Australian Bankers' Association

Submission to the
Reserve Bank of Australia

Credit Card Networks in Australia: An Appropriate Regulatory Framework

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Executive Overview

Credit Card Networks in Australia: An Appropriate Regulatory Framework

A. Background and General Principles

'Designation' of open credit card schemes in Australia

On 12 April 2001 the Reserve Bank of Australia (RBA) formally 'designated', under the *Payment Systems (Regulation) Act 1998* (PSRA), the 'open' credit card systems operating in Australia — Bankcard, MasterCard and Visa. The RBA focused on:

- arrangements for setting *interchange fees*, paid by 'merchant acquirers' to 'issuers';
- the *membership rules* of the schemes; and
- the so-called *'no surcharge' rule*, requiring merchants not to charge customers more for using credit cards.

This submission by the Australian Bankers' Association (ABA) is lodged on behalf of ANZ Bank, Bank of Queensland, BankWest, Bendigo Bank, Commonwealth Bank of Australia, National Australia Bank, St George Bank, Suncorp Metway and Westpac Banking Corporation. It was prepared with assistance from The Allen Consulting Group Pty Ltd and Gilbert and Tobin Lawyers, and with expert advice on cost measurement issues. It canvasses how a public interest test and related tests required by the PSRA should be applied in determining whether, and if so in what form, to regulate in this area.

Grounds for designation

The RBA and the Australian Competition and Consumer Commission (ACCC) previously released a *Joint Study*[1] which was critical of aspects of current arrangements, and appears to be the basis for the decision to designate. ABA notes that a number of expert economic studies have taken issue with aspects of the *Joint Study*, as cited in an ABA Media Release dated 11 May 2001. A critique of the *Joint Study* analysis is included in this submission. ABA agrees with the *Joint Study* that arrangements for access and the setting of interchange fees should be *transparent and objective,* but notes that existing arrangements have produced interchange fees that are among the lowest in the world; and there are very liberal existing avenues for economic participation in the credit card systems, on both issuing and acquiring sides, consistent with maintaining their safety and stability.

Regulation via an 'access regime'

The PSRA allows the RBA to set '*standards*' or, under a fuller set of criteria and process protections, an '*access regime*'. In both cases an overall public interest test, based on efficiency and competition, applies. However, in the case of the determination

[1] *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, RBA and ACCC, October 2000.

of standards it is the only criterion, whereas in the case of the imposition of an access regime additional criteria, including the interests of current participants, must be taken into account. ABA is strongly of the view that if access and/or interchange fee setting are regulated, this should be via an *access regime,* particularly since there may be material commercial impacts — and this in itself places considerable weight on procedural fairness. Moreover, ABA believes that the Parliament intended access pricing to be considered under the access power, while the power to make standards applies to other matters such as technical *operational* or prudential standards.

'Access' is defined in the PSRA as "the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable". ABA considers that the 'terms' of access necessarily encompass the basis on which interchange occurs — i.e. payment and receipt of the interchange fee.

'Access' should clearly be interpreted as effective *functional participation* i.e. being connected into a credit card system *as a user* and able to transact, as a credit card issuer and/or acquirer. The PSRA does *not* confer any power to regulate in respect of intellectual or other property or governance (voting) rights.

Broad criteria for an access regime

In ABA's view, an access regime should be imposed if and only if it clearly:

(i) benefits consumers;

(ii) maintains a level playing field for all card schemes;

(iii) promotes efficiency and innovation; and

(iv) does not compromise prudential standards, safety and stability.

It must also give full weight to the interests of existing participants as well as access seekers. Regulation should also be the *minimum necessary* to achieve a clear gain to the public interest, net of all its costs; and should set *principles* rather than rigidly prescribing their detailed application, leaving maximum flexibility to compete to the commercial parties. There should be no duplication of regulation by other authorities.

Competitive neutrality

Particularly given that at least one of the two 'closed' credit card systems (American Express and Diners Club) operates in Australia what appears to be a four party scheme with third party issuers and interchange fees, ABA argues that the second broad criterion above requires that any regulation of interchange fee setting, access and the 'no surcharge' rule should apply equally to those schemes.

B. Criteria for an Access Regime: Statutory Requirements

The public interest test

Section 8 of the PSRA contains a public interest test founded on efficiency and competition, with emphasis on safety:

> "In determining, for the purposes of this Act, if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:
>
> (a) being (in its opinion):
>
> (i) financially safe for use by participants; and
>
> (ii) efficient; and
>
> (iii) competitive; and
>
> (b) not (in its opinion) materially causing or contributing to increased risk to the financial system."
>
> s. 8 *Payment Systems (Regulation) Act 1998*

In considering the public interest, clearly weight should be given to interests of the current participants, access seekers, cardholders and merchants who want an efficient, competitive payment system that is safe and reliable. This balancing of considerations should contribute to the improved welfare of all parties and the broader community.

Economic efficiency as key criterion

In ABA's view, it is most appropriate for *economic efficiency* in the broadest and most dynamic sense (including safety and stability) to be the RBA's over-arching criterion in determining the public interest in the current inquiry process, and in its ultimate decisions. What must be applied is a *broad and dynamic* concept of economic efficiency, including ensuring that:

- particularly by allowing participants in the credit card networks the opportunity to earn a return on their past investments in building the systems, with a view to encouraging new investments, incentives for further development of the networks are kept strong;
- maximum flexibility is left to the commercial parties to differentiate and compete in the payments services they offer;
- a neutral competitive environment, i.e. a 'level playing field', is maintained, not only between and within the open schemes, but between them and the closed schemes and other payments systems;
- Australian arrangements are consistent with global arrangements applying in these systems — thereby, among other considerations, avoiding additional compliance costs or the inhibition of international competition entering this market; and
- particularly in any new arrangements for access, there is no diminution of the high standards of safety and stability of these systems, and public confidence in them.

The interests of current participants

Under an *access regime*, the interests of existing participants as well as access seekers must be taken into account. To a large extent, the considerations of efficiency and competition imply this. Pricing will give adequate weight to investment incentives and efficiency objectives where it fully reflects the costs of the interchange service. More specifically, it implies that regulated pricing should allow the recouping of the large sunk investment made by participants in the open schemes in Australia in the recent past, in developing and building participation in these systems.

The important implication for setting interchange prices is that if costs incurred by issuers are wrongly excluded and benefits to cardholders are consequently diminished, customers will be discouraged from holding cards, external benefits will be reduced and the overall system will be smaller than is optimal. Moreover, if the regulatory structure does not reward the undertaking of risky, but potentially very useful, innovation, then that innovation will not take place. Regulation that results in fees that are too low in relation to cost and risk is also likely to drive out smaller players and weaken competition. Equally, of course, interchange fees that are too high will discourage merchant acceptance of the card concerned, as the schemes recognise. (E.g. Visa has in every market where it has applied its cost-based methodology set interchange fees below full cost.)

Interests of access seekers

Access seekers will be well served if:

- access terms and conditions are fair and reasonable, with prices reflecting efficient provision of the services;
- non-price eligibility criteria are objective, i.e. relate to safety and other vital scheme interests, the technical functioning of the network etc; and
- processes for setting prices are clear and transparent.

Interests of merchants, consumers and the community

Merchants have a specific interest in a robust and expansive network because of the particular benefits associated with customers using credit cards, including higher sales, reduced cash handling costs, and better control of fraud, theft and credit losses.

For consumers the key attribute of credit cards is that they free them from the immediate liquidity constraint i.e. with credit cards, consumers do not have to have sufficient funds in their transaction accounts immediately to make purchases. They can therefore better manage their personal finances while being better able to take advantage of buying opportunities. This also benefits merchants, since consumers can spend more and sooner. The implication is that it would not be in the public interest to regulate pricing in a way which ignored the significant *externality benefits* — since this would lead to a loss of those social benefits, enjoyed widely by the community.

