



charge a “fee for service” for accepting credit cards. At the same time, an acquirer and a merchant would be able to agree that the amount of any such fee would be limited to the fees paid by the merchant for credit card transactions. The three party card schemes, American Express and Diners Club, impose the same set of restrictions on merchants and would be required to remove these restrictions if a standard on merchant pricing came into force.

Regulatory action on access, merchant pricing and interchange fees

The Reserve Bank considered whether a standard on interchange fees would also be needed to achieve effective reform of the designated credit card schemes. While the ending of scheme restrictions on access and merchant pricing might be necessary to promote competition and market discipline, such action, on its own, might not be sufficient to ensure that the collective setting of interchange fees in Australia, by scheme members that are otherwise competitors, produces a level of interchange fees that is efficient and in the public interest. If not, a standard on interchange fees would also be needed to promote competition and the efficient pricing of credit card services to cardholders and merchants.

The Reserve Bank’s **standard on interchange fees** would provide an objective, transparent and cost-based benchmark against which interchange fees in each designated credit card scheme could be assessed. The benchmark, which would be reviewed regularly, would be based on credit card payment services which are provided to merchants and for which card issuers incur costs. Each scheme would be required to publish its interchange fees determined in accordance with this standard.

5. IMPACT ANALYSIS

Parties affected

The impact of the options considered by the Reserve Bank would fall, in different ways, on the following parties:

- (i) the community as a whole, including consumers who do not use credit cards;
- (ii) credit cardholders;
- (iii) merchants that accept credit cards for payment; and
- (iv) the credit card schemes and financial institutions which are members of these schemes.



No regulatory action

In the absence of regulatory action by the Reserve Bank, credit card scheme restrictions that suppress or distort the normal market mechanisms would in all likelihood remain largely in place. Neither MasterCard nor Visa has proposed changes to its current membership criteria or to its restrictions on merchant pricing. While Bankcard has liberalised its membership criteria to allow for non-traditional participants (provided they are guaranteed by a supervised financial institution), the potential competitive impact of a new entrant to Bankcard is significantly limited if that entrant cannot also participate in the international credit card schemes. The designated credit card schemes and their members have not indicated a willingness to consider any significant reduction in interchange fees, which underpin current incentives for consumers to use, and merchants to accept, credit cards. As noted, however, it is not possible to anticipate the proposals that might be made if the schemes were to seek authorisation of their interchange fee arrangements under the *Trade Practices Act 1974*.

Under these circumstances, the price signals facing consumers choosing between different payment instruments would continue to encourage the use of credit cards, a relatively costly instrument, over less costly alternatives that provide similar transactional benefits. Merchants would continue to face the cost burden in the first instance. While individual merchants accept credit cards as part of a strategy of winning sales from, or not losing sales to, competitors, no convincing evidence has been provided – in Australia or elsewhere – that merchants as a whole gain a permanent increase in sales by accepting credit cards to offset the higher costs. As a consequence, average costs in the payments system would be higher and the resources that could be directed into other productive uses would be reduced. The Australian community would continue to pay a higher cost for its retail payments system than is necessary.

The consequences of these inefficient price signals for total payments system costs are substantial. As an illustration, Table 3 shows the costs of providing credit and debit card payment services under two different growth scenarios over the next five years. Under Scenario I, growth of credit and debit card usage is assumed to continue at the same rates as the past five calendar years, when the number of credit card transactions grew by 24 per cent per annum and the number of debit card transactions by 12 per cent per annum. Under Scenario II, growth in both payment instruments is assumed to be 18 per cent per annum, the average growth in these two instruments combined over the past five years. If current trends were to continue (Scenario I), the cost of providing the card payment system would be



Table 3: Growth in payments system costs

	Cost per \$100 transaction ^a (\$)	Annual cost 2001 (\$b)	Annual cost 2006 (\$b)	
			Scenario I	Scenario II
Credit card	2.01	1.6	4.8	3.7
Debit card	0.41	0.3	0.5	0.6
Total		1.9	5.3	4.3

a Reserve Bank of Australia and Australian Competition and Consumer Commission (2000).

around \$1 billion per annum higher after five years than would be the case if growth were more evenly shared between credit and debit cards (Scenario II).

