Financial Services Consumer Policy Centre

Response to:

Reserve Bank of Australia Reform of Credit Card Schemes in Australia

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Financial Services Consumer Policy Centre
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1 Introduction

1.1 Summary

The Financial Services Consumer Policy Centre welcomes the opportunity to comment on the Reserve Bank of Australia's "Reform of Credit Card Schemes in Australia" consultation document.

We believe that there are clear grounds for these long overdue reforms, and we believe that the RBA is exercising its powers correctly. We have some recommendations for minor improvements that may enhance consumer protection and participation in the reform process, however we support the three core proposed reforms in full:

- The 'no surcharge' rule should be prohibited;
- The interchange fee should be set through an independent process based on the RBA's draft standard; and
- The credit card system should be opened up to more vigorous competition and barriers to entry should be lowered.

1.2 Consumer use of credit cards in Australia

Credit cards are a popular payment instrument for some, but not all, Australian consumers. There are around 9.7 million credit card accounts in Australia, with numerous consumers holding more than one card. The value of credit card transactions overtook debit-card transactions in 1997.

However, there is a clear disparity between wealthy consumers, who use credit cards, and poorer consumers, who are more likely to use cash, cheques or debit cards. 70 percent of people earning less that $20,000 do not own a credit card. Only 20 percent of people on incomes of $60,000 or more do not own a credit card.

In addition, credit card use has grown quickly, and has gradually transformed from a situation where the majority of consumers were transactors (always paying off balances before incurring interest) to today's situation where the majority of consumers are revolvers (incurring interest each month and maintaining a rolling debt).

Credit card use in Australia[1]

Year	*Total Accounts ('000)*	*Total amounts outstanding ($m)*	*Total value of limits ($m)*
Nov 1997	7818	8582	28111
Nov 2001	9648	19379	57910
	+ 23%	+ 126%	+106%

[1] RBA Bulletin January 2002

1.3 Reserve Bank of Australia powers

We believe the current reforms are a good first step, but that additional reforms will be required in other parts of the payments system, preferably in the near future.

However, we do not agree that the RBA's step by step approach to reform is somehow prejudicing participants in the four party schemes. The interchange fee is largely a by-product of the four party system. The four party system itself is the dominant force in credit cards. There is no significant harm in tackling the largest and most inefficient part of the payment system as a first step, as long as attention is eventually turned to smaller players and other inefficiencies.

Indeed, those parties who are complaining that American Express and Diners Club have been excluded from the reform process appear to be deliberately ignoring the known intention of the RBA to deal with this issue in due course. The Consultation Document at page 78-79 (and repeated elsewhere) clearly states:

> "The Reserve Bank has concluded that a standard on merchant pricing is needed, in the public interest, to promote efficiency and competition in the payments system… The Reserve Bank will consult the three party card schemes, American Express and Diners Club, on why the standard on merchant pricing should not apply to them."

The large players (banks and credit card companies) should support ongoing (and speedy) reforms across the entire payments system, rather than trying to derail the current reforms on the basis that the entire task is not yet complete.

2 Abolition of the 'no surcharge' rule

2.1 Cross subsidy from the poor to the wealthy

The issue of 'perverse cross subsidisation' is at the core of the Financial Services Consumer Policy Centre's objection to the current system.

Our objection derives from the reality that those people with the least access to credit card facilities are in practice paying the highest cost. This perversity is derived as a result of the current system's embedding of transaction costs into the cost of every good sold and service provided. This in turn distorts the cost of goods and services for those who do not use credit cards as a means of payment.

Central to our approach is the issue of access and equity. Access and equity principles dictate that no consumer be worse off or pay a higher cost for a good or service which they are not receiving. This forms the nucleus of consumer protection laws and is rooted in the psyche of 'fairness and justice'. Unfortunately, the current approach to payment systems has been responsible for facilitating the precise opposite of what is deemed 'fair'.

Poor consumers are paying for the 'fly buys' points of affluent consumers. Poor consumer are subsidising the cost of credit card transactions for affluent consumers. In fact, this perverse situation is also played out at business level whereby small business subsidise big business by virtue of higher interchange fees paid. That said, it is clear that the current credit card interchange fee system is one that by default is structured to advantage affluent consumers and big business at the expense of poorer consumers and small business.

