



Of the comments from individuals, some are strongly supportive of the Reserve Bank's reforms while others are concerned that they would be charged higher fees for credit card services.

Consultation with other government agencies

The Reserve Bank has kept the ACCC informed throughout the development of its reform measures. It has worked with the Australian Securities and Investments Commission (ASIC), and will be consulting with State and Territory fair trading authorities, to ensure that the disclosure requirements imposed on merchants by fair trading legislation are clear to merchants that choose to charge according to the means of payment. The Reserve Bank has also consulted with APRA about the draft authorisation guidelines and prudential standards for the new class of specialist credit card institutions.

7. CONCLUSION AND FINAL REFORM MEASURES

The Reserve Bank has considered the views put to it in submissions from and discussions with a wide range of interested parties.

The Reserve Bank acknowledges the widespread acceptance of credit cards in Australia and the benefits that they can provide to individual cardholders and merchants. At the same time, however, it is not persuaded by arguments that allowing normal market mechanisms to operate more effectively in the Australian payments system is against the community's interest. It does not accept that continued growth in the use of credit cards at the expense of alternative payment instruments necessarily adds to the community's welfare. In particular, it remains of the view that the benefits of credit cards to cardholders and merchants as a whole – in the form of a permanent increase in sales or a reduction in transaction costs – are overstated. Other payment networks can also gain from being larger in size and the mix of payment instruments in these circumstances ought to be one for consumers to decide in a competitive market place, in response to efficient price signals. These conditions do not prevail in the retail payments system in Australia.

The Reserve Bank accepts that interchange fees can play a role in redressing imbalances between the costs and revenues of issuers and acquirers in four party credit card schemes. However, it is not convinced that community welfare would be maximised if the setting of interchange fees, which play a pivotal role in determining price incentives for cardholders and merchants, were left entirely to the schemes and their members in Australia without any external scrutiny or



accountability to the community. The Reserve Bank does not accept that interchange fees are collectively set in Australia under strong competitive conditions. Such claims are not consistent with the dominant position of the four major banks in the credit card schemes, the limited ability of merchants to resist credit cards or with the rigidity, lack of transparency and common level of interchange fees in the schemes over many years.

In the absence of rigorous theoretical guidance, credit card schemes adopt different methodologies as a basis for determining interchange fees. The designated credit card schemes argue against the need for the Reserve Bank to determine a standard on interchange fees. Their members, however, have accepted that interchange fees should be set on the basis of an objective, transparent and cost-based methodology. The schemes have rejected the cost-based methodology in the Reserve Bank's standard on interchange fees, but two of the schemes have proposed alternative methodologies which are also cost-based. Bankcard has argued for the inclusion of a wide range of additional costs on the "outsourced store card" argument, which is discussed further below. MasterCard has proposed the interchange fee methodology it uses in some other countries, which includes the cost of credit losses. In Australia, cardholders using revolving credit facilities are fully covering average credit losses by paying interest rates well above rates on other unsecured personal lending. If card scheme members were to include credit losses in interchange fee calculations, card issuers would be recovering the costs of credit losses twice. The alternative cost-based methodologies would therefore have the effect of charging to merchants, and to the community as a whole, credit card costs that arise out of the provision of specific credit card services to cardholders.

Visa, on the other hand, eschews a cost-based approach in favour of a "balancing" methodology, which it treats as secret. Visa has provided the Reserve Bank with a listing of cost and revenue categories on which information is collected from Visa participants, but no details on the methodology itself or how it is applied. The methodology therefore does not meet a basic test of transparency. Both MasterCard and Visa have advised that they use their methodologies only as a guide to setting interchange fees and that they also exercise commercial judgment in determining the level of fees.

The methodologies applied by the international credit card schemes have been under official review in some other industrial countries. In the United Kingdom, the Office of Fair Trading (OFT) notified MasterCard/Europay in September 2001 that it proposed to make a decision that agreement among MasterCard/Europay members on the level of their multilateral interchange fee is in breach of UK competition law and does not qualify for exemption. The OFT considers that the



agreement on this fee increases retail costs and the prices paid by consumers for goods and services. The OFT has yet to make a final decision.