C. Pricing Principles for Interchange Fees

General approach

ABA notes that a number of well tried methodologies exist for setting interchange fees (or have been proposed), and each has its attractions, particularly in a commercial, market context. One example is the 'Baxter' or Visa methodology, which considers revenues as well as costs, and brings in commercial judgement to set interchange *fees* in a separate step after interchange *costs* have been calculated. (Judgement has invariably been exercised to date to set fees below full calculated cost.)

There is no one 'right' methodology, and in ABA's view it would be inappropriate for a single, specific methodology to be prescribed by regulation. Rather, *regulation should be concerned with defining the acceptable 'envelope'* within which the commercial parties to each scheme would be able to determine a specific methodology suitable to that scheme. ABA is of the view that definition of the regulated 'envelope' governing the setting of interchange fees should be based on *avoidable costs* — as explained below, the relevant economic costs to the issuing function of providing credit card payment services on a sustainable basis, without providing other services. This is consistent with views previously expressed by the ACCC and RBA. Members of the scheme would be able to select any specific methodology, including e.g. one of the internationally implemented methodologies, provided that the fee adopted were not higher than that defined by the 'envelope'.

Key basis for regulated pricing: avoidable cost of providing payment functionality

ABA argues that to meet the key efficiency criterion under the PSRA public interest test, the regulated 'envelope' for interchange fees should be based on the *avoidable cost* of operating a credit card network *as a payment system* — i.e. the costs necessary to providing the distinctive 'buy now, pay later' payment functionality, as provided by credit cards and charge cards. While the *option* of revolving, i.e. of accessing extended credit, is very important to that functionality, and to the externalities generated in credit card systems, costs associated with its actual use would not be counted.

Efficiency then requires that interchange fees be set no higher than the *stand alone cost* of sustainably providing the 'buy now, pay later' functionality, and no lower than the *incremental cost*. Any regulated 'envelope' need only govern the former, however, leaving flexibility to the commercial parties to choose their own specific fee setting methodologies within that, having regard to competitive requirements etc. In the foregoing, "sustainably" is intended to convey the importance of comprehending all of the costs — including e.g. marketing, promotion and retention costs — of maintaining and growing participation in these systems over time, so sustaining the externalities that participants including merchants enjoy.

Desirable features of a regulated pricing methodology

In more detail, the desirable key features of a methodology used for regulating interchange fee setting (i.e. for determining the 'envelope') include:

- it should provide a *cost-based* justification for the level of interchange fees that is *transparent* to merchants, cardholders and the community in general. (Here, 'cost' is used in the economic sense, including a normal return on capital — including for example investments in new technology as well as capital invested in the existing systems.) Generally, the methodology should address the effect of the level of interchange fees on the *efficient pricing* of credit card services to both cardholders and merchants;

- it should encompass *only those costs related to the payments network services* provided to merchants by the credit card systems, with their distinctive 'buy now, pay later' feature. (While the *option* of accessing revolving i.e. extended credit is important to that feature of these networks, and to the externalities merchants enjoy, costs associated with its use are not counted. Here 'network' refers not to physical networks, but to the overall system of mutual participation by merchants and consumers which the credit card schemes intermediate through their issuers and acquirers.) A methodology should be based on *avoidable costs*, i.e. exclude costs and revenues not related to those payment-enabling services provided by the credit card network;

- it should govern fees by limiting recovery to *stand alone cost,* as a maximum, permitting *commercial flexibility* up to that level;
- it may make provision for *differential interchange fees*, where appropriate on the basis of objective and significant differences in cost among classes of transactions;
- it should be *forward looking*, so that any anticipated factors significantly affecting cost are taken into account;
- it should incorporate effective procedures to ensure the *integrity of data* used in the interchange fee calculation; and
- it should be *reviewed at intervals* which strike a reasonable balance between certainty and keeping pace with changes affecting costs, unforeseen events etc.

Relevant issuers' costs

The costs of the credit card issuing function that would be involved in stand alone, sustainable provision of the payment functionality include:

- fraud costs;
- credit losses and collections on those amounts related to purchases in the period just prior to the cardholder defaulting on payment (i.e. excluding costs related to default on extended credit repayments);
- the cost of equity capital;
- sunk costs (i.e. the capitalised economic losses associated with the start-up period of the credit card networks and not yet amortised);
- operating costs, such as staff costs, facilities costs, systems and data processing costs; and
- marketing, promotion and retention costs.

Review cycle

ABA believes that an appropriate interchange fee setting methodology should provide for review and recalculation at intervals which provide a measure of certainty while being frequent enough to avoid substantial discrepancies opening up. Regulation should not however prescribe a specific interval. Nor should it prescribe a specific means of encouraging best practice efficiency (e.g. applying the average cost from a data collection which excludes some of the less efficient). Any such means should avoid driving out smaller players, so limiting competition.

Summary of appropriate principles for regulated interchange fee setting

The box below summarises the *pricing principles* governing interchange fee setting that could be expressed in an access regime under the PSRA.

Box A

APPROPRIATE PRINCIPLES TO GOVERN CREDIT CARD SYSTEM INTERCHANGE FEE SETTING

A credit card scheme's rules governing interchange fee setting would be regarded as appropriate if they conform to the following principles:

(i) The rules apply a clear, *transparent and objective* methodology which is consistent with *economic efficiency*, having regard to *externalities* and *competitive* impacts;

(ii) The methodology is *cost-based*, consistent with *rewarding investment*, having regard to its risks; and to recouping sunk costs of past investments;

(iii) The methodology is designed to recover in aggregate *no more than the stand alone economic costs* of sustainably delivering the 'buy now, pay later' payment functionality only — with *differentiation* of fees allowed where appropriate on the basis of significant cost differences among classes of transactions;

(iv) The methodology has specific means (e.g. benchmarking) to encourage *best practice efficiency* and allows for anticipated future *developments* significantly affecting costs;

(v) The rules set a *review cycle* which strikes a reasonable balance between giving *certainty* and avoiding significant discrepancies as best practice costs change; while allowing for major unforeseen developments; and

(vi) The rules otherwise leave maximum *commercial flexibility* to scheme participants.

'Sunsetting' of regulatory regime itself

Any regulated regime should itself be subject to a zero-based review after a sunset period.

Ensuring no regulatory duplication

Any regulated regime under the PSRA for interchange fee setting should be framed to ensure that conduct by scheme members which complies with the regime is not subject to review or challenge under the *Trade Practices Act 1974* (TPA). The RBA has advised the members of the schemes that any action it may take under the PSRA following designation will take into account the fact that there is a Memorandum of Understanding (MOU) between the RBA and the ACCC. The RBA has assured the scheme members that its intention is to ensure, by utilising the processes provided under the MOU, that the outcome of any regulation by the RBA produces regulatory certainty with regard to both the PSRA and the TPA. The ABA expects that the consultation document to be issued by the RBA in the course of this inquiry will outline the way in which this regulatory certainty will be achieved.

D. Appropriate Regulation of Access to the Designated Schemes

Scope of access regulation

While the RBA designation statement refers to 'membership' of credit card systems, it is important to distinguish among:

(i) *effective economic participation*, which is most relevant in considering whether rules restrict competition. Apart from membership of the schemes *per se*, they all have very liberal additional avenues for economic participation (e.g. co-branding on the issuing side, or facility or service provision in acquiring);

(ii) *membership* in the full sense of having rights and entitlements in respect of scheme intellectual property, governance, scheme profits etc; and

(iii) *participation as a user* of a credit card payment system, as either acquirer or issuer — i.e. being effectively connected into the system and able to transact.

The PSRA defines the term 'access' in the third sense above. It is ABA's strong view that the RBA should regulate only *use* of the system in the third sense above i.e. *effective functional participation as a user*, and *not* in the second sense of ownership and/or governance rights etc. Moreover, ABA believes that an access regime under the PSRA should only set out the *principles* to be adhered to, and not prescribe the specific rules that schemes may adopt in complying with them.

