit cards to consumers. Credit cards offer convenience and security, and prior to the introduction of loyalty schemes, were already increasing in popularity relative to other payment mechanisms, particularly cash and cheques.

But the introduction of loyalty schemes changed the pace and nature of credit card uptake, and has been funded by those who gain little or no benefit from them.

The increasing proportion of 'revolver' cardholders and those people who do not hold a credit card are paying for the 'transactor' cardholders, who have the means to pay off their outstanding balance within the interest-free period, and get paid by the bank in the form of loyalty points for doing so. This bribe is being funded by other credit cardholders through high interest rates and by all consumers in higher prices for goods and services charged by merchants recouping the merchant fee they pay to cover the high interchange rate set by banks.

As found by the RBA and ACCC in their Joint Study into credit card schemes, the issuing banks and card schemes use their market power to set the interchange fee in an opaque manner, at a rate which not only covers the cost of issuing and acquiring credit cards, but also the loyalty schemes which have 'turbo-boosted' the growth of the credit card market.

In essence, the banks recoup sufficient revenue from the interchange fee to not only cover their costs, but also offer incentives for consumers to take on credit, which an increasing proportion are doing on an interest-bearing basis, delivering further revenue to the banks.

3. Scope of the Inquiry

The lack of transparency in the setting of the interchange fee by the issuing banks and schemes has long been a concern of regulators, raised in a 1992 Prices Surveillance Authority report, and culminating in the designation of the credit card system by the Reserve Bank under the powers conferred on it under the *Payments Systems (Regulation) Act 1998* ('the Act').

This legislation was part of a package which implemented the recommendations of the Wallis Inquiry to increase competition and improve efficiency in the financial system, while preserving its integrity, security and fairness. It aimed to "strengthen, and make more transparent and accountable, the regulation of the payments system undertaken by the Reserve Bank of Australia."[8]

Under the Act, the RBA has unlimited authority over the payments system and any decision it makes cannot be challenged or appealed on the merits. The RBA has relied on these powers to conduct its current inquiry, and prepare its proposed reforms for implementation later this year.

This action follows almost a decade of inquiry and negotiation with the banks to achieve a more transparent, accountable and cost-reflective mechanism for setting the interchange fee. It follows attempts by the ACCC to negotiate authorisation of the credit card system with the banks, and subsequent legal action against the National Australia Bank on the grounds it had breached the price fixing provisions in section 45 of the *Trade Practices Act*.

[8] Hon Peter Costello MP, *Explanatory Memorandum*, Payment Systems (Regulation) Bill 1998, p. 1.

ACA concurs with the RBA finding that current credit card arrangements do not meet the public interest test laid down in the Act, and warrant the reforms proposed to promote fairness, efficiency and competition in the payments system.

Impact on international investment
It has been argued that the reforms send the wrong signals to international business, and will discourage investment. It is true Australia is being closely watched by other countries, as the first jurisdiction to take this sort of action. But Australia will send far a more damaging signal by not acting, that Australian financial services regulators will bend to business pressure if enough is applied.

Such an outcome would be directly contrary to the aims of the Wallis reforms and the Federal Government's stated intention of attracting international investment by enhancing Australia's reputation as a well-regulated, efficient location for investment. There are a number of countries around the world which trade on their reputation for lax regulation and over-accommodation of the wishes of business. Australia has not hitherto expressed any wish to join their ranks, and must resist pressure to do so.

Scope of Powers

Questions have been raised over whether the RBA has exceeded its powers by designating four-party, or 'open' schemes, and not including the three-party 'closed' schemes (American Express and Diners Club) in its regulatory action, and therefore breaching what the Australian Bankers' Association has referred to as a basic policy of competitive neutrality.

It is the view of the ACA that action in one area of the credit card system should not be taken to preclude future regulatory action in other areas. Indeed, the ACA recommends (below) that this process be only the first step in a comprehensive review of the setting and level of other interchange arrangements.

Moreover, the fact that these schemes remain outside the scope of the current action is no argument against the need for such action. The size of the bank-issued cards market, and the number of people affected make it the obvious candidate for immediate reform. The charge card schemes still hold very little of the card market relative to the dominance of the credit card schemes.