Visa has made major changes to its approach in the case of its cross-border interchange fees in Europe in response to concerns about its methodology – including the lack of transparency – expressed by the European Commission. To receive an exemption under European Union competition rules, Visa proposed moving to a cost-based methodology that would be used as an objective benchmark against which its cross-border interchange fees would be assessed. This proposal was accepted by the European Commission in July 2002. Cross-border interchange fees will now be capped at the level of costs for certain specific services – transaction processing, the payment guarantee (including fraud costs and credit losses) and the interest-free period – provided by Visa card-issuing banks. The actual level of these fees will be the lower of this cap and the staged reduction in weighted average interchange fees, to 0.7 per cent in 2007, offered by Visa.

The international credit card schemes remain opposed to removal of their restrictions on merchant pricing, and have done so in other jurisdictions only when required by authorities to do so. None of the designated credit card schemes has offered to liberalise its minimum entry standards under which, broadly speaking, only authorised deposit-taking institutions supervised by APRA are eligible for membership. Two of the schemes retain “net issuer” or “balanced development” rules and two schemes impose penalties on members whose business is weighted heavily towards acquiring rather than issuing.

Overall, there is little prospect of significant change to the *status quo* if the regulations of the credit card schemes, which their Australian members collectively determine or agree to enforce, remain in place. The Reserve Bank has not been convinced by the arguments that these private-sector regulations are to be preferred, in the public interest, to the freeing up of the normal market mechanisms to promote competition and efficiency in the Australian payments system. The Reserve Bank has therefore rejected option (i) of taking no regulatory action. It believes that regulatory action is necessary to address the problem that the Australian community is paying a higher cost for its retail payments system than it would if the normal market mechanisms were working effectively.

The Reserve Bank has also rejected option (ii) under which it would confine the use of its regulatory powers to ending scheme restrictions on access and merchant pricing. Taking these steps would be consistent with the Reserve Bank’s objective of giving greater rein to normal competitive processes and would, over time, inject greater market discipline into the setting of interchange fees in the designated credit card schemes. The Reserve Bank does not accept that removal of the restraint



on trade imposed on merchants by the international credit card schemes is against the public interest because merchants with monopoly power might seek to exploit consumers. Even if some consumers might have little choice about where to shop, they can switch to other payment instruments if they think that any “fee for service” charged by a merchant for credit card acceptance is too high.

On its own, however, regulatory action under option (ii) is unlikely to create a strong competitive environment quickly. Such an environment requires the emergence of a credible threat of entry to the acquiring market by one or more non-traditional participants of substance, and the establishment of merchant freedom to charge according to the means of payment as an effective discipline on merchant service fees. Until there is more robust competition, the circumstances under which credit card interchange fees are collectively set in Australia create the risk that interchange fees would not be set at an efficient level, resulting in distorted price signals to cardholders and merchants.

For these reasons, the Payments System Board has decided that the Reserve Bank will introduce a package of reforms, discussed as option (iii), to promote greater competition and a more efficient allocation of resources in the Australian payments system. The reform measures, introduced under the *Payment Systems (Regulation) Act 1998*, involve:

- a standard on interchange fees that involves an objective, transparent and cost-based benchmark against which interchange fees in the designated credit card schemes can be assessed;
- a standard on merchant pricing that removes the restriction imposed by the international credit card schemes on the freedom of merchants to charge according to the means of payment; and
- an access regime that removes the restrictions on the eligibility of non-financial institutions to apply to participate in the designated credit card schemes, and removes “net issuer” and “balanced development” rules and associated financial penalties that disadvantage participants seeking to specialise in acquiring.

American Express and Diners Club have each given an undertaking to the Reserve Bank that they will remove their restrictions on merchant pricing when the standard on merchant pricing comes into force. These undertakings are set out in [Attachment 4](#). Hence, no one credit or charge card scheme will have a competitive advantage over any other in this respect.