Third party access

Consistent with other access regimes, access to the open credit card schemes should be conceived in terms of providing entities with access (as users) to the schemes' *services,* i.e. in terms of effective functional participation. In the context of the credit card systems, the implication is that while under the PSRA the RBA may regulate access to the services necessary to acquiring and or issuing, there is no basis for imposing any transfer of direct or indirect property rights of any kind.

Domestic and international card schemes

Concrete reforms have already been adopted by the Bankcard Association of Australia for the domestic Bankcard scheme, and in ABA's view they embody appropriate principles which could be reflected in a regulated regime governing access by third party users of the card systems *in the Australian context*. ABA stresses the dangers in extrapolation to the institutional contexts of other countries, and hence to those rules of the international open schemes that apply across regions.

ABA emphasises that the Australian banks which are members of the international open schemes in question (MasterCard and Visa) do not control the membership rules of those schemes and have only limited influence in respect of those schemes' operations.

It is a highly efficient solution for credit card schemes to avoid costly duplication of what official prudential regulators do in providing a high degree of assurance of institutions' ability to settle. Hence they have generally limited eligibility to bank-like financial institutions under official prudential regulation — in Australia, 'authorised deposit-taking institutions' (ADIs). Nevertheless, Bankcard considered alternatives that would allow non-ADI entry while satisfying both safety and efficiency concerns, and found an alternative that effectively met these concerns.

Under Bankcard's new access rules, membership is open to any entity that is:

- an authorised deposit-taking institution (ADI) in Australia supervised by the Australian Prudential Regulation Authority (APRA); or
- a financial institution supervised by an official prudential regulator in another country that is recognised by APRA; or
- an entity whose liabilities in respect of Bankcard are guaranteed by an APRA supervised organization (or an organization supervised by a foreign prudential regulator recognised by APRA) under a guarantee that survives the commercial failure of the entity.

Under Bankcard's new rules, a non-ADI access seeker only needs an ADI guarantor — who will no doubt charge less if the merchant's businesses poses low risks. (There are some 285 ADIs, plus all those under recognised supervision elsewhere.) In turn the guarantor's official prudential regulator will want to be assured that it can carry the exposure. For Bankcard, this is an effective and very efficient way of handling the prudential issue. Other possible alternatives are not fully effective and/or efficient.

Bankcard has also introduced lower and simpler membership related fees, and is taking a liberal approach on both self acquisition (by merchants) and specialised acquiring (without issuing) — matters which pose legitimate concerns for open credit card schemes.

Self acquisition and 'net issuer' rules

The valid rationale for self acquisition policies is that if a participant were to be a significant acquirer and merchant, a classical principal-agent conflict of interest risk can arise — given that the acquirer must enforce merchant compliance with obligations and must itself be responsible for paying issuers in some circumstances (i.e. charge-backs, non-delivery of prepaid goods and services etc).

All of the schemes currently have a type of 'net issuer' requirement, although in various forms. After entry to the schemes, members typically face an additional loading if their issuing activity becomes too low relative to their acquiring activity.

The rationale for such rules is that the externalities from maintenance and growth of a scheme are seen to be associated with issuing more than acquiring, and inherent asymmetries in the commercial interests between these functions are minimised or avoided if members are typically *substantial issuers and acquirers.* The loadings are therefore designed to address this asymmetry of interest between issuers and acquirers by requiring acquirers to make an appropriate contribution to the schemes' development that they otherwise would not make. In addition, by addressing this asymmetry of interests between issuers and acquirers, this rule helps to promote the expansion of the schemes, which depends more on issuing effort than acquiring effort.

Since under Bankcard's new rules, the official regulator must be satisfied that the member or guarantor is able to settle obligations upstream, Bankcard no longer prohibits members from acting as self acquirers. It also decided that there was no need to prohibit or restrict specialised acquirers, other than to require them to make an appropriate contribution to scheme development through a (very low) 'Incentive Fee'. That is, it has relaxed its 'net issuer' rules as well as those on self acquisition.

While Bankcard has liberalised its approach to self acquisition and 'net issuer' rules, these remain matters about which other open schemes have legitimate concerns. As emphasised above, Bankcard's considerations should not be extrapolated to the international open schemes.

Summary of appropriate principles for regulated access to the schemes

Appropriate principles which might be expressed in an access regime under the PSRA governing access to open credit card systems, following from the above analysis, are summarised in the box below.

Box B

APPROPRIATE PRINCIPLES TO GOVERN CREDIT CARD SYSTEM ACCESS RULES

A credit card scheme's rules governing access would be regarded as appropriate if they conform to the following principles:

(i) *Access is in terms of the services required for effective functional participation* in credit card issuing and/or acquiring i.e. effective connection into the system, as a user, and ability to transact. Any conferring of rights in respect of intellectual or other property or governance is solely at the discretion of the scheme.

(ii) *Eligibility criteria are transparent and objective*, and are no more onerous than required to protect the legitimate interests of the scheme, including in respect of safety and security, scheme stability and protection of brand and reputation. *Exercise of discretion* in relation to the granting of access is confined to substantial grounds impinging on those legitimate interests.

(iii) *Eligibility arrangements minimise costs* of administration and compliance, for both the scheme and access seekers.

(iv) *Access related fees* are fair and reasonable and are determined under rules conforming to pricing principles.

E. The *Joint Study* Analysis: Critique

Joint Study's analysis of profit margins

The *Joint Study* claims that profit margins in both credit card acquiring and issuing are unjustifiably high. However, the *Joint Study*'s analysis of this question is flawed and its conclusions are unwarranted, for several reasons.

First, the *Joint Study* incorrectly excludes the cost of loyalty programs from its analysis of issuers' profits. Loyalty programs are a genuine cost to card issuers, with real resources being paid to the program partners (airlines etc).

Second, the *Joint Study* errs by considering just one year of accounting data (1999) in its analysis of profits. This 'snapshot' view ignores the losses that were incurred by banks for many years as the credit card networks were rolled out. In economic terms, these losses can be thought of as an investment, which is only now yielding a positive accounting return.

Third, the *Joint Study* uses the wrong test for excessive profitability. The correct test is that price should lie in the range bounded by incremental cost (at the bottom) and stand alone cost (at the top). The Joint Study has not demonstrated that the relevant price of credit card issuing (the interchange fee) exceeds the stand alone economic cost of issuing, nor has it demonstrated that the relevant price of acquiring (the merchant service fee) exceeds the stand alone economic cost of acquiring.

Joint Study's analysis of credit losses

The *Joint Study* incorrectly states that no provision for credit losses should be made in the interchange fee, since such losses are accounted for in the interest rates charged on revolving balances. However, this ignores the credit losses from cardholders who do not revolve and so pay no interest.

Joint Study's ignores competition from closed credit card schemes

The *Joint Study* virtually ignores the competition that open credit card schemes face from closed credit card schemes and so takes no account of the effect of setting the interchange fee too low, or too high. Open scheme interchange fees are set at a level which just balances the interests of consumers, merchants, issuers, and acquirers. All four parties must be willing to participate if such schemes are to survive and prosper. If the interchange fee is set inappropriately, consumers and merchants will find it advantageous to migrate to closed schemes and issuers and acquirers of open cards will no longer be in the credit card business.

Joint Study exaggerates barriers to entry

The *Joint Study* claims that the scheme rules are anti-competitive barriers to entry, especially in acquiring. However, there are very good reasons for acquirers to be financially sound, and to be seen to be sound, because they do pose settlement risk.

The scheme rules, for both acquirers and issuers, are justified as they constitute no more than reasonable prudential measures. In any case, these rules place restrictions on scheme membership, not participation. Non financial institutions can (and do) participate in the economic sense in acquiring by providing communications equipment and services, and participate in issuing though 'co-branded' credit cards.

F. The 'No Surcharge' Rule

The 'no surcharge' rule prohibits merchants from charging customers more if they pay by credit card, i.e. prohibits price discrimination against credit card purchasers, although in a limited sense. It does not prevent merchants from offering discounts to consumers who tender payment in particular forms, typically cash.