Parties bearing impact of this option

In the absence of regulatory action by the Reserve Bank, the costs of providing credit card services in Australia would continue to be borne by:

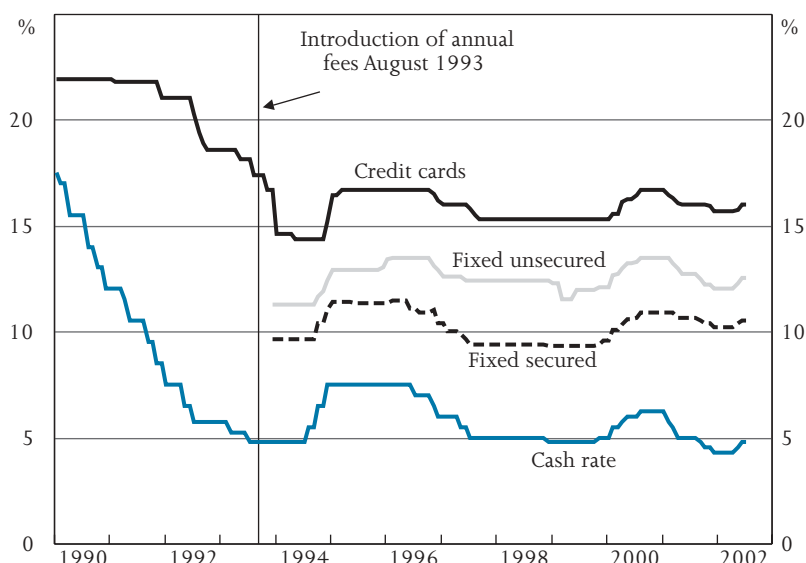
- (i) credit cardholders who use the revolving line of credit;
- (ii) merchants that accept credit cards for payment; and
- (iii) the community as a whole, including consumers who do not use credit cards.

Credit cardholders who do not settle their credit card account in full by the due date generally pay interest rates significantly above rates on other forms of lending. Credit card lending is unsecured and thus riskier than other types of personal credit provided by financial institutions. Nonetheless, interest rates on credit card lending are on average around three percentage points above the rates for other forms of unsecured personal lending (Figure 3) and are not as responsive to changes in funding costs as other retail interest rates (Table 4). In recent interest rate cycles in Australia, financial institutions have passed almost the full amount of official interest rate increases on to credit card interest rates, but only around one-half of official interest rate reductions.

The community also bears the costs of providing credit card services through higher prices for goods and services. In the first instance, the burden falls on merchants that accept credit cards, particularly smaller merchants. As noted, merchant service



Figure 3: Selected interest rates



Source: Reserve Bank of Australia *Bulletin*.

Table 4: Responsiveness of interest rates*
percentage point change

Interest rate cycle	Changes in cash rate target	Changes in credit card rates ^a	Changes in mortgage rates ^b	Responsiveness of:	
	A	B	C	Credit card rates (B/A)	Mortgage rates (C/A)
Tightening phase 1994	+2.75	+2.35	+1.75	0.85	0.64
Easing phase 1996-1998	-2.75	-1.40	-4.00	0.51	1.45
Tightening phase 1999-2000	+1.50	+1.40	+1.55	0.93	1.03
Easing phase 2001	-2.00	-1.05	-2.00	0.53	1.00

* Measured from peak to trough/trough to peak in the relevant interest rates.

a Midpoint rate of major banks.

b Banks' standard variable housing loan rate; average rate of large lenders.