The Reserve Bank’s reforms are consistent with the broad objectives of the Government’s competition policy. They will allow normal market mechanisms to work more effectively in the Australian payments system and reduce its overall costs to the community. This will be achieved through:



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- lower merchant service fees as a direct consequence of reduced interchange fees, which will pass through to consumers in the general level of prices;
 - greater market discipline on merchant service fees because of the freedom of merchants to recover their credit card costs from cardholders;
 - more efficient and transparent pricing of credit card services to cardholders and merchants; and
 - greater competition in the provision of credit card services to cardholders and merchants from the entry of non-financial corporations of substance.

The principles that consumers should face prices that take into account the relative costs of producing goods and services, as well as demand conditions, and that resources should be free to enter a market in response to above-normal profit opportunities, have been the guiding principles for tariff reform and market deregulation in Australia. Such market reforms may impact unevenly on different groups – some gaining, some losing – but they are now the well-established route to more efficient use of resources in the Australian economy. The Reserve Bank's reforms are fully in line with these principles. The reforms will have a direct impact on credit cardholders and are likely to result in some re-pricing of credit card payment services, but such a move towards "user pays" is the means by which the price mechanism directs users of the payments system towards the most efficient choice of payment instruments.

The Reserve Bank does not accept that its reforms of the designated credit card schemes constitute a regulatory bias that favours the three party card schemes, American Express and Diners Club. Such a claim neglects the dominant market position of the four party schemes in Australia, whether measured in terms of their share of the credit and charge card market, the size of their merchant base or the number of consumers who hold cards of both types of schemes. The Reserve Bank has not been persuaded that competition in the payment card market, strengthened by its reform measures, will encourage the growth of the smaller, higher cost card schemes over the larger, lower cost schemes in Australia. On the contrary, the freedom of merchants to charge a "fee for service" for credit and charge card acceptance can be expected to put strong competitive pressure on the higher cost card schemes and ensure that these schemes also bear the impact of the Reserve Bank's reforms.

While the purpose and likely effect of the Reserve Bank's reforms are unchanged from the draft standards and access regime released in December 2001, the consultation process has been valuable in identifying the main public interest issues involved in the operation of credit card schemes in Australia and in allowing interested parties to seek further information about the proposed reforms. A number



of submissions also offered suggestions for simplifying the drafting of the standards and access regime, which the Reserve Bank has incorporated in the final versions.

Standard on interchange fees

The main variations to the draft standard on interchange fees involve:

- (i) application of the objective, transparent and cost-based methodology to calculate a “benchmark” for interchange fees in each designated credit card scheme rather than to calculate interchange fees for different categories of transactions; and
- (ii) inclusion of additional “eligible costs” in the cost-based methodology.

The draft standard provided for differential interchange fees for different types of transactions (electronic vs other) and differences in the credit card payment services provided to merchants (payment guarantee vs no payment guarantee), each to be calculated on the basis of “eligible costs” as defined in the standard. One important reason for differentiating the services provided to merchants was to address the anomaly in current arrangements for “card not present” transactions in Australia, where merchants (such as Internet merchants) bear the costs of fraud – because they cannot meet scheme requirements for a payment guarantee – but nonetheless incur the higher interchange rate on such transactions. This point was highlighted in the Joint Study.

An alternative approach suggested to the Reserve Bank that would achieve the same outcome on average would be to apply the cost-based methodology to calculate a benchmark for each scheme, against which the **weighted average** of interchange fees in that scheme would be assessed; the schemes and their members would be free to determine interchange fees for different categories of credit card transactions using whatever methodologies they choose. The Reserve Bank has accepted this approach. It will provide more flexibility to the credit card schemes while ensuring that interchange fees in each scheme, on a weighted average basis, do not exceed the level determined by the cost-based benchmark, whenever that benchmark is calculated or interchange fees are changed. At the same time, the Reserve Bank expects each of the designated credit card schemes to address the anomaly in the pricing of credit card payment services to merchants that cannot, in practice, satisfy scheme conditions for receiving a guarantee against fraud.