The *Joint Study* criticised the 'no surcharge' rule, arguing that it distorts price signals (i.e. the relative price of purchases made by credit card and made by other means) and hence is inefficient. The *Joint Study* also argued that the 'no surcharge' rule leads to a cross subsidy from non-credit card paying consumers to credit card-paying consumers.

ABA's view is that the *Joint Study*'s conclusions on this subject were, at best, unproven. The *Joint Study* did not take into account the valid key rationale for the 'no surcharge' rule, which is to reflect the fundamental positive externality of credit card networks, and to stop merchants 'free riding' on the benefits that the schemes create. If a large enough number of merchants surcharged, credit card use would become unattractive for consumers, and this would ultimately hurt all merchants. However, individually, some merchants may (without the rule) lack the incentive to act in a way that does not harm the scheme as a whole. Significant non-adherence could deter consumers, who would face the risk of price discrimination if they used a credit card.

In practice removing this rule might not make a great deal of practical difference, which has been the experience in Europe (since most merchants implicitly reflect the externality by voluntarily applying it). Thus ABA's view is that the RBA needs to demonstrate, against the evidence to the contrary, that the 'no surcharge' rule is indeed harmful to competition and welfare, and that removing it would lead to tangible net benefits. In ABA's view, the RBA has not done this, and unless it does, under the principles of good regulation there is no case for regulatory intervention here. The 'no surcharge' rule should be allowed to remain in place as a reasonable commercial practice.

The *Joint Study* also uses an incorrect test for cross subsidy. The fact that credit card users and non-credit card users pay the same prices, even though the merchant may incur higher costs with the former (because of the merchant service fee) is not evidence of the existence of cross subsidy.

Chapter 1

Background and General Principles

1.1 'Designation' of Open Credit Card Schemes in Australia

Background to designation

On 12 April 2001, the Reserve Bank of Australia (RBA) formally 'designated', under the *Payment Systems (Regulation) Act 1998* (PSRA), the open credit card systems (or 'schemes') operating in Australia — those operated by Bankcard, MasterCard and Visa. (These schemes are termed 'open' because they have a policy of admitting numbers of participants meeting their rules, both on the side of issuing cards to cardholders and on the side of servicing merchants. Institutions may be members of more than one scheme and typically a member both issues cards and services merchants.)[2]

Designation followed a decision by the Australian Competition and Consumer Commission (ACCC) to pass the matter to the RBA, rather than proceed with action it had taken challenging, under the *Trade Practices Act 1974* (TPA), collective arrangements for setting interchange fees (see below) in the schemes. It also followed the release of a *Joint Study* by the RBA and the ACCC[3] which was critical of aspects of current arrangements — notwithstanding that interchange fees in Australia are among the lowest in the world; and that very liberal avenues exist for economic participation in the open credit card systems (e.g. via co-brand partnerships on the issuing side or facilities and service provision in acquiring).

Main issues identified

The three aspects of the schemes on which the RBA focused in its 12 April statement are:

- arrangements for setting *interchange fees*, wholesale fees paid by 'merchant acquirers' (i.e. those financial institutions, members of the schemes, which provide credit card services to merchants) to 'issuers' (institutions which provide services to cardholders). These fees are set collectively by scheme members;
- the *membership rules* of the schemes; and
- the so-called *'no surcharge' rules* that each scheme has, requiring merchants not to charge cardholders more than those paying by other means.

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[2] The RBA stated on 12 April that it will be reviewing one aspect also affecting the so-called closed credit card schemes (American Express and Diners Club) — the so-called 'no surcharge' rule that they have in common with the open schemes. (These schemes are termed 'closed' because they do both card issuing and servicing of merchants themselves; in recent times, however, they have in fact opened up on the issuing side and do pay interchange fees to institutions, generally banks, issuing cards for them. These fees are, however, set unilaterally or bilaterally rather than collectively as in the open schemes.) The RBA also stated on 12 April that it will not be reviewing fees charged to merchants or cardholders, or credit card interest rates, in the course of this inquiry.

[3] *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, RBA and ACCC, October 2000. This study appears to be the basis for the decision to designate.

A range of subsidiary issues also arise, e.g. the implications for the competitive dynamics of the credit card (and wider payments services) markets — in particular as between the open and closed schemes — and on incentives for investment in the further development of these systems.

The RBA also described the course of the procedural steps which it envisaged. Designation initiates the process of bringing the identified payments system(s) under the regulation of the RBA. It is the first step towards establishing standards and/or access arrangements, determined by the RBA under a public interest test. In the first instance, designation opens an inquiry process in which the RBA seeks views and information from interested parties, leading to the release of a consultation document (an Issues or Discussion Paper). There will then be further consultations and ultimately — if it is decided by the RBA that regulation is indeed warranted — a binding determination putting a regulatory framework in place.

This submission: Banking industry views

This submission by the Australian Bankers' Association (ABA) to the inquiry is lodged on behalf of ANZ Bank, Bank of Queensland, BankWest, Bendigo Bank, Commonwealth Bank of Australia, National Australia Bank, St George Bank, Suncorp Metway and Westpac Banking Corporation. It was prepared with assistance from The Allen Consulting Group Pty Ltd and Gilbert and Tobin Lawyers, and with expert advice on cost measurement issues. It canvasses how a public interest test and related tests required by the PSRA should be applied in this context, in determining whether to regulate the identified credit card systems and if so, under what framework — i.e. what are the most appropriate standards and access arrangements that should apply, if any are imposed by regulation. While the RBA has foreshadowed that a regulatory framework will indeed be imposed at the end of the current inquiry process, ABA notes that whether to do so at all is a decision which is to be taken later, based on the inquiry process now in train.

General considerations of process

Experience concerning access regimes and associated standards under other regulatory practice in Australia suggests that before imposing a regulatory framework, the following matters should be considered:

- clear identification of the services or system concerned (already effected in this case via designation);
- clear identification of the market(s) in which any regulation would be intended to promote competition and ultimately, improve economic efficiency;
- assessment of the degree of competition in those markets, and possibly at other relevant levels of supply chains; and
- assessment of whether it is feasible, having regard to factors such as existence of important externalities, uniqueness of technology and/or intellectual property, and the pace of innovation and change, to regulate prices while at the same time protecting investment incentives. In other words, all regulation has costs — particularly where factors such as those just enumerated are present — and should itself be subject to rigorous benefit/cost assessment.

ABA's view

ABA notes that the Commonwealth Government has had a long-standing commitment to ensuring that subordinate legislation can be described as *'minimum efficient regulation'*. As such, it is mandatory for all Commonwealth departments, agencies and statutory authorities to prepare a regulation impact statement (RIS) when making, reviewing and reforming regulations. ABA presumes that the RBA will, in the Issues or Discussion Paper that it will release after a first round of consultation, as well as in its final determination, address the matters that a regulatory impact statement would normally cover. It is of course only good practice for a regulator to publish the reasons underpinning its decisions.

ABA also suggests that any regulatory framework be 'sunsetted' — i.e. subject to a zero-based review after a reasonable period, say five years — particularly since in this area of imposition of access regimes (by contrast with other sectors), there is no avenue for appeal other than via the Federal Court under administrative law.

Studies already undertaken

To varying extents, the issues in this inquiry have already been canvassed, not only in the RBA/ACCC *Joint Study* but in two economic studies commissioned by seven of the ABA's members (the so-called 'Review Banks'[4]) under terms of reference which had the concurrence of the ACCC — in turn consulting with the RBA:

- *Report on Credit Card Interchange Fees to Review Banks*, Frontier Economics, January 2001; and
- *Economic Review of Credit Card Scheme Membership Rules*, The Allen Consulting Group, January 2001.

Other economic studies commissioned by individual organizations with a stake in these issues were cited in an ABA Media Release dated 11 May 2001. These studies were critical of a number of aspects of the analysis presented in the *Joint Study*.

In ABA's view, the RBA needs to take this extensive body of expert work fully into account in reaching a decision on whether to impose a regulatory framework and, if it does so, on the content of that framework.