This system which generates massive profits for the big banks has caused the extremely efficient EFTPOS system to either atrophy or otherwise become extremely expensive. This is especially in view of the fact that Australian banks have not invested in technology which would allow consumers to pay bills using their own money (with the exception of BPay). The lack of investment in the EFTPOS, Direct Debit and Debit Card infrastructure has caused credit card usage to boom whilst the more efficient and more financially prudent manner of paying - 'using your own money' - has declined.

The massive promotion of credit cards has seen to it that more and more consumers are purchasing goods and services using credit. As the credit card system expands, those people not able to access credit have had to deal with a further entrenchment of their disadvantage. This comes as a result of the general expectation that all consumers have access to credit cards. This pattern is replicated in general banking, insurance, and superannuation whereby public and institutional policy is structured within the boundaries of an explicit assumption that all consumers have access to those services.

The profit driven haste in which Australian banks and other credit providers have disseminated credit cards has meant that those with limited credit access are forced into what has become an expensive way of paying bills and goods and services. For whilst credit card transactions have no upfront costs, the alternative way of paying by either cash or debit have become relatively expensive in view of the very limited access to free transactions.

The issues of perverse cross-subsidisation and unchecked expansion of credit cards are major distorters of access to reliable, cost effective and fair transactional facilities to poorer consumers as well as those who do not wish to have a credit card. The current system is forcing Australian consumers to embrace credit cards regardless of affordability and cost. The system distorts the cost of goods and services and is fundamentally unfair.

2.2 Price signals

As well as the unchecked haste of credit card distribution, price signals are a key factor in influencing consumers to take up credit cards in Australia.

The major price signal faced by Australian consumers is the asymmetry of the pricing structure between credit cards and debit cards. Australian consumers choosing to pay for a good or service using their own money must pay an upfront transaction fee. On the other hand consumers electing to pay using credit are not required to pay any transaction fees.

This anomaly is derived from the fact that fees and charges for debit card transactions have exponentially increased. Over the past five years the fees on debit cards alone have increased by 400+ per cent. Likewise, access to cash has become increasingly expensive with over the counter transaction costs also increasing at a rapid rate and the imposition of a minimal number of free transactions per month. The hefty increases in fees and charges on debit card transactions come at a time when bank profits are at an all time high. Equally anomalous is the fact that Australian banks have always refused to divulge the true cost of providing EFTPOS and ATM transaction services at the point of sale.

On the other hand, credit card pricing signals are designed to encourage consumers to conduct as much of their spending using credit as possible. This is facilitated by virtue of the fact that the cost of credit card transactions is embedded into the cost of all goods and services and hence the fees and charges are diffused amongst all consumers regardless of whether they use credit cards or not.

It is also the case that traditional upfront annual charges on credit cards have either dramatically reduced or been done away with altogether. This provides consumers with the added perception that their credit card is charge free.

The explosion of credit card usage has also been accompanied by reward schemes and offers which reward increased spending. Further still, Internet shopping has meant that people are forced to have a credit card if they want to purchase anything on the web.

Where credit cards are used for Internet transactions, the “card not present” rule means that the merchant bears the cost of any unauthorised transaction. Conversely, if a consumer uses a debit product, they will be liable for the costs of any unauthorised transactions. In addition, it is very difficult for consumers to purchase a good over the Internet using debit facilities, This very strange price signal can only lead us to believe that credit card providers are willing for merchants to bear the cost of fraud, if in return greater credit card business is generated for themselves. Unfortunately, it is the community at large which ends up making up the short fall in the form of greater fees and charges on other banking products and higher interchange fees. It is quite remarkable that credit card providers are in a virtual ‘win win’ situation regardless of fraud.

Price signals are key drivers of credit card usage in Australia. As a result of the current payments system which limits competition, the cartel structure of Visa and Mastercard and the massive dissemination of unsolicited credit card limit increases; credit card providers have been able to circumvent conventional economic notions of supply and demand in order to create artificial price signals which fuel a distorted demand process.

2.3 Likely impact of reform

The Financial Services Consumer Policy Centre supports the RBA's principle of allowing surcharging. The Centre takes the view that this new policy would have slow take up rates by merchants who for so long have been accustomed to embedding the cost of merchant fees. However, the Centre also takes the view that in due course a cultural sea change will develop whereby merchants begin to feel more comfortable with the surcharge. This will come about as a result of possibly more attractive prices for their goods and services and also the strong likelihood of discounting for debit and cash payments.