Other drafting changes on the application of the standard involve:

- a longer implementation period for the schemes to determine interchange fees in accordance with the cost-based benchmark, and flexibility to recalculate the benchmark within the normal three-year review period if the schemes believe that changes in costs or other factors warrant;



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- removal of the requirement in the draft standard that the designated credit card schemes publish their aggregate cost data, which the schemes and their members have argued is commercially sensitive. The schemes are, however, required to provide their cost data to the Reserve Bank and to publish their interchange fees; and
 - addition of a requirement that the designated credit card schemes provide the Reserve Bank with an annual certification of compliance with the standard.

The Reserve Bank has considered arguments in some submissions that any methodology based on the credit card payment services provided to merchants should include costs additional to those in the draft standard. These arguments are generally founded on the “outsourced store card” concept outlined in Section 6, which claims that merchants accepting credit cards are effectively “outsourcing” the provision of a proprietary store credit card and should bear whatever costs they would incur if they were to issue a card themselves. On this basis, some submissions argued for inclusion of a wide range of additional costs – including the cost of funding the interest-free period, credit losses, statement production and mailing, and the cost of loyalty programs – while others argued for inclusion of only a portion of these costs. As a minimum, however, the submissions were strongly of the view that the cost of funding the interest-free period should be included as an eligible cost, on the argument that the interest-free period is a defining characteristic of the credit card – it lets cardholders buy now and pay later. If issuers cannot recover the cost of providing the interest-free period in the interchange fee, they will need to recover it directly from cardholders, fundamentally changing the nature of the credit card.

The “outsourced store card” argument has some conceptual appeal in understanding the historical origins of the general purpose credit card and its penetration of retail markets. However, the argument is difficult to generalise to market segments where credit card acceptance is increasing but where store cards or in-store credit have never been offered, such as utilities, educational institutions and transport. Submissions from merchants have also noted that the general purpose credit card does not provide the same loyalty benefits and has not replaced the store card or in-store credit in some retail segments; some merchants continue to offer a store card to encourage customer loyalty. Some financial institutions might also be recovering some of the cost of the interest-free period directly from cardholders, in the form of higher interest rates on cards with this facility compared with cards without an interest-free period.

The “outsourced store card” argument, in the Reserve Bank’s assessment, does not provide a convincing rationale for including a wide range of additional costs in



the cost-based benchmark. The Reserve Bank is prepared to include the cost of funding the interest-free period as an “eligible cost”, but only as part of the transition to a lower level of credit card interchange fees in Australia. This decision will be reviewed in five years in light of market responses, and regulatory developments overseas. However, the Reserve Bank has not been persuaded that other costs of clear benefit to cardholders, such as statement production and mailing and the costs of loyalty programs, or which are already covered by cardholders, such as the cost of credit losses, should be included in the cost-based benchmark.

The Reserve Bank has also considered arguments for the inclusion of various “costs of capital” in the cost-based benchmark. The amortised costs of any investments undertaken to provide credit card payment services to merchants, such as investments in processing systems or fraud-reducing technology, are eligible costs. There would also be logic in including the cost of capital held against operational risk, to the extent that the risks arise out of the provision of services to merchants. However, the Reserve Bank has found that systems for measuring capital held against operational risk are immature compared to other costing systems, and measurements vary widely between the major banks. For these reasons, the Reserve Bank has concluded that this item is not appropriate for inclusion in the cost-based benchmark, but it will revisit this decision if, in future, operational risk capital is more clearly defined by prudential standards or otherwise. The cost of capital held against credit risk on outstanding credit card balances is, in the Reserve Bank’s view, a cost that arises directly out of the provision of revolving credit facilities to cardholders and, as in other areas of bank lending, is appropriately recovered through the interest rate charged on these facilities.

Issuers’ costs eligible for inclusion in the Reserve Bank’s cost-based benchmark are therefore:

- costs incurred principally in processing credit card transactions;
- costs incurred principally in respect of fraud and fraud prevention;
- costs incurred principally in providing authorisation of credit card transactions; and
- costs incurred in funding the interest-free period on credit card transactions.