1.2 The Basis for Payment System Regulation in Australia

Origins in financial system reform and competition policy

The Financial System (Wallis) Inquiry[5] made a number of recommendations intended to promote competition and efficiency in payments systems, while protecting their safety and stability. The Government accepted the thrust of the Wallis recommendations in this area — payments systems — and gave effect to its recommendations through the PSRA.

[4] ANZ Banking Group, Bank of Queensland, Bank of Western Australia, Commonwealth Bank of Australia, National Australia Bank, St George Bank, Westpac Banking Corporation.

[5] *Financial System Inquiry Final Report*, Canberra, AGPS, 1997.

The general philosophy underlying this and related reforms in Australia is that of competition policy generally (i.e. to maximise community welfare by promoting efficiency through competition). In relation to payment systems, regulation intended to enhance efficiency by fostering competition might be judged on whether it is likely to yield benefits such as a wider choice of payment services, lower service charges, and service improvements.

Payment system reform has been undertaken, however, mindful of the need to ensure the safety of the financial system. Indeed, the Treasurer emphasised in responding to the Wallis report that guidelines for access to clearing systems and settlement accounts, "will ensure there is no compromise in safety and stability objectives".[6]

The RBA's relevant powers to regulate

Under the PSRA, the RBA has been given a number of wide-ranging powers with respect to the payments systems.[7] The RBA may:

- designate a payments system;
- impose an access regime on a designated system (s. 12);
- vary an access regime applying to a designated system;
- make (or facilitate the making of) standards for a designated system (s.18); and
- direct participants in a designated payments system to take (or refrain from taking) action.[8]

Designation of a payments system serves the purpose of identifying it. This will lead to an inquiry, but need not lead to the imposition of regulation.

Co-regulatory intent and minimisation of imposed regulation

Furthermore, as clearly stated in the Explanatory Memorandum accompanying the *PSR Bill*, the regulatory system in this area is built upon a *co-regulatory* foundation. That is, the regulatory regime acknowledges that various private mechanisms already exist that provide (or facilitate) access to payments systems. For example:

- the Australian Payments Clearing Association (APCA) provides a forum through which parties can participate in the development and oversight of payments systems; and
- the existence and growth of the payments systems generally — and credit card networks in particular — has been through both bilateral and multilateral negotiation among many commercial parties.

A co-regulatory approach acknowledges such existing mechanisms and arrangements among the commercial parties and seeks to impose additional official regulation only to the minimum extent necessary to achieve public interest objectives.

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[6] Treasurer's Statement of 2 September 1997, p 5.

[7] While the PSRA makes the RBA the formal decision-maker under the PSRA, a Payments System Board (PSB) has been established and given oversight responsibility for this function. The RBA statement on designation of 12 April 2001 notes that designation follows a decision by the PSB.

[8] This set of powers goes further than those possessed by the (ACCC) in other analogous contexts. For example, Part XIC of the *Trade Practices Act 1974* deals with access to telecommunications systems, but the ACCC has no equivalent power to impose an access regime.

The Treasurer in his Second Reading Speech stated that "… formal regulation will only be imposed … to the minimum extent necessary to achieve the public interest". The EM (paragraph 5.13) makes a similar statement:

> "While not required by law, it is expected that designation generally will occur only after substantial consultation with participants and after consideration of alternative regulatory approaches and voluntary arrangements have been exhausted."

What follows designation and what criteria apply

Once a payments system has been designated and the RBA decides to proceed to mandate standards and/or an access regime, the PSRA requires that it mandate *the most appropriate regime* taking into consideration the public interest. In the case of an access regime it must also consider the interests of current participants, those who may seek access and any other matters considered relevant.[9]

Given the origins of the PSRA in the general application of competition policy, it is reasonable to see efficiency, in the broadest economic sense, as at the core of the public interest test.

ABA's view

ABA considers that as *pricing principles* are intimately bound up with terms of access, such principles should most appropriately be dealt with as part of an *access regime*. In this case the need to take into account the fairness and transparency considerations which the PSRA associates with the imposition of an access regime would be automatic, as ABA considers it should be — particularly given that the commercial impacts of regulation may be significant.

In ABA's view also, the overarching criterion in the public interest test of efficiency cannot be a static yardstick in this context, but must be a dynamic one which explicitly considers:

- safety and stability of, and public confidence in, the credit card systems;
- incentives to invest in the further development of these networks (including the implications for how returns on past investment are treated);
- network externalities; and
- the competitive dynamics within and between these systems and vis-à-vis the competing closed credit card systems and other payments systems.

Particularly in view of the fact that at least one of the two 'closed' credit card schemes (American Express and Diners Club) operates in Australia what appears to be a four party scheme with third party issuers and interchange fees, ABA argues that the last criterion above — i.e. the *competitive neutrality* principle — requires that any regulation of interchange fee setting, access and the 'no surcharge' rule should apply equally to those schemes.

It is widely recognised that over-regulation can weaken incentives to invest and innovate, and may give rise to technology and service choices which are sub-optimal. As recognised by the ACCC recently:

[9] Other matters that might be considered relevant would presumably include impacts on specific relevant groups (e.g. small merchants, cardholders, users of other payments systems etc). See Chapter 2.

> "In addition, access regulation may discourage investment in new facilities or the enhancement of existing facilities which may be caught by regulation. Regulation may deter future investment as the owner would not have full control over its facility and potential investors may decide that it is better to wait for others to invest first if there are a number of firms considering entry. For instance with innovative services in particular, where the return on investment is highly uncertain, if the investment does not succeed, the investor will incur all of the cost of the investment and if the investment does succeed the gains may have to be spread amongst the investor and the access seekers."[10]

In this regard, ABA notes that the Joint Study expressed doubt about whether issuers should recover a return on capital invested through the interchange fee, based upon the authors' understanding of the treatment of returns on capital in the methodologies used for setting interchange fees by the two main international open credit card schemes (MasterCard and Visa). However the RBA must clearly make its regulatory decisions in accordance with the PSRA and not in accordance with its understanding of methodologies applied commercially in other contexts. ABA notes that members of the three designated open credit card schemes in Australia have made very large investments in the development of these schemes, and did not begin to recoup economic returns on those investments until the mid 1990s, and that treatment of returns on past investments will bear importantly on incentives for future investment.

ABA considers that addressing such issues as key matters bearing on the public interest should go a long way towards ensuring appropriate treatment of the interests of both current participants (issuers, acquirers, merchants and cardholders, as well as the schemes themselves) and parties that might seek access. Chapter 2 discusses in more detail the concept of a public interest test and how it should apply.

1.3 This Report

The remainder of this report is structured as follows:

- Chapter 2 canvasses in more detail how the statutory criteria for imposition of a regulatory framework should be applied.
- Chapter 3 provides ABA's response to the RBA/ACCC *Joint Study*, addressing the main economic issues on which the decisions to impose a regulatory framework and on its content must be founded.
- Chapter 4 articulates ABA's proposals for the features of a regulated methodology for setting interchange fees.
- Chapter 5 sets out ABA's position on scheme membership issues.
- Chapter 6 addresses the 'no surcharge' rule.

[10] Australian Competition & Consumer Commission, *"Public Inquiry into the declaration of domestic intercarrier roaming and Part XLC of the Trade Practices Act 1974"*.

Chapter 2

Statutory Criteria for Imposition of an Access Regime

2.1 Introduction

The criteria set out in the PSRA

This chapter examines the approach that ABA believes the RBA should take in considering each of the statutory criteria that must be taken into account in imposing an access regime. Section 12 of the PSRA says that in imposing an access regime the RBA should have regard to:

> “ (a) whether imposing the access regime would be in the public interest; and
>
> (b) the interests of the current participants in the system; and
>
> (c) the interests of people who, in the future, may want access to the system; and
>
> (d) any other matters the Reserve Bank considers relevant.”