The elimination of distortionary price signals will allow for a more organic economic supply demand cycle to take place. This in due course will engender potential economic benefits deriving from greater competition.

2.4 Consumer protection mechanisms

There have been suggestions (chiefly in large bank and credit card company submissions) that once the prohibition on surcharging is removed, merchants will profiteer by passing on higher costs to credit card holders, beyond their actual merchant fee and internal processing costs.

We believe this is unlikely to be a significant issue for several reasons:

- Many merchants operate in highly competitive markets with very thin margins and mobile consumers – all factors which are absent in banking. Indeed ABS data shows that average profit margins in Australia are 9%. However the profit margin in the retail sector is just 3% and the profit margin in the financial services sector is 25%. We are more optimistic that true costs will be passed on to consumers in nearly any business sector other than banking.

- There will be many circumstances where consumers use a credit card to pay for a government service (federal, state, local) where the 'merchant' will have no profit motive and is unlikely to profiteer.

- Consumers will, for the first time, have the option to avoid the (previously hidden) costs by choosing an alternative payment instrument. The availability of this choice will help ensure surcharges do not blow out to the point where they are completely uncompetitive with cash or debit products.

- Consumer protection agencies such as the ACCC and State Fair Trading agencies can play a role in preventing such profiteering (consumer education, monitoring, media alerts). Again, these agencies have a higher success rate in other business sectors than they do in banking.

- Regulators or consumer organisations will challenge the first few businesses who attempt to overcharge consumers when they apply the surcharge. This has been the case in other jurisdictions where surcharging is allowed, and there is currently litigation in the United Kingdom on this very point. Again, litigation which would never even be contemplated against a bank would be pursued against smaller merchants in order to set a precedent.

- Consumer publications (newspapers, magazines, web sites) would provide comparative information on surcharging to consumers.

We believe that a reasonable "settling in" period should be allowed to occur, in which merchants will decide how much to surcharge, and the other measures described above will come into play. After one year, if the above measures fail, we will pursue more formal regulatory intervention (such as a formal reference to the ACCC).

In any case, the marginal difficulties which consumers may face under the new arrangements should not serve as a barrier to the removal of the restrictive and anti-competitive 'no surcharge' rule.

2.5 Recommendation

The Financial Services Consumer Policy Centre fully supports the abolition of the 'no surcharge' rule.

In addition we believe that surcharging by merchants should be subject to a general watching brief, with the option to make a formal reference to the ACCC for monitoring and intervention after twelve months.

3 Setting the interchange fee through an independent process based on the RBA's draft standard

3.1 Current price setting arrangements

Current price setting arrangements are unsatisfactory for a variety of reasons:

- There is no transparency about how the interchange fee is set
- The fee is set by a private collective process
- There is no independent assessment of the fee
- The fee has not really changed in more than two decades despite considerable efficiency improvements in all aspects of the system
- Participants have been able to build in costs using 'hindsight' and then argue that the price must be maintained because of these new costs (such as loyalty points)
- The fee is not the subject of regular review
- The fee is said to include costs which are paid for elsewhere by consumers (such as credit risk)

3.2 The RBA draft standard

The Financial Services Consumer Policy Centre seeks an objective, transparent method of fee calculation based on actual costs. We therefore support the draft standard proposed by the RBA.

Some specific costs should be permanently excluded from the setting of the interchange fee:

3.2.1 Loyalty points

Loyalty points are not a core part of the payment system. They are a glossy add on that have benefited the banks and a minority of wealthy consumers (not the growing number of consumers - revolvers – who incur interest). When loyalty points were introduced, the interchange fee did not increase, so to suggest in hindsight that the costs of loyalty points are somehow a burden that justifies maintaining a high interchange fee is nonsensical.