In broad summary, the designated credit card schemes and their members have a series of steps to undertake to conform with the standard on interchange fees. The first step will be to calculate the cost-based benchmark for each scheme. This will require the largest issuers in each scheme to provide data on eligible costs to an independent expert appointed by the scheme, who will calculate the cost-based benchmark in percentage terms. The benchmark for each scheme will normally apply for three years.



The second step will be for the participants in each scheme to determine interchange fees such that the average of these fees, weighted by the share of total transactions to which each interchange fee applies, is equal to or less than the cost-based benchmark. If a scheme wishes to change its interchange fees in the period between recalculations of the benchmark, it will need to ensure that the new set of fees conforms with the last benchmark calculated. However, it will not need to adjust interchange fees if the weighted average changes because the share of total transactions to which each interchange fee applies (ie the weights) changes over time.

The third step will be for the scheme to provide the details of its calculations of the cost-based benchmark to the Reserve Bank and to publish its interchange fees. For reasons of commercial sensitivity, the cost-based benchmark itself does not need to be published.

The Reserve Bank has also developed a Guidance Note on application of the standard, including the definition and measurement of eligible costs, and provided the designated credit card schemes an opportunity to comment on a draft of this Note. The Guidance Note is set out in [Attachment 5](#). The Guidance Note does not impose legal obligations on the schemes and their participants, but the Reserve Bank expects adherence to it as a way of ensuring consistency in the calculation of the cost-based benchmark for each scheme.

Standard on merchant pricing

As specified in the Consultation Document, the objective of the Reserve Bank's reforms in this area is to remove restrictions imposed by the international credit card schemes on the freedom of merchants in Australia to set their own prices. The final standard addresses this objective explicitly but the Reserve Bank, in response to comments received, has made some changes to the draft standard to simplify its application.

The standard provides that neither the rules of a designated credit card scheme nor any participant in the scheme may prohibit a merchant from charging a credit cardholder any fee or surcharge for use of a credit card in a transaction. At the same time, the standard states that a merchant may voluntarily agree with its acquirer to limit the size of any "fee for service" to the fees incurred by the merchant in respect of credit card transactions. The Consultation Document had noted that such agreements would not be inconsistent with the draft standard but, in the interests of removing uncertainty, this position has now been made explicit in the standard.



Access regime

The access regime provides that any authorised deposit-taking institution in Australia, including the new class of specialist credit card institutions, is eligible to apply to participate in the designated credit card schemes in Australia. However, in response to comments received, the Reserve Bank has made some changes to the drafting to clarify the rights and obligations of the schemes and their members, and to simplify the application of the access regime.

The access regime now makes explicit that a designated credit card scheme is free to impose its own business and operational criteria in assessing applications to participate in its scheme. However, it must not discriminate between specialist credit card institutions as a class and other authorised deposit-taking institutions as a class in relation to any of these criteria, or to the rights and obligations of participants in the scheme. Each scheme must also publish the criteria it imposes in assessing applications for participation in Australia. This replaces the requirement in the draft access regime that the schemes publish their rules governing eligibility for participation and the terms of participation. The requirement that the schemes give prior notice to the Reserve Bank of any changes to the rules governing eligibility for participation has been removed.

The access regime prohibits the imposition of any restrictions or form of penalties on participants seeking to specialise in acquiring.

APRA has released its draft prudential standards on risk management of credit card activities that will apply to authorised deposit-taking institutions, including the new class of specialist credit card institutions. The draft prudential standards and authorisation guidelines for specialist credit card institutions are given in [Attachment 6](#).

8. IMPLEMENTATION AND REVIEW

The standard on interchange fees applies to all three designated credit card schemes. To allow the schemes and their participants time to make any necessary adjustments to their costing systems, the standard will not come into force until 1 July 2003. The cost-based benchmark for each scheme must be calculated by 1 October 2003 on the basis of eligible costs for the 2002/03 financial year; if appropriate costing systems are not in place for the full year, eligible costs may be calculated for the six-month period ending 30 June 2003. The average of interchange fees for each scheme as at 31 October 2003 must not exceed the cost-based benchmark for that scheme.