The chapter first provides an overview of how to apply those criteria, drawing on approaches taken in other sectors. Second, how the concept of the “public interest” should be interpreted is considered. Third, there is discussion of how the interests of current participants and access seekers should be taken into account. Fourth, the need to avoid excessive regulatory intervention is considered among other factors the RBA should take into account.

2.2 The Scope and Content of an Access Regime

Regulating interchange fee setting as part of an access regime

It is ABA’s view that, if there is to be regulation, then both interchange fee setting and participation in credit card schemes should be regulated via an *access regime* as defined in s. 12 of the PSRA, rather than via a *standard* (s. 18). ‘Access’ is defined in the PSRA as “the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable”. The ‘terms’ on which an access seeker may become a participant in the system, as a user, necessarily and fundamentally include the basis for participating in interchange — i.e. payment and receipt of the interchange fee.

There are a number of other considerations which support the conclusion that any terms and conditions with a material commercial and financial impact should be regulated under an access regime rather than via a standard. Importantly, these include the fuller criteria to which the RBA must have regard in respect of access regimes, and the fuller process protections that apply. The RBA must take account of the interests of present participants in respect of the imposition of an access regime, and not (or not explicitly) in respect of the imposition of standards. Further, in relation to determination of access regimes there cannot be any exemption from the statutory consultation process. However, by contrast, in urgent cases standards may be determined without consultation. That would not be satisfactory if standards related to conditions with a material commercial and financial impact.

The ABA does not believe that the Parliament intended to confer upon the RBA the power to regulate the payment of fees between participants in a payment system using a power which does not expressly require due process to be afforded to existing scheme participants and does not require the RBA to have regard to their commercial interests.

The Explanatory Memorandum to the *Payment Systems (Regulation) Bill 1998* (EM), in describing the new regulatory framework in paragraph 1.6 describes the determination of standards as "the determination of standards for the operation of payment systems". In ABA's view, the Parliament intended that the scope of 'standards' in the PSRA encompass matters such as technical *operational standards*, e.g. messaging formats and protocols for communication links and prudential standards.

Experience with access regimes in other sectors

It is worth noting that in the era of competition policy, there is now much experience with third party access regimes in other sectors. There is provision in Part IIIA of the *Trade Practices Act 1974* for a "generic" access regime. There are also industry-specific access regimes in gas, electricity, railways and telecommunications.

These regimes vary significantly in their details, reflecting the public policy and industry-specific factors relevant to each sector. However, they have a number of core elements in common that should be considered by the RBA as relevant to its determination of the scope and content of a payment systems access regime:

- each specifically defines, or contains mechanisms for the precise identification of the services to which an access obligation attaches;
- each imposes access obligations on the provision of "services" — that is, in general terms, access is to a "service" and not to the facility providing the service, or to rights associated with the ownership, governance and management of the business which operates the facility. No access regime confers any rights to either use or ownership of intellectual property;
- each contains general principles or criteria which are to be taken into account in determining the terms of access, including "the legitimate business interests of the provider", the "interests of all persons who have rights to use the service" and "the direct costs of providing access";
- in the case of the gas and electricity access regimes there are specific mechanisms for the determination by a regulator of "reference tariffs" or "maximum prices." In the case of the telecommunications regimes the ACCC determines "pricing principles";
- each contains mechanisms for the arbitration of disputes;
- each contains rules which govern the information the access provider must make available and how access applications are dealt with;
- each contains rules or principles which are intended to protect the legitimate interests of existing users of the services;
- each expressly provides that facilities owners/operators are not obliged to incur costs in expanding or extending their facilities in order to satisfy the requests of access seekers; and

- each provides that, in the resolution of access disputes, the regulator/arbitrator must take into account the "operational and technical requirements necessary for the safe and reliable operation of the facilities".

These precedents clearly vary in detail, but all provide for: specification of services which are subject to the access obligation; price or the determination of price; non-price terms and conditions; processes for dealing with access applications; processes for the resolution of disputes; and protections for the owner/operator in respect of the safe and reliable operation of the facility and the extension/expansion of the facility. ABA considers that they provide a reference point for the range of considerations for an access regime which may be imposed on credit card systems by the RBA.

It is finally worth noting that regulators have consistently sought to maintain the principle that an access regime is in lieu of the normal operation of market forces and is a facilitator for their operation, not a wholesale substitute for market-based commercial dealings. This, of course, echoes the guidance in which the RBA's powers under the PSRA are to be exercised with the minimum possible regulatory intervention.

Appropriate general criteria for applying the PSRA

Based on the above discussion, ABA considers that the following general criteria are relevant to any exercise of the powers conferred by the PSRA, in particular the power to impose an access regime:

(i) ***In the public interest***: The overarching goal of this test is to promote competition and efficiency while avoiding risks to the credit card system or wider financial systems. (This is discussed in Section 2.3 following.)

(ii) ***Fair and reasonable***: The terms of the access regime must be fair and reasonable, balancing the interests of existing issuers, acquirers and future access seekers.

(iii) ***Commercially realistic***: The commercial interests of the current participants need to be given substantial weight, taking into account their obligations to shareholders and other stakeholders, including the need to earn commercial returns on capital invested.

(iv) ***Protects technical standards***: The terms of access should also take into account the operational and technical requirements necessary for the safe and reliable operation of the payment system.

(v) ***Pricing principles integral to access regime***: Pricing principles under which parties may determine prices should be set out as an integral part of the access regime.[11]

(vi) ***Efficient pricing principles***: The principles should take full account of all the legitimate costs of the credit card networks, as well as considering network externalities.

(vii) ***Commercial flexibility***: The interchange fee set as part of access pricing should enable issuers and acquirers maximum commercial flexibility, e.g. within a price cap.

[11] The Productivity Commission in its position paper, *Review of the National Access Regime*, March 2001, has emphasised (p 178) that pricing guidelines are the main vehicle for giving effect to the objectives of access regulation.

(viii) ***Competitive neutrality***: In considering an access regime, the RBA should carefully consider the implications for competition between and among open and closed credit card schemes and other payments systems.

(ix) ***Transparency***: The methodology for setting terms of access and access prices should be clear and transparent.

(x) ***Minimality and positive net benefit***: Regulatory intervention should be the minimum necessary, and be constrained so that the likely costs of intervention do not outweigh the likely benefits.

2.3 The Public Interest Test

Conceptual origins in competition policy

This section discusses the interpretation of the public interest criterion in the PSRA. A public interest criterion is an increasingly common feature of Australian regulatory models. Such tests have found favour as a means of acknowledging that:

> "Competition is not about the pursuit of competition per se. Rather it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives. These accommodations are reflected in the content and breadth of application of pro-competitive policies, as well as the sanctioning of anti-competitive arrangements on public benefit grounds."
>
> *Report by the Independent Inquiry into National Competition Policy*, August 1993

Section 8 of the PSRA contains a relatively tightly defined public interest test:

> "In determining, for the purposes of this Act, if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:
>
> (a) being (in its opinion):
>
> (i) financially safe for use by participants; and
>
> (ii) efficient; and
>
> (iii) competitive; and
>
> (b) not (in its opinion) materially causing or contributing to increased risk to the financial system.
>
> The Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so."
>
> s.8 *Payment Systems (Regulation) Act 1998*

Pursuing efficiency while protecting safety, avoiding risk, balancing interests

The question is how the relative concerns identified in s. 8 should be addressed. The Government has placed some emphasis on the risk criteria — in sub-s. 8(b). The Explanatory Memorandum stated that, "In balancing these factors, the RBA will ensure that there is no material increase in systemic risk, but is not limited to these factors."[12] It is clear that the RBA is being asked, in applying the public interest test, to identify arrangements (if any are imposed) that would maximise efficiency, and competition as

[12] EM, p 15.

an intermediate objective, subject to not compromising the safety of the particular system in question or increasing risk to the wider financial system. Indeed, an intervention that caused instability in one or more payments systems and/or sought to pass back substantial prudential oversight functions from official regulators to such systems clearly would not be 'efficient'.