4. Proposed reforms

The RBA has set out three key reforms to the credit cards system:

- Recalculation of the interchange fee formula;
- Abolition of the 'No Surcharge' rule; and
- Opening credit card issuing and acquiring to new entrants.

Recalculation of interchange fee formula

Existing formula

ACA agrees with the RBA finding that "there is no evidence that credit card interchange fees in Australia have been regularly reviewed by scheme members" and "In contrast to the practices of the international schemes in other countries, no formal methodologies for determining these fees have been applied.".[9]

[9] RBA *Consultation Document*, p. 34.

Current setting processes are characterised by opacity and appear to be based on the market power of the dominant participants rather than a methodology which would respond to changes in costs of conducting card issuing and acquiring. This has created a situation where it is difficult to determine what costs are recouped through the interchange fees, and to prevent other costs from being loaded into the calculation of interchange.

The banks have argued variously, that different fees and charges recoup the costs of different credit card features. ACA is concerned this provides an opportunity for 'double-dipping' on cost recovery by the banks. By way of example, the difference in interest rates paid by cardholders for cards with loyalty programs and interest-free periods is explained by the banks as necessary to pay for those features. Yet the banks have also argued that the interchange fee pays for these features. This is strong justification for making the calculation of interchange more transparent, and more reflective of the true costs of issuing and acquiring cards.

The participants have argued that in the absence of regulatory action by the ACCC and RBA, it is likely that the rate would have fallen upon revision. From the time the concerns over the setting process were first raised in the early 1990s, through the negotiations with the ACCC and its legal action in 1999, ACA would argue the banks and schemes have had ample opportunity conduct such a review and avoid the designation of the system. Indeed, the Chairman of the ACCC has stated that attempts to negotiate authorisation of the credit cards system with the banks broke down, even after indications from the ACCC that any request for authorisation would be treated 'sympathetically' by the regulator.[10]

The lack of movement in the interchange rate over the past decade is further reason for reform of the interchange setting process to make it more responsive to cost changes. The banks have consistently argued that Australian interchange fees are lower than those in other countries.[11] However, the greater flexibility and responsiveness of international setting mechanisms suggest that if the Australian process was less rigid, the interchange fee would be lower still. While banks will argue that the interchange fee be maintained at a level to promote the growth of the credit card network, in contrast to the United States experience, they have not passed on the lower costs delivered by the economies of scale from this strong growth.

Revised formula

ACA supports the revised formula proposed by the RBA , based on an 'objective, transparent and cost-based' method of calculation. ACA believes the revised formula will achieve the important aims of preventing banks from loading costs into the interchange calculation not associated with credit card issuing or acquiring, or which are already recouped elsewhere.

It will also send clear signals to consumers about what they are paying for their credit card, and why. In the absence of transparency and in the context of complex cross-subsidisation of credit card transactions, consumers cannot make decisions about which method of payment is most efficient and suited to their needs. Current arrangements direct the costs of providing features such as loyalty scheme away from those who benefit from them to those who gain little or no benefit, and who are less able to afford them.

At the heart of this recalculation is the inclusion of only those 'eligible costs' attributable to the provision of credit cards. These would comprise processing and transaction costs, verification and fraud prevention costs and the cost of guaranteeing payments to merchants.

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[10] House of Representatives Standing Committee on Economics, Finance and Public Administration: Review of the Annual report of the Australian Competition and Consumer Commission 1999-2000 *Hansard* 30/3/2001.

[11] Australian Bankers' Association *Submission to RBA Inquiry into Credit Cards 2001*, p. 39.

The revised formula excludes costs associated with credit risk and such efforts to promote network growth as loyalty schemes. ACA believes this is appropriate.

Credit risk
Banks cover the cost of credit risk through the setting of interest rates to cardholders, in the same way they set rates for other forms of unsecured and secured credit. There is little justification for this cost being built into the interchange fee. The banks have argued as merchants enjoy the benefits of increased spending the credit facility may generate among cardholders of limited liquidity, they should bear some of the costs of providing that credit. This argument is inconsistent with how costs of credit risk are borne on other credit products.