Source: Reserve Bank of Australia *Bulletin*.



fees on credit cards average 1.8 per cent of the value of each credit card transaction and can be up to four per cent for smaller merchants. The floor on merchant service fees is determined by interchange fees, which average 0.95 per cent per transaction. After paying these fees to issuers, the amount retained by acquirers for providing services to merchants averages around one per cent per transaction, and can be as high as three per cent in the case of smaller merchants. As discussed in the Consultation Document, there is a range of evidence to suggest that, if credit card scheme restrictions were to remain in place, competition in the credit card acquiring market would be less effective than it might be. This evidence includes the level of margins in credit card acquiring (around 67 per cent on information provided to the Joint Study); the proportion of merchant service fees retained by acquirers in Australia (around 50 per cent) compared with acquirers in the United States and Europe (around 20 per cent); and the unwillingness of acquirers in Australia to offer a flat fee for acquiring services in line with the nature of costs incurred by acquirers.

In the absence of regulatory action by the Reserve Bank, merchants would continue to pay a higher price for credit card acquiring services than if more competitive conditions prevailed. They would also be prevented by credit card scheme restrictions from passing merchant service fees onto customers who choose to use credit cards. Merchants would continue to face an “all or nothing” choice – accept credit cards and absorb the merchant service fees into their overall cost structure, or refuse to accept credit cards at all. Their ability to resist credit cards would be increasingly eroded as consumers responded to current price incentives by increasing the take-up of credit cards and demanding to make more and more use of them. Merchants would have only limited negotiating power to put pressure on merchant service fees and, indirectly, interchange fees.

In these circumstances, the community as a whole, not just those who use credit cards, would continue to bear the costs of providing credit card services, in the form of higher prices for goods and services. This burden is diffused over a wide range of markets, in which varying mixes of payment instruments may be used, and over millions of consumers undertaking a myriad of transactions. In total, however, the impact on the general level of prices is likely to be significant. Merchant service fees on credit cards currently cost merchants around \$1.5 billion a year. Unless merchants as a whole gain a permanent increase in sales or other benefits from accepting credit cards, this cost is passed into price levels, depending on supply and demand conditions in each market.



Beneficiaries under this option

If credit card scheme restrictions were to remain largely unchanged, the main beneficiaries of the arrangements would continue to be:

- (i) credit card transactors who settle their credit card account in full each month; and
- (ii) credit card scheme members and the schemes themselves.

Credit card transactors make only a very small contribution to the revenues earned by credit card issuers (Table 5). Transactors pay, at most, an annual fee to hold a credit card but receive interest-free credit and may be eligible for loyalty points which accrue in proportion to the value spent on their credit card. Around one-quarter of credit card balances outstanding do not attract interest. Based on information provided to the Joint Study by card scheme members, revenues received from transactors from annual fees fall short of the cost of providing the interest-free period and loyalty points by around \$90 million a year. That is, transactors are subsidised by this amount each year.

A continuation of current price incentives would be expected to increase the size of the transfer from the community to credit card scheme members. Credit card issuing and acquiring are currently very profitable activities in Australia. Information provided to the Joint Study by card scheme members showed that the provision of credit card services generates revenues well above average costs, especially for

Table 5: Direct contributions to issuing revenues
per \$100 transaction, 1999

	\$	%
Revolvers ^a	1.64	61.2
Transactors ^b	0.10	3.5
Merchants ^c	0.95	35.3
Total revenues	2.69	100.0

a Interest payments plus 75 per cent of revenue from annual fees and other sources.

b 25 per cent of revenue from annual fees and other sources.

c Interchange fee revenue.

Source: Reserve Bank of Australia (2001).



financial institutions which are both significant card issuers and acquirers. The margins are particularly wide in credit card acquiring (Table 6). Although card scheme members were generally unable to supply suitable capital data, indicative figuring by the Reserve Bank – based on the main risks against which capital would be held – suggested that the margins in credit card issuing and acquiring were well above what would be required to provide a competitive rate of return on capital.

The designated credit card schemes would also continue to benefit from current arrangements. MasterCard and Visa earn revenue from credit card activities in Australia through their operational role in providing switching facilities to participants. The schemes typically charge their members a flat fee per transaction for processing transactions through their switch, a source of income which has risen significantly over recent years in line with the strong growth in the number of credit card transactions.