Loyalty point have been the focus of much of the media debate concerning the proposed reforms, and the banks have threatened to reduce or withdraw loyalty points if the reforms go ahead. This crude attempt at blackmail will, we are sure, be ignored by the RBA. Instead, basic principles of fairness should be applied:

1. The costs of loyalty points should only be passed on to participants in loyalty schemes (eg through a membership fee)

2. Any such fees should bear some relation to the actual cost of loyalty schemes
3. Consumers should receive correct price signals

While there is some chance that loyalty points may disappear or reduce as a result of these reforms, there is an equal chance that they will continue to be offered. Loyalty points have flourished in numerous circumstances, without the involvement of credit cards at all. Indeed, even in Australia Woolworths Ezy banking offers loyalty points for debit card use.

Ultimately, the greatest damage from the boom in loyalty points has been the development of an incorrect price signal to consumers. A consumer wishing to pay a simple bill will choose by far the most expensive payment instrument (a credit card) instead of a cheaper alternative (eg direct debit) simply because they will earn a few loyalty points. Under current arrangements, the consumer who chooses the direct debit option will probably pay a small fee to their bank, they will also pay a higher than necessary price for the goods or services because of the costs to the merchant of processing other people's credit card payments, and just to rub salt into the wound, they will be paying for someone else's loyalty points.

3.2.2 Credit risk

Banks have claimed in other fora that credit risk justifies high credit card interest rates (see ABA response to criticism re time taken to pass on cuts in official interest rates) and high cash advance fees (see ANZ justification for increasing cash advance fees in 2001). We do not oppose banks attempting to pass on the costs of credit risk in some way to consumers, however there are three conditions:

1. The costs of credit risk should only be passed on once, not two or three times
2. The fees or interest rate should bear some relation to actual credit risk (which in Australia is very low according to the ABA's own figures)
3. Such costs should not be passed on to non credit card users

Once these three principles are accepted, it is clear that credit risk should not be included as an eligible cost in the new standard.

3.2.3 Interest free periods

Interest free periods are already a matter of choice for credit card consumers, as cards are available without interest free periods, usually at a much lower interest rate. It seems clear that the costs of the interest free period are therefore already built in to the interest rate – otherwise there could be no justification for the difference in the interest rate between 'vanilla' cards and those card which have all the 'bells and whistles'.

There are four principles which should be followed:

1. The costs of interest free periods should only be passed on once, not two or three times
2. The fees or interest rate should bear some relation to the actual cost of interest free periods
3. Such costs should not be passed on to non credit card users
4. Such costs should not be passed on to credit card users who have credit cards which do not offer interest free periods

3.2.4 Sunk costs

Again, banks and credit card companies are entitled to attempt to recover their current and previous capital expenditure on the credit card network. However, the interchange fee is simply not the appropriate place to attempt to recover these costs. The interchange fee is a set fee paid between network participants (and passed on to consumers via merchants). The link between capital expenditure and the returns from the interchange fee is flimsy. Banks have several other avenues to recover sunk costs, all of which are subject to the market and more closely linked to the actual capital expenditure. These include the non-interchange part of merchant fees, and other revenue from credit card consumers (annual fees and interest). Sunk costs should not be passed on to non credit card users.

3.3 An independent process

We fully support the introduction, for the first time, of an independent process to assess eligible costs and set an appropriate interchange fee. We also support the regular review of such fees, and agree that three years is an appropriate period between reviews.

We note that adoption of the standard's independent process will remove the legal uncertainty surrounding the current practice of setting fees collectively – a practice which appeared to breach the price fixing prohibitions in the Trade Practices Act.

3.4 Recommendation

The Financial Services Consumer Policy Centre fully supports the proposed standard for determining "eligible costs" in the interchange fee. We support the development of an independent process to review the interchange fee, and we also support the restriction of eligible costs to three categories:

- Processing costs
- Fraud and fraud prevention costs
- Authorisation costs

4 Opening up the credit card system to more vigorous competition and lowering barriers to entry

4.1 Competition in the banking industry

Australia has one of the most concentrated banking markets in the world. The banking sector is dominated by the giants CBA and NAB. Consider the following two tables. Although Table 1 is slightly dated (prior to rationalisation in Australia) this table does show figures for the market share of both the top three banks and the top five banks in each jurisdiction.