The same argument that merchants may benefit from spending generated by personal loans and credit advanced by banks has not led to merchants sharing the cost of credit risk on those products. While consumers continue to take out personal loans for large purchases, such as a car, computer, or holiday, the merchants who benefit from the spending do not pay the bank for it.

In this light, the recent trend by banks to steer personal loan applicants to credit cards, as reported to ACA by consumers, points to the greater profitability of credit cards to banks, who appear to be ‘double-dipping’ in recovering their credit risk provisioning. Whether this has also enabled banks to alter their risk profiling and increase their risk exposure also warrants further investigation.

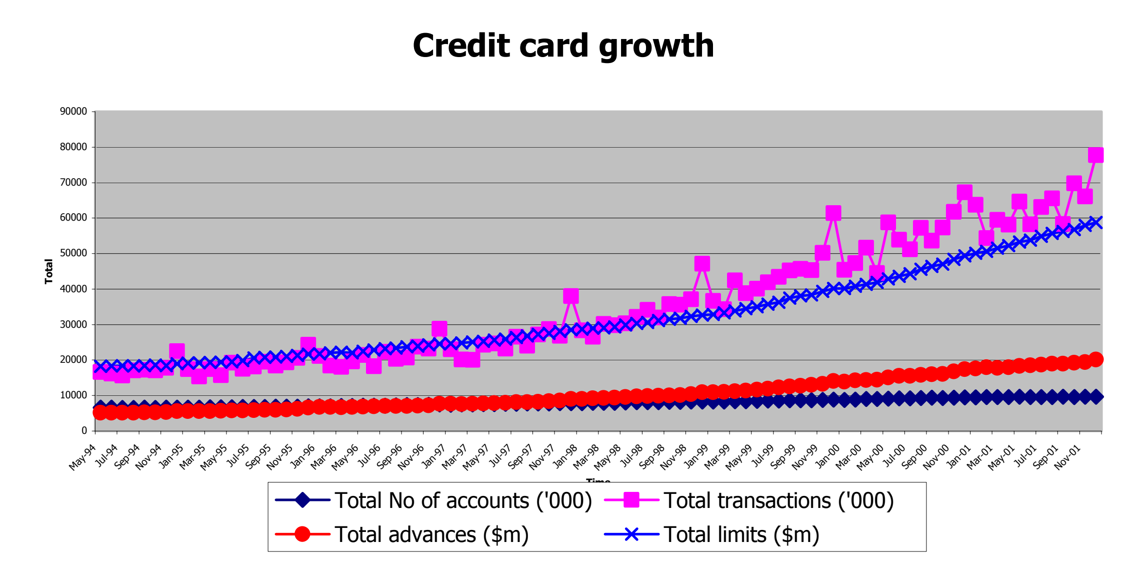
Loyalty schemes
ACA agrees loyalty schemes are not a necessary cost of providing a credit card system, but have been an extremely useful tool employed by the banks to promote the growth of the credit card network. The banks have argued that a cut in the interchange fee will lead to the reduction or withdrawal of loyalty programs. The effect of loyalty schemes on network expansion is discussed below, but it is worth noting that the interchange level did not rise when they were introduced in the mid-1990s, indicating they are not only paid for by the interchange, but also from the unit cost reductions growth of the network has delivered and in the higher interest rates paid by cardholders.

Other elements of the revised interchange calculation process include requirements that the level be assessed at three year intervals by an independent expert, whose decision and reasons must then be made publicly available. These proposals are welcomed by the ACA as necessary components of ensuring the transparency and accountability currently absent from the system.