Regulatory action on access and merchant pricing

The Reserve Bank's access regime and standard on merchant pricing would remove two impediments to effective competition and improved efficiency in the Australian payments system.

Table 6: Credit card issuing and acquiring
costs and revenues per transaction
\$, 1999

Issuing		Acquiring	
Revenues	2.69	Revenues	1.78
		Direct costs	0.43
		Interchange paid	<u>1.06</u>
Direct costs	<u>1.93</u>	Costs	<u>1.49</u>
Margin	0.76	Margin	0.29
(mark-up over direct costs)	(39%)	(mark-up over direct costs)	(67%)
Costs of loyalty programs	0.46		

Source: Reserve Bank of Australia and Australian Competition and Consumer Commission (2000).



The access regime would remove the current barriers to entry to the designated credit card schemes for non-financial corporations, but without compromising the safety of the schemes. Non-financial corporations of substance would become eligible to apply to participate in the schemes in their own right, through a financial subsidiary that would specialise in credit card activities. Such subsidiaries would form a new class of specialist credit card institutions, to be authorised and prudentially supervised by APRA. Competition from such non-traditional players, particularly those able to take advantage of scale economies in processing or funding, would improve the range and pricing of credit card payment services to cardholders and merchants. This is consistent with the objective of the reforms recommended by the Financial System Inquiry that non-traditional institutions be able to compete in payment technologies as a means of increasing competition and lowering costs.

The standard on merchant pricing would remove a restraint on trade imposed by MasterCard and Visa that denies merchants the freedom to set prices for customers that promote the competitiveness of their business. The standard would ensure that a merchant accepting a MasterCard or Visa credit card is free to charge according to the means of payment; if it so wished, it could charge a “fee for service” for accepting the credit cards of these schemes.

Beneficiaries under this option

The lifting of credit card scheme restrictions on access and merchant pricing through Reserve Bank regulatory action would benefit:

- (i) credit cardholders who use the revolving line of credit;
- (ii) merchants that accept credit cards for payment; and
- (iii) the community as a whole, including consumers who do not use credit cards.

Cardholders who use the revolving line of credit would benefit from stronger competitive pressure on credit card interest rates. As with the market for residential mortgages in Australia in the 1990s, when the entry of specialist mortgage originators pushed spreads between the standard mortgage rate and the cash rate from four to below two percentage points, new entrants would provide scope for greater competition in credit card issuing.

Merchants, and ultimately the community, would benefit from the participation of specialist credit card acquirers with new skills and efficiencies to bring to the designated credit card schemes. The credit card acquiring market, as noted above, is one in which more effective competition is needed to put pressure on merchant



service fees and improve efficiency. So-called “net issuer” or “balanced portfolio” rules in MasterCard and Visa prohibit participants acting only as an acquirer, while the MasterCard and Bankcard schemes have financial penalties for participants whose activities are more heavily weighted towards acquiring than issuing. The access regime precludes any “net issuer” or “balanced portfolio” rules and associated financial penalties or loadings.

Freedom for merchants to charge according to the means of payment would introduce normal market disciplines into negotiations between merchants and acquirers over merchant service fees, and eliminate the “all or nothing” choice currently facing merchants deciding whether to accept credit cards. In principle, the higher are merchant service fees levied by an acquirer, the more likely is the merchant to pass the fees onto credit cardholders. Some merchants that had previously refused to accept credit cards because of their costs might decide to do so when they can pass these costs onto credit cardholders. A larger network of merchants accepting credit cards would be of benefit to all credit cardholders. Smaller merchants paying the highest merchant service fees would have a better negotiating position and would benefit, more generally, from greater competition in the credit card acquiring market.