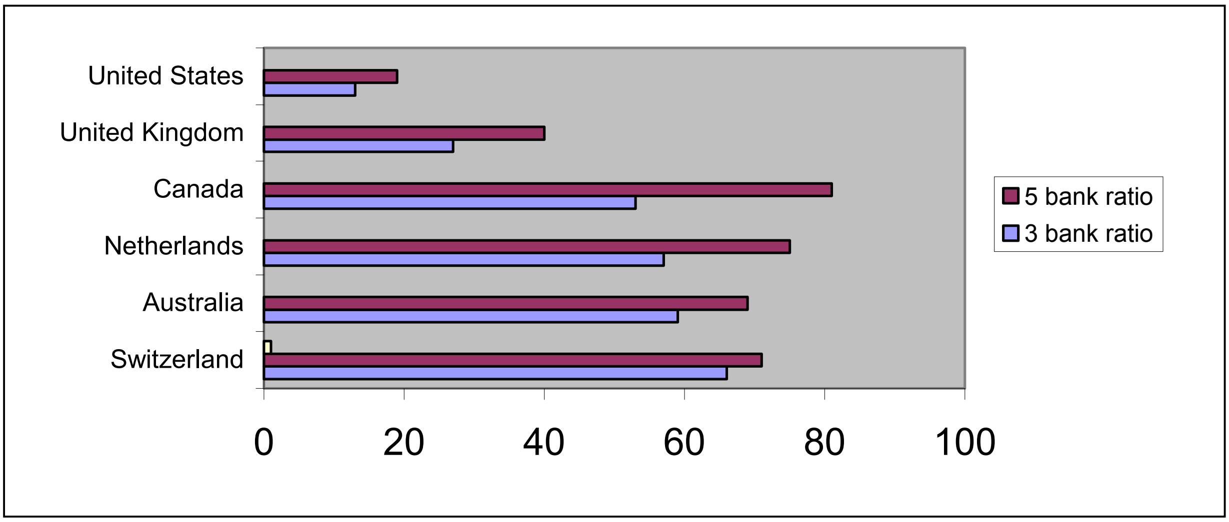


Table 1: Bank Concentration in 1997 – 3 and 5 bank ratios

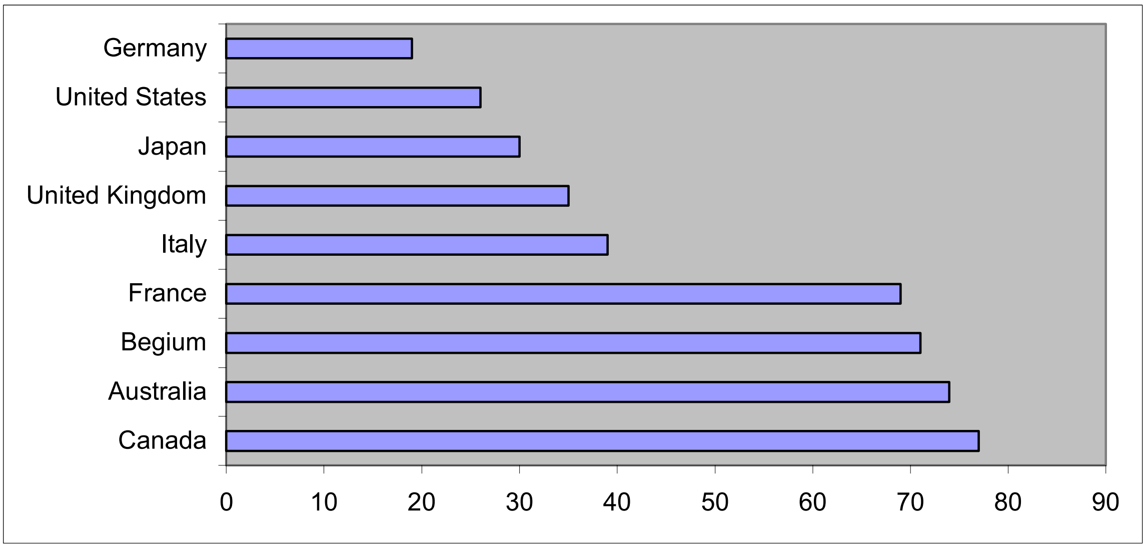


Table 2: Banking Concentration in 1999 – 5 bank ratio

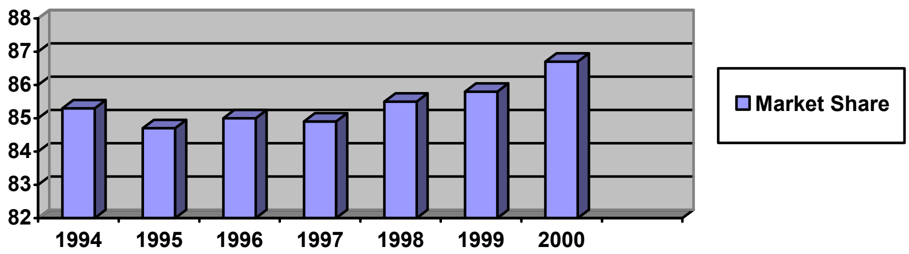
Table 2 shows the concentration of market share by the top five banks in each jurisdiction, (based on late 1999 statistics), as published by the International Bank of Settlements in January 2001.[2]

In both tables Australia performs very poorly when the market share of the top three or top five banks is considered.

4.2 Competition in the credit card industry

Australia's credit card market is highly concentrated, with the four major banks, ANZ, Westpac, Commonwealth and National Australia Bank, having more than 80 percent of both the issuing and acquiring markets.

Table 3: Card Issuing - Share of Big Four Banks



The three largest credit card schemes, Bankcard, Visa and Mastercard have a completely dominant share of the market. Between them they have 92%. of cards on issue and 85% of the combined value of all credit card and charge card transactions.

There is some limited competition with smaller players, and with participants in three party charge card schemes (eg American Express and Diners Club). However, this competition is marginal when one considers the scale of the domination of the major players.

4.3 Barriers to entry

The RBA has found that through a mixture of scheme policies and regulation, access to credit card schemes is severely restricted. However, since the release of the consultation document, all players appear to support removal of unnecessary barriers to entry, and we expect that membership of the schemes will be opened up to new players.

The major remaining hurdle is the concern that new entrants may lead to a higher level of risk. On this point we have three choices:

1. To restrict entry to regulated Authorised Deposit-taking Institutions (ADIs)
2. To open entry to all players
3. To restrict entry to players willing to submit to specific prudential supervision

[2] Bank of International Settlements, Consolidation in the financial sector, 2001 at http://www.bis.org/publ/gten05.htm

The Financial Services Consumer Policy Centre supports option three. This will involve APRA supervising specialist institutions (not ADIs) which wish to enter the credit card system. They will also have to submit to establishing:

- Special business vehicles which will operate the credit card service
- Adequate (and separate) capital
- Risk management policies
- Credit quality standards
- Liquidity management standards

Under these proposals, specialist institutions would be on close to level terms with ADIs in terms of risk profile.

4.4 Recommendation

The Financial Services Consumer Policy Centre supports the development of new prudential standards which should apply to non ADI entrants to the credit card market. All other barriers to entry (such as exist in the credit card company rules) should be removed.

These arrangements should be the subject of close monitoring, regular review and public reporting by the RBA and APRA.

5 Conclusion

5.1 Full support for reforms

The Financial Services Consumer Policy Centre fully supports all three core proposed reforms, with some minor suggested improvements as set out above.

5.2 Full endorsement of ACA submission

The Financial Services Consumer Policy Centre fully endorses the submission of the Australian Consumers' Association. A range of other consumer organisations have endorsed these two key consumer submissions, and a list of additional endorsements will be supplied to you separately.

5.3 Next steps

We urge the Payment Systems Board of the Reserve Bank of Australia to continue with reform of the Australian payment system. In our view this might include efforts to examine three party credit card schemes (especially 'no surcharge' rules), ATM network pricing and participation, B-Pay and EFTPOS fee arrangements and new technology payment systems.

We look forward to the implementation of the three proposed reforms, and the development of a more open and transparent payment system in Australia, which sends correct price signals to Australia consumers.

We would welcome the opportunity to appear before staff of the Payment Systems Board to discuss these issues in more detail.

Chris Connolly and Khaldoun Hajaj
Financial Services Consumer Policy Centre
March 2002

6 Appendix - About the Centre

The Financial Services Consumer Policy Centre is a not for profit research organisation affiliated with the University of New South Wales Faculty of Law.

The Centre has expertise in all issues of consumer banking and has been at the fore of advocating for responsible and ethical banking practice.

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