This interpretation is essentially that given in the Treasurer's public statements about the PSRA. He said that its purpose is to:

> "promote greater competition, and through it the achievement of greater efficiency, across the spectrum of financial and payment services … [while] ensuring that standards of financial safety are not diminished."
>
> Treasurer's 2.9.97 Statement, pp 3-4

The Explanatory Memorandum gave further guidance (paragraph 3.17) about how the RBA should use its powers, again emphasising safety along with the over-arching objective of promoting competition and efficiency in the public interest, but emphasising also considerations of fairness and transparency:

> "Regulation of the payment system needs foremost to promote competition and efficiency while ensuring security, confidence and stability in the system.
>
> The regulator is to ensure, in consultation with the existing participants, that conditions of access to designated payment systems are fair, transparent and contestable."

Further general guidance on the application of a public interest test can be gained from the fact that the National Competition Council (NCC), in applying the access regime in Part IIIA of the TPA, has identified economic efficiency as the key public interest criterion related to access regulation generally in Australia.[13]

In line with the experience of other regulators, the public interest should more generally be taken to denote considering and balancing the interests of the current participants, access seekers, cardholders and merchants who want an efficient, competitive payment system that is safe and reliable. This balancing of considerations should contribute to the improved welfare of all parties and the broader community.

Efficiency as over-arching criterion

The RBA should adopt a *broad and dynamic* concept of efficiency, so that:

- particularly by allowing participants in the credit card networks the opportunity to earn a return on their past investments in building the systems, with a view to encouraging new investments, incentives for further development of the networks are kept strong;

- maximum flexibility is left to the commercial parties to differentiate and compete in the payments services they offer;

- a neutral competitive environment, i.e. a 'level playing field', is maintained, not only between and within the open schemes, but between them and the closed schemes and other payments systems;

- Australian arrangements are consistent with global arrangements applying in these systems — thereby, among other considerations, avoiding additional compliance costs or the inhibition of international competition entering this market; and

[13] NCC, *The National Access Regime: A Draft Guide to Part IIIA of the Trade Practices Act*, 1996.

- particularly in any new arrangements for access, there is no diminution of the high standards of safety and stability of these systems, and public confidence in them.

Essentially, regulation should ensure that the conditions for *dynamic* and *productive* efficiency are maintained, as well as the more static concept of *allocative* efficiency.

Neutral terms of competition between (and within) systems

A dynamic concept of efficiency also requires that *competition* be both effective and neutral (undistorted). This includes:

- ***within open credit card systems***, competition among participants, including competition between issuers to attract cardholders and encourage them to acquire and use their cards, and competition between acquirers in securing merchant acceptance contracts;

- competition ***between and among the open credit card schemes and with the closed schemes*** in attracting cardholders and merchants; and

- competition ***between credit card networks*** (whether open or closed) ***and alternative payments services*** such as cash, cheques or EFTPOS.

2.4 The Interests of Current Participants

The RBA is required in imposing an access regime to take into account the interests of participants in the payments system and the interests of those who may want access to that system or systems. The PSRA itself provides little guidance in its definitions as to how their interests should be taken into account.

Credit cards are a service offered jointly to merchants and consumers by acquirers and issuers.[14] Thus issuer and acquirer interests should be considered as interrelated, as should merchant and consumer interests. (In economic terms, all these parties share network externalities.)

Issuer and acquirer interests: efficient pricing, rewards to investment, and flexibility

Issuers and acquirers have a predominant interest in an access regime which:

- is based on efficient pricing, that rewards investment and encourages future investment and innovation;

- allows competitiveness with other payment products; and

- allows for commercial flexibility in setting interchange fees.

Access regulation can deter prospective investments even if regulated access prices provide a reasonable return on capital for the facilities concerned. There is always the possibility that a prospective project will be unsuccessful. Hence, if regulated access prices for successful projects provide a return to investors sufficient only to cover the risk-adjusted cost of capital for those projects, then the average return across a diversified holding of projects would be less than the cost of capital.

[14] Joshua S. Gans and Stephen P. King, "The Role of Interchange Fees in Credit Card Associations: Competitive Analysis and Regulatory Issues", University of Melbourne, 29th November 2000.

Another possibility is that investment may be delayed, or there may be counter-incentives for investors to build smaller than optimal facilities, or extensions, or engage in less than optimal provisioning of existing facilities. These could have particularly adverse implications for the technological superiority of Australia's current payment system.

Need to allow recoupment of costs including investment return

A major implication of the above is that the pricing methodology should allow the recouping of the large sunk investment made by participants in the open schemes in Australia in the recent past in developing and building participation in these systems.

Pricing will give adequate weight to investment incentives and efficiency objectives where it fully reflects the costs of the interchange service. The most appropriate means to do this is by determining the costs that would be avoided if the service were not offered (and so represents the incremental cost of providing the service) — see Chapter 4 below.

Network externalities

In credit card systems each additional cardholder provides an external benefit for merchants that accept credit cards, and vice versa. Roughly, each new cardholder adds similar incremental value to the network from the point of view of merchants, and more merchants accepting cards benefit the cardholder. There is no reason to think that as networks become larger the incremental externalities decline. Thus, the issues for sustaining a credit card network are whether the sum of the benefits to cardholders, merchants, issuers and acquirers exceeds the costs of the network as a whole and whether this is also true for each group.[15]

The important implication for setting interchange prices is that if costs are incurred by issuers are wrongly excluded and benefits to cardholders are consequently diminished, customers will be discouraged from holding cards, external benefits will be reduced and the overall system will be smaller than is optimal. Moreover, if the regulatory structure does not reward the undertaking of risky, but potentially very useful, innovation, then that innovation will not take place. Regulation that results in fees that are too low in relation to cost and risk is also likely to drive out smaller players and weaken competition. Equally, of course, interchange fees that are too high will discourage merchant acceptance of the card concerned, as the schemes recognise. (Visa, for example, has in every market where it has applied its cost-based methodology set interchange fees below full cost.)

2.5 Merchant and Consumer Interests

The network externalities generated in credit card schemes indicate that merchants and consumers have a interest in an expanding network where the sum of the benefits exceeds the costs.

[15] The interchange fee can be interpreted as the means by which some of the benefits of the system to merchants are transferred from acquirers to issuers, so that all stakeholders are net beneficiaries. Without the interchange fee the open credit card networks would not exist, because issuers would be net losers and refuse to take part.

Merchant benefits and costs

Merchants have a specific interest in a robust and expansive network because of the particular benefits associated with customers using credit cards:

- reduced cash handling costs;
- fraud control;
- reduced risk of non-payment (e.g. from dishonoured cheques) and theft protection; and
- some customer information collection.

For some merchants, specifically those who sell over the internet, credit cards are effectively the only means by which they can accept payment. Of course, merchants do not receive these benefits for free. They pay a percentage of their credit card receipts (the merchant service fee) to their merchant acquirer who provides them with the technology and systems that enables merchants to take credit card payments. They also pay a small fixed rental on their credit card payment equipment. In general, merchants will accept credit cards if the value of the benefits they receive exceed the costs (merchant service fees plus fees covering provision of network access, including equipment required, etc).

No quantitative Australian data are currently available on the benefits to merchants of accepting credit cards. The Australian Retailers Association (ARA) has recently made data on the costs public.[16] According to an ARA survey of its members conducted in October 2000, the average merchant service fee (MSF) was 1.85 percent, with a range from 0.9 percent to 4.0 percent.[17] The MSF decreases as retail turnover increases. The MSF for retailers with very small turnover ($100,000) averaged 2.53 percent; it averaged 1.75 percent for retailers with $1 million turnover; and 1.35 percent for retailers with turnover of $100 million.[18]

According to the ARA data, average retail turnover among its members is about $900,000 and 29.4 percent of sales are by credit card. With the average MSF of 1.89 percent, retailers are paying, on average, $5000 per year in merchant service fees on their credit card sales. It is not difficult to imagine that, by offering the option of credit card payments to their customers, retailers would generate enough extra sales and other benefits to offset this cost.[19]

Consumer benefits and costs

For consumers the key attribute of credit cards is that they free them from the immediate liquidity constraint i.e. with credit cards, consumers do not have to have sufficient funds in their transaction accounts immediately to make purchases. They can therefore better manage their personal finances while being better able to take advantage of buying

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16 Australian Retailers Association, Submission to the Reserve Bank of Australia & Australian Competition and Consumer Commission, Debit and Credit Card Schemes in Australia a study of Fees and Access, January 2001.