If overseas experience is a guide, the removal of scheme restrictions on merchant pricing may not have a large impact on the pricing strategies of merchants. Many merchants may judge that it is not worth their while to charge a “fee for service” for accepting credit cards, or may be under strong competitive pressure not to do so. To the extent that merchants do charge, however, consumers choosing between different payment instruments would face price signals that were more reflective of the costs of providing these instruments; the higher costs of credit cards would not need to be built into the overall cost structure of these merchants so consumers using less costly payment instruments would gain from a lowering of prices. Overall, the community would benefit from more efficient price signals.

Parties bearing impact of this option

The Reserve Bank’s regulatory actions, by promoting competition and efficiency, would be likely, over time, to reduce the size of the transfer from the community to financial institutions from credit card usage. This would have an impact on:

- (i) credit card schemes and their members; and
- (ii) credit cardholders.

Incumbents in the designated credit card schemes would face greater competition in both credit card issuing and acquiring, putting pressure on profit margins. If growth in the number of credit card transactions were to slow as consumers



switched to other payment instruments in response to more efficient price signals, the profit projections of incumbents would need to be scaled back. The credit card schemes themselves would expect to experience a slowing in the growth of revenue from processing fees for the same reason.

The force of competition would determine how individual card issuers respond in pricing their credit card services to credit cardholders. If merchants were to charge a “fee for service” for accepting credit cards, cardholders using their credit cards at these merchants would face more of the resource costs of providing credit card payment services. They would, of course, have the option of avoiding those costs by switching to lower cost payment instruments.

Over time, the Reserve Bank’s regulatory actions would also inject greater market discipline into the setting of interchange fees in the designated credit card schemes. The participation of specialist credit card acquirers would give merchants a stronger and more independent voice in the fee-setting process, while the freedom of merchants to charge according to the means of payment would strengthen the balancing forces on collective interchange fee setting. Issuers in a scheme seeking to increase interchange fees would be forced to reconsider the level of these fees if merchants passed the resulting higher merchant service fees onto cardholders, thereby discouraging credit card usage.

The time-frame for achieving greater market discipline on interchange fees is, however, uncertain. What is required is a credible threat of entry to the acquiring market by one or more non-traditional participants of substance, and effective pressure on merchant service fees from merchant freedom to charge according to the means of payment. Until such requirements are met, the collective fee-setting process in each of the designated credit card schemes would continue to be dominated by the four major banks, the main suppliers of credit card services and most other payment instruments in Australia, and there would be no assurance that interchange fees were being set at an efficient level.

Regulatory action on access, merchant pricing and interchange fees

The Reserve Bank’s standard on interchange fees would provide objectivity and transparency to the process by which interchange fees are collectively set in the designated credit card schemes. By requiring that interchange fees meet a cost-based benchmark, based on credit card payment services that are principally of benefit to merchants, the standard would ensure that merchants, and the community as a whole, did not bear credit card costs that arise out of the provision of specific credit card services to cardholders.



The outcomes of the standard on interchange fees would be determined by the cost calculations to be carried out by participants in each of the designated credit card schemes. On the basis of the most recent costs provided to the Reserve Bank by each of the four major banks, the standard would be likely to result in a significant reduction in the average of interchange fees in Australia from the current level of around 0.95 per cent of the value of each credit card transaction. Since interchange fees set a floor for merchant service fees, the reduction in interchange fees would be expected to result, *pari passu*, in lower merchant service fees. Competition would be expected to ensure that these lower fees were, in turn, passed through to the final prices of goods and services.

Beneficiaries under this option

The Reserve Bank's standard on interchange fees would reinforce the impact of regulatory action on access and merchant pricing in improving competition and efficiency in the Australian payments system. Additional to the benefits accruing under option (ii), the parties benefiting from the standard on interchange fees would be:

- (i) merchants that accept credit cards for payment; and
- (ii) the community as a whole, including consumers who do not use credit cards.

Merchant service fees on credit cards cost merchants around \$1.5 billion a year. Regulatory actions under option (iii) would strengthen competitive pressure on these fees and reduce average costs for merchants: each 0.1 percentage point reduction in merchant service fees would involve a reduction of around \$100 million in the size of the transfer from the community to financial institutions. To the extent that merchants avail themselves of their freedom to charge a “fee for service” for accepting credit cards, the costs of accepting credit cards would no longer be reflected in the prices of goods and services paid by all consumers.