Impact on Spread of Network

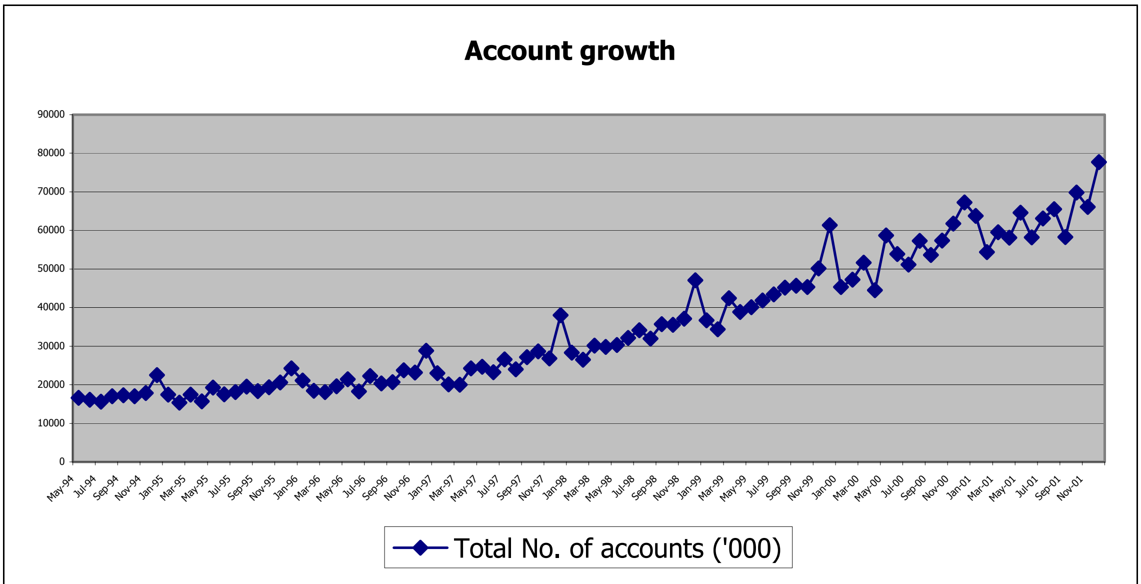
ACA believes the rapid expansion of the credit card network in recent years has brought it to maturity. Credit cards are the fastest-growing method of payment in Australia and, contrary to bank claims, are not suffering any “constant significant lapse rates”.[12] Table 4.1, below, shows the constant growth in credit card accounts, transaction, outstanding balances and limits over the past 8 years.

[12] ANZ Bank *Response to RBA/ACCC Study*, 29/1/2001, p.18.



Source: Reserve Bank of Australia Bulletin, C01 Statistics

Table 4.2, below, gives further detail on the growth in accounts over the past 8 years, with little evidence of 'significant lapse rates'. in fact, the growth rate in account numbers is still strong, reaching nearly 10 million accounts.



Source: Reserve Bank of Australia Bulletin, C01 Statistics

As such, it is difficult to justify the inclusion of loyalty scheme costs in the calculation of interchange on the basis they are required to promote network expansion. If anything, the strong growth of credit cards relative to other payment mechanisms would appear to suggest banks need to put greater efforts into promoting mechanisms such as EFTPOS and debit cards, which have suffered lapse rates.

ACA further argues that if loyalty points are so essential to the expansion of the credit card network, they are only serving to distort the development of an efficient payment system. If consumers cannot be persuaded to take up credit cards on the basis of convenience, security and value, but must be bribed with loyalty points, this points to deficiencies in credit cards relative to other payments mechanisms.

The inefficiency that loyalty schemes promote has been noted above, with competition developing on the basis of loyalty schemes, rather than on the basis of security or cost. Competition on these fronts could have delivered features more to consumers' benefit, such as lower interest rates, in line with those offered for other forms of unsecured credit, or enhanced security features, such as that only now being offered by Visa[13].

Impact on credit vs charge card network expansion

ACA does not share the banks and schemes' concerns that limiting the ability of issuers to use the interchange to fund expansion of the network will enhance the popularity of charge cards among consumers. The growing proportion of 'revolvers' relative to 'transactors' would appear to mitigate any migration of consumers from credit cards to charge cards, where the outstanding balance must be repaid within a specified time period, unlike credit cards, where an outstanding balance may be held indefinitely, subject to payment of an interest charge.

Moreover, it may be more efficient for some migration to take place. Transactors' card usage patterns are more suited to the features of a charge card, as they do not need the ongoing credit facility. Credit card issuers do not reap revenue from these customers, and it is they who are contributing to the high interchange and interest costs paid by other cardholders, merchants and consumers as a whole, through their ability to earn free loyalty points.

