

28 April 2008

**Via email to:** [pysubmissions@rba.gov.au](mailto:pysubmissions@rba.gov.au)

**Michele Bullock**  
**Head of Payments Policy Department**  
**Reserve Bank of Australia**  
**GPO Box 3947**  
**SYDNEY NSW 2001**

Dear Ms. Bullock,

**RE: PRELIMINARY CONCLUSIONS OF THE RBA'S 2007/08 PAYMENT SYSTEMS REVIEW**

Enclosed please find a paper entitled "Regulatory intervention in the payment card industry by the Reserve Bank of Australia: Analysis of the Evidence," dated 28 April 2008 that I have prepared along with William Bishop, Kyla Malcolm, and Nicole Hildebrandt in the London office of CRA International (CRA). We submit this analysis in response to the request for public comment that accompanied the release on 21 April 2008 of the RBA's preliminary conclusions concerning the effects of its intervention.

Based on our review of the evidence in Australia, we cannot agree with the RBA that close oversight of retail payment remains necessary. In particular, while we agree that the RBA should step back from the regulation of interchange fees in Australia, we cannot agree that the RBA should reintroduce such regulation in the future in the event that interchange fees increase.

CRA is a leading economics consulting firm that provides economic, financial, strategic, and business management advice to law firms, corporations, accounting firms, and governmental organizations. CRA serves clients from 23 offices on four continents. Further information on CRA and the authors of this paper is available from our website ([www.crai.com](http://www.crai.com)).

The analysis in our paper is based on an exhaustive review of the existing evidence on the impacts of the RBA's regulatory intervention, including the evidence presented in submissions to the RBA over the past year. In addition, our analysis makes use of new research, including interviews with and data from MasterCard Worldwide and the major Australian banks. While our research was funded by MasterCard, the views expressed in the paper are our personal views, based on our independent analysis of the evidence.

We believe that government agencies should resort to economic regulation only if there is clear evidence of market failure and only if there is reason to believe that regulation is likely to benefit consumers. For the reasons explained in our paper, we believe the RBA has not justified its initial intervention in the payments system by reference to any market failure, nor has it justified

a continuation of its intervention. The empirical evidence on the actual effects of the RBA's intervention provides no support for the view that the payment system in Australia is now operating more efficiently or that consumers have derived any net benefits from the intervention.

The RBA's intervention has led to higher cardholder fees and less valuable reward programmes. At the same time, there is no evidence that these undeniable losses to consumers have been offset by reductions in retail prices or improvements in the quality of retail service.

A more detailed summary of our conclusions follows:

- Increased cardholder fees and reduced benefits. As the RBA has acknowledged in its preliminary conclusions, the mandated reductions in interchange fees “have resulted in a reduction in the value of reward points and higher annual fees, increasing the effective price of credit card transactions facing many consumers.” On average, the annual fees for standard four-party credit cards increased by 22% between 2001 and 2004, while annual fees for rewards cards increased by 47%-77%. By our estimate, cardholders in Australia are now paying approximately AU\$480 million more in additional fees for credit cards each year. American Express has also increased cardholder fees. Meanwhile, data from RBA suggests that the value of reward points for four-party cards has declined by approximately 23%. Although intended by the RBA, these effects nonetheless represent harms to consumers.
- Pass-through to retail consumers. One of the RBA's key expectations was that reductions in interchange fees would lead to reductions in merchant service charges that would in turn be passed on to final consumers in the form of lower retail prices. As expected, the reductions in interchange fees have led to a significant reduction in merchant service charges, benefiting merchants to the extent of approximately AU\$870 million per year. Merchants, however, have not presented any empirical evidence documenting the extent to which these reductions have been passed through to consumers, and neither has the RBA or anyone else.
- Impacts of surcharging. In its preliminary conclusions, the RBA reports that 23% of larger merchants and 10% of smaller merchants now impose surcharges on purchases made with credit cards. While the RBA has asserted that surcharges tend to be set in line with merchant service charges, the evidence shows that in fact, on average, surcharges on users of four-party cards have exceeded average merchant service charges. These surcharges imply that some merchants are using surcharges to price discriminate against cardholders and to capture some of the value that would otherwise be derived by consumers from the use of payment cards.

- Innovation and market structure. Despite the increase in cardholder fees and the reduction in benefits, the mandated reduction in interchange fees has reduced the profitability of issuing four-party credit cards. This has also harmed consumers to the extent that it has reduced the incentives of issuers to invest in new types of cards and payment system innovations. In addition, we believe that the RBA's new "access regime" has had no significant effect in encouraging new entry into card issuing and acquiring. Indeed, viewed in their entirety, the RBA's regulations may have led to an increase in market concentration by making it harder for smaller issuers to compete and helping to force some smaller issuers out of the market.
- Basis for regulatory intervention. In its preliminary conclusions, the RBA continues to assert that its interchange regulations have contributed to an improvement in overall resource allocation. This assertion is based on the view that the RBA regulations have induced a significant number of consumers to use debit cards for transactions that otherwise would have been made using credit cards, and that the use of debit cards is less costly in resource terms than the use of credit cards. We show in our paper that there is no basis for either of these key assumptions. Instead, there are fundamental flaws with the RBA's resource cost analysis, and with its conclusions regarding the impact of its regulations on allocative efficiency.

Rather than improving resource allocation in Australia, we believe that the RBA's intervention has redistributed wealth. There is no evidence that the undeniable losses to consumers from higher cardholder fees and reduced card benefits have been offset by reductions in retail prices or improvements in the quality of retail service. The RBA's intervention has redistributed wealth in favour of merchants. We see no justification for the continuation of the RBA's regulation of interchange fees and hope that the RBA will reconsider its preliminary conclusions in coming months.

Sincerely,

Robert Stillman  
Vice President  
CRA INTERNATIONAL