By requiring that the designated credit card schemes publish their interchange fees, the standard would improve transparency in the fee-setting process and ensure that merchants, and the community as a whole, know the costs that are being passed to them through interchange fees. Identifying the specific cost categories that make up the cost-based benchmark would also give card scheme members and merchants an incentive to address these costs.

Parties bearing impact of this option

Additional to the impact of option (ii), the parties bearing the impact of the standard on interchange fees would be:



- (i) credit card schemes and their members; and
- (ii) credit cardholders.

A significant reduction in average interchange fees would mean a reduction in interchange fee revenues for all credit card issuers. Revenues from this source account for about one-third of revenues from credit card issuing. There is no reason to expect that the reduction in interchange fee revenues would fall disproportionately on small and efficient credit card issuers, but high-cost issuers might find the reduction difficult to manage. The credit card schemes would expect to experience a slowing in the growth of revenue from processing fees if the Reserve Bank's regulatory actions, taken together, led consumers to switch to lower-cost payment instruments.

It would be a matter for individual card issuers, in competition with other issuers, to determine how they would respond to lower interchange fee revenues. Current levels of profitability are high and some issuers might absorb some or all of the reduction in revenues. Other issuers might want to wind back the subsidies received by credit card transactors by moving in the direction of the "user pays" approach they take in pricing other payment instruments that they provide. In contrast to some other countries where transaction fees and charges for payment instruments are rare, Australian consumers typically pay for their payment services. Financial

Table 7: Expected impact of reforms on financial institutions

	Revenues \$b, 2001	Expected impact
Interchange fees	0.9	Downward pressure from standards on interchange fees and on merchant pricing, and from access regime
Margin on acquiring services	0.8	Downward pressure from standard on merchant pricing and access regime
Interest margin on credit card borrowings	1.6	Downward pressure from access regime
Annual fees	0.2	Downward pressure from access regime; upward pressure from standard on interchange fees



institutions have levied fees on cheque and debit card (EFTPOS) transactions for some years, and the fees are increasingly related to the costs of providing these services.

The expected impact of the Reserve Bank's regulatory actions, taken together, on the revenues earned by financial institutions from credit card activities is summarised in Table 7.

6. CONSULTATION

Throughout the reform process, the Reserve Bank has attached high priority to consultations with interested parties.

The Joint Study published in October 2000 generated considerable comment from all sections of the community, including the credit card schemes, financial institutions, merchants and consumer representatives. In the six-month period before the designation of the three credit card schemes in April 2001, the Reserve Bank received 22 written submissions containing a wide range of views on the findings of the Joint Study and recommendations both for and against regulatory action.

Following the designation, the Reserve Bank received a further 45 written submissions over the remainder of 2001. It considered all of the material provided and held numerous meetings with organisations which had made submissions to discuss their comments in detail. This consultation process culminated in the publication of the Consultation Document in December 2001. The Consultation Document reviewed the main regulations of the four party credit card schemes from the public interest viewpoint, taking into account the issues raised in the submissions. It provided extensive discussion of the purpose and effect of the Reserve Bank's proposed reform measures in promoting efficiency and competition in the Australian payments system. At the same time, the Reserve Bank published a commissioned report on the operations of credit card schemes from an international expert in network economics, as well as all of the prior public submissions it had received.

As required under the *Payment Systems (Regulation) Act 1998*, the Reserve Bank invited submissions from interested parties on its proposed reform of credit card schemes, by a date specified to be 15 March 2002. Submissions were received by that deadline from 28 organisations and a number of members of the public. The Reserve Bank has considered all of those submissions in finalising its reform measures. Comments and other material were also received after the submission deadline, which the Reserve Bank has also considered. A list of organisations that provided submissions and other material is in [Attachment 3](#).