Under the RBA reforms, consumers will receive clearer price signals about the charges generated by their card use, and which products best suit their needs. However, while their credit card business may not generate revenue for the bank, the other business these customers bring to the bank may be worth retaining through maintenance of existing credit card features.

Impact on banks

Analysts vary in their assessments of the likely impact of any interchange cut on bank profitability.

Deutsche Bank has estimated an earnings loss of up to 3 percent, with Credit Suisse estimating an industry-wide net revenue loss of up to $220 million.[14] The impact is expected to vary across the banks. As the bank with the largest credit card issuing business relative to other areas, ANZ saw its cards division increase its pre-tax profit to $65 million in the 6 months to June 30 2001, an increase of 18 percent. Credit Suisse has estimated potential earning losses of up to $57 million, or 2.5 percent. It further estimates the Commonwealth Bank is likely to absorb about $60 million of earnings run-off, about 2 percent of the forecast 2003 profit, with Westpac and NAB to record losses of approximately $40 million[15].

Other analysts are more optimistic about the impact of the changes on profit forecasts, predicting the changes will result in only 'incremental revenue leakage', with the banks still able to recoup losses.[16]

The banks themselves have estimated the likely rate cut as from between 80 and 120 basis points to about 35 to 40 basis points, halving the aggregate profitability from about $600 million to about $300 million. They argue that competitive pressures mean they will need to

[13] 'Verified by Visa', launched February 2002.
[14] George Lekakis "Credit card reforms to hit profits", *Australian Financial Review*, 20/12/2001, p. 35.
[15] Ibid.
[16] UBS Warburg analyst, Mr Graham Malony, as reported in George Lekakis "Credit card reforms to hit profits", *Australian Financial Review*, 20/12/2001, p.35.

recoup this lost revenue by cutting back on credit card features such as interest-free periods, loyalty schemes and the chargeback mechanism.[17]

ACA agrees with the opposing view taken by the ACCC, that: "in the new competitive world, banks may discover that it will not be so easy for them to abandon loyalty programs…Some banks may make outrageous claims and threats but most will buckle down to living in a more competitive credit card market."[18]

The resources and efforts the banks have devoted to building up the credit card network, the growing importance of credit card revenues to earnings and the continued demand for credit card products are strong incentives for banks to continue issuing and acquiring credit cards.

The threats to card offerings currently emanating from banks do not detract from the validity of arguments for interchange reform. ACA and consumers in general are used to the banks recouping lost revenue by charging high fees and rationalising offerings where insufficient competition allows them to do so. The clearest example of this in recent years is the sharp increase in fees and charges levied on transaction accounts to recoup revenue lost from greater mortgage competition. Threats of fee increases are no reason to oppose reforms designed to bring wider benefits to consumers, but a signal that greater competition is required in other areas of banking.

Impact on Consumers

While ACA does not endorse the rationalisation of credit card features, such as interest-free periods or loyalty schemes, it should be noted an increasing proportion of consumers would not be affected by such moves.

Interest-free periods

The introduction of interest-free periods have proved a very popular feature with many consumers, promoting 'transactor' behaviour, where the cardholder uses the card to smooth their payments over the relevant interest-free period, avoiding transaction fees and enjoying the convenience of a charge facility without accessing revolving credit.

However, the proportion of cardholders who enjoy this feature is decreasing, as more and more cardholders maintain outstanding balances, using the credit facility and paying associated interest rate costs. ACA has commenced an education campaign to encourage revolvers to switch cards to lower-cost, 'no-frills' products, which do not offer an interest-free period, but charge a lower ongoing rate.

These cardholders, which Mastercard has estimated as more than half of all cardholders, would not be affected by any bank rationalisation of interest-free periods, as they are not currently deriving any benefit from that feature. If anything, they may be encouraged to switch to a product better suiting their revolving credit needs.

Loyalty schemes

Consumers report varying degrees of satisfaction with loyalty schemes. A 2001 CHOICE survey of subscribers revealed four in five of respondents had a loyalty program linked to their credit card. of those in loyalty programs, over one-quarter thought it was either poor value ofrvery poor value and another third thought it was only fair value for money. Only 36 percent of respondents believed their loyalty program good or excellent value for money.

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[17] ABA Ceo David Bell : "In a competitive world you seek to recover the cut in revenue", quoted in John Breusch and George Lekakis, with Damien Lynch "Banks threaten to end benefit programs", *Australian Financial Review*, 15/12/2001, p. 4.

[18] Ibid.

Around three in ten people had changed where they shopped in order to earn more points, and over two in five had taken advantage of bonus offers. Almost 60 percent were putting more purchases on credit than they did previously, in order to obtain more reward points. The most popular choice for loyalty point redemption was plane flights, with almost half of those respondent who had redeemed points choosing this option. A smaller proportion, of about 30 percent, had redeemed vouchers for gifts or products valuing less than $500.

This redemption pattern reflects the popularity of credit card loyalty schemes offering frequent flyer points.

The MasterCard analysis of the Australian credit card market endorses the prominence of frequent flyer points, but suggests other reasons for possible rationalisation, including increasing cost to issuing institutions of frequent flyer points:

> "The market has been fixated with airline loyalty programs, which have driven significant card and sales growth but little revolving credit growth. The success of these reward programmes has led the airlines to increase significantly the cost of points to financial institutions, which has resulted in pressure on expense lines. Rationalisation of programmes is a possibility."[19]

Viewed in this context, threats to discontinue loyalty programs as a consequence of the interchange rate cut are less persuasive. The demise of Ansett and the Global Rewards program is likely to have exacerbated this cost pressure, with Qantas able to raise its price for points, in the absence of any competition. It appears from the MasterCard material that banks and the schemes are already looking for alternative, cheaper, methods to encourage credit card growth.

In any case, with the most popular form of loyalty schemes, those offering frequent flyer points, likely to become much more expensive for financial institutions, including them in the 'eligible cost' for interchange calculation would likely result in an increase in the fee level. This would exacerbate the existing undesirable situation of cross-subsidisation of loyalty schemes by all consumers through yet higher prices for goods and services and is further argument for the exclusion of loyalty scheme costs from the caluclation of interchange.

Chargeback and other fraud protection

Given the revised interchange formula includes costs associated with protecting against fraud in eligible costs, ACA cannot understand threats to chargeback and other fraud protection from the banks.[20]

ACA also believes sufficient commercial incentives exist for continued innovation in the credit card market, particularly in the area of security, to encourage consumers to transact electronically, once again promoting the spread of credit cards to the exclusion of other payment mechanisms.

Consumers have little confidence in electronic transactions, and unless the schemes and issuers address that lack of confidence through improved security, they will not reap the rewards of increased electronic transacting – which automatically extends the credit card payments network to their advantage.

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[19] Mastercard, ibid., p. 1.

[20] ABA CEO David Bell: "There could also be some watering down of the money-back guarantees that the card schemes provide when merchants fail to deliver goods or services to consumers", George Lekakis "Radical blueprint for credit card reform", *Australian Financial Review*, 15/12 /2001, p. 3.

With the exception of online banking, which they perceive as being underwritten by bank security guarantees and the EFT Code, consumers are currently wary of electronic transacting. Expansion of the electronic network is dependent on the implementation of enhanced security measures to protect consumers from fraud.

Removal of no surcharge rule

ACA supports the abolition of the so-called 'No Surcharge' rule, imposed on merchants through the terms of their agreement with the international credit card schemes. ACA believes there is sufficient competition in the markets currently generating high credit card transactions (retail, bill payment) to act as a disincentive to direct charging, or profit-taking by merchants.

This confidence is reflected in several submissions from the market participants themselves. Earlier this year, Mr John Verco, the then Mastercard head of Australian operations stated:

> "Evidence from various markets around the world, including the UK where surcharging has been allowed, shows that in competitive market segments surcharging is driven out".[21]

And the ANZ Response to the RBA/ACCC Study makes the following point:

> "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. Few, if any, merchants would risk the near-certain hostility they would face from consumers if they attempted to charge more for credit card transactions'.[22]

Retailers have also endorsed this view. The head of one of Australia's largest retailers, Gerry Harvey, of Harvey Norman, has confirmed that most retailers would be reluctant to implement surcharging, instead continuing to absorb costs (likely to be substantially lower after the interchange recalculation):

> "It's a nice thought for all of retailers to charge customers another 3 or 4 per cent if they use their credit cards but realistically the customer's not going to pay that and it's not an issue".[23]

The ABA has argued the retail sector is more concentrated than the credit card market, and that this will merely see a shift in revenue from interchange from banks to merchants .[24] There are several flaws to this argument.

First of all, it is effectively arguing that banks are more entitled to the windfall profit interchange generates than are retailers. It also assumes that the only actors will be retailers. Bill payment is a fast-growing area of credit card use, where competition between the utilities, telecommunications companies and other institutions offering credit card payment to their customers will also militate against surcharging.

The argument also ignores customer mobility. The banking sector is unusual in that not only is it heavily concentrated, but customer mobility is severely constrained by the difficulties associated with changing from one institution to another. However, in the retail sector, consumers are more easily able to take their business to another provider offering cheaper, or better service. So while there may be concentration of players, there is still strong competition

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[21] George Lekakis and Ben Seeder "MasterCard against change", *Australian Financial Review*, 13/12/2002, p. 42.
[22] As published in vol. I of submissions received by the Reserve Bank, E.1, p. 16 at 4.18.
[23] Lyall Johnson & AAP "Reserve challenge to $3b card market", *The Age*, 15/12/2001, p. 3.
[24] David Bell "Retailers enjoy cut of the cards", *Australian Financial Review*, 26/2/2002. p. 59.

for customers and a greater likelihood the benefits of the interchange cut will be realised by consumers than under current arrangments.

If arguments that credit card handling is often cheaper for merchants than other methods, such as cash or cheques are accepted, they provide further argument against the likelihood of surcharging, which would provide a disincentive to a lower cost payment method. This was advanced by the ANZ in its response to the Joint Study:

> "Merchants would be further reluctant to pass on the merchant service fee for credit card transaction because these transaction reduce cash handling and cheque processing costs".

ACCC price monitoring power

However, ACA acknowledges that less competitive markets, such as aviation, will require monitoring and enforcement action against profit-taking.

ACA recommends the Federal Treasurer grant a price surveillance and enforcement power to the ACCC to ensure merchants do not profiteer from the uncapped surcharge, or double-dip on merchant fee recovery from their customers.

New Entrants

The third reform proposed by the RBA will allow new entrants into the credit card issuing and acquiring markets, subject to prudential and operational requirements. ACA supports this proposal as a means of encouraging much-needed competition in the credit card market.

The RBA has likened this reform to the opening up of the mortgage lending market, which delivered substantial cost reductions to consumers. [25] There are a number of institutions, including retailers, utilities and telecommunications companies, as well as other financial institutions, which would be able to meet the prudential and operational standards required to enter the market, and ACA looks forward to some of these taking the up the opportunity this reform will provide.

Moreover, in the intervening period, as has been seen in other sectors, (such as aviation), the possibility of competition can act as a spur to improved standards of goods and services, resulting in gains for consumers. While not all of these institutions will necessarily be able to compete at the higher-cost end of the market, the growing market for lower-cost 'no-frills' cards may provide sufficient incentive for entry.

7. Conclusion

These reforms have been over a decade in the making, and should be implemented according to the original timeframe enunciated by the RBA – by the end of 2002. There has been ample opportunity for negotiation and consultation through the years and different regulatory actions undertaken to resolve the inefficiencies of the credit card system. As the market continues to grow, so too do the costs of these inefficiencies.

The sooner these reforms are implemented, the sooner other inefficiencies and flaws in the Australian payments system can be addressed, to the benefit of all participants, and consumers in particular.

[25] George Lekakis "Radical Blueprint for credit card reform", *Australian Financial Review*, 15/12/2001, p. 3.

About the ACA

The ACA is an independent not-for-profit, non-party-political organisation established in 1959 to provide consumers with information and advice on goods, services, health and personal finances, and to help maintain and enhance the quality of life for consumers. Independent from government and industry, it lobbies and campaigns on behalf of consumers to advance their interests.

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