17 The median MSF was 1.75 percent, so the average is not much distorted by large retailers who pay a lower MSF.

18 The average fee covering provision of network access (including required equipment) was just $311.69 per annum.

19 According to Food Marketing Institute (FMI) data on the costs of cash handling, if retailers' credit card sales were replaced by cash sales, they would incur extra cash handling costs about equal to the amount saved on merchant service fees. (Food Marketing Institute, *EPS Costs: A Retailer's Guide to Electronic Payment Systems Costs*, 1998.)

opportunities. This also benefits merchants indirectly, in two ways. First, the total amount of purchases by consumers increases; second, it brings forward the timing of purchases. For merchants, it is better to make a sale sooner rather than later. For many consumers, borrowing at credit card interest rates is preferable to taking out personal loans or other forms of consumer finance because credit card loans are more flexible and entail fewer transaction costs.

The evidence that liquidity constraints can bind people's spending behaviour, and that credit cards relieve those constraints, is very clear. Increases in credit card limits generate an immediate take up in available credit and spending.[20] In Australia, a study by the RBA showed that financial liberalisation and innovation have significantly altered consumption behaviour by reducing liquidity constraints.[21]

By relieving liquidity constraints, credit cards enable consumers to optimise their spending decisions — how much to spend and when. This is of direct benefit to consumers and indirectly benefits merchants who are the recipients of consumers' less distorted, more efficient, spending decisions.

Interests of Access Seekers

There are a number of issues that have typically been taken into consideration in assessing the interests of access seekers that are relevant to payment systems:

- access is designed for services which downstream users require;
- access terms and conditions should be reasonable, meaning that prices should reflect efficient provision of the service (subject to commercial viability);
- some non-price barriers to access may be necessary, for example in relation to safety issues and the technical functioning of the network;
- access arrangements should include incentives for the service provider to improve efficiency over time; and
- processes setting prices should be clear and transparent.

2.6 'Other Relevant Matters'

Additional matters considered in other regulatory contexts

Some guidance on other factors that could be considered by the RBA in applying the PSRA can be gleaned from what has generally become known as the 'public interest test' contained in sub-cl.1(3) of the intergovernmental *Competition Principles Agreement* (*CPA*):

> "Without limiting the matters that may be taken into account, where this Agreement calls:

20 T. Japelli, S. Pischke and N. Soules, "Testing for Liquidity Constraints in Euler Equations with Complementary Data Sources", *Review of Economics and Statistics*, 80(2), pp 251-262, 1999, Sidney Ludvigson, "Consumption and Credit: A model of Time-Varying Liquidity Constraints", Review of Economics and Statistics, 81(3), pp 434-447, 1999, D Gross and N Souleles, "Consumer Response to Changes in Credit Supply: Evidence from Credit Card Data", Wharton School Financial Institutions Center Working paper 00-04, February 4 2000.
21 Adrian Blundell-Wignall, Frank Browne, Stefano Cavaglia and Alison Tarditi, "Financial Liberalisation and Consumption Behaviour", RBA Discussion Paper 9209, September 1992.

(a) for the benefits of a particular policy or course of action to be balanced against the costs of the policy or course of action; or

(b) for the merits or appropriateness of a particular policy or course of action to be determined; or

(c) for an assessment of the most effective means of achieving a policy objective;

the following matters shall, where relevant, be taken into account:

(a) government legislation and policies relating to ecologically sustainable development;

(b) social welfare and equity considerations, including community service obligations;

(c) government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;

(d) economic and regional development, including employment and investment growth;

(e) the interests of consumers generally or of a class of consumers;

(f) the competitiveness of Australian businesses; and

(g) the efficient allocation of resources."

Weighing the benefits and costs of regulation

In ABA's view, however, the most relevant 'other matter' for the RBA to assess in considering the public interest, the interests of current and future potential participants, and its overarching goals of efficiency and competition, is *the need to avoid excessive regulatory intervention* and to apply a basic benefit/cost test to any regulatory framework proposed.

The Productivity Commission has recognised in its recent position paper, *Review of the National Access Regime*, that the merits of access regulation have been the subject of debate and that relevant regulatory agencies must consider whether the benefits of access regulation are sufficient to justify its costs and whether such regulation is the best instrument for pursuing underlying objectives. Thus, in designing efficient regulatory responses to access problems, regulators need to:

- carefully define and assess the market power they are seeking to address, and hence advance competition and efficiency; and

- assure themselves that any regulatory intervention can be sufficiently well defined so that the likely costs of intervention are not so great as to outweigh the likely benefits of ameliorating any identified market failure — i.e. that a basic benefit/cost test is passed.

(There is also a need for *regulatory certainty* in the application of the PSRA, so as not to imperil the security of the payment system, and also to ensure that there is not the threat of application of different regulatory powers under the TPA.)

Thus effective assessment of the market is essential to good regulatory design. An appropriate access regulation has potentially significant costs. The very nature of regulation means that regulators will often be operating with highly imperfect information which means that "the spectre of regulatory failure looms large" (*Review of the National Access Regime,* p 35).

This is particularly so in systems – such as the payment systems – which are in a state of great technological change. The Productivity Commission has noted that this puts a premium on flexible and responsive policies to address potential market failure.

Avoiding excessive regulatory intervention

Further, the Productivity Commission concluded that it is important not to overstate the extent of market power and reinforces the need for any inquiry by a regulator not to dismiss the "no regulation" option, particularly given the potential costs of remedial intervention (*Review of the National Access Regime,* pp 52 & 70). The costs from access regulation — involving a significant abrogation of private property rights — can be exacerbated where there is uncertainty about the property right implications of changes to access regulation but can also give rise to other costs, including:

- administrative costs for the regulator and compliance costs of business;
- constraints on the scope of infrastructure providers to deliver and price their services efficiently;
- reduced incentives to invest in infrastructure facilities;
- inefficient investment in related markets; and
- wasteful strategic behaviour by both service providers and access seekers.

The RBA must determine, in its opinion, how significant these costs will be in any given situation. The cost and benefits will crucially depend upon the pricing rules that underpin access regulation.

Chapter 3

The *Joint Study* Analysis of Credit Card Systems: Critique

3.1 Introduction

General response to the Joint Study

The RBA/ACCC *Joint Study*[22] (hereafter the '*Joint Study*') is critical of important aspects of open credit card networks in Australia.[23] At a general level, the *Joint Study* concludes that interchange fees (the payments from credit card acquirers to credit card issuers) are too high, with the corresponding implications that charges levied directly on cardholders by issuers are too low, as well as profit margins being excessive. According to the *Joint Study*, along with aspects of credit card scheme rules, such as the 'no surcharge' rule, under-pricing to cardholders has led to overuse of credit cards for transactions, especially relative to debit card use, since debit card transactions are cheaper to produce.

ABA believes that this conclusion is not valid. Credit cards provide consumers with payment flexibility, relieve liquidity constraints and offer a long term line of credit. Debit cards do not typically provide these facilities. A significant shortcoming of the *Joint Study* is that its conclusions about efficiency — the efficiency of open credit card schemes considered in isolation and the relative efficiency of open credit card schemes compared to other payment mechanisms — is not supported by logical argument based on economic analysis or the known facts about credit card networks.

Indeed the *Joint Study* gives little weight to the network externalities enjoyed by both cardholders and merchants or to the extent that they are attributable to the sunk investments in developing the networks, in the relatively recent past; and to current efforts, especially by issuers, to maintain and grow the schemes.

The *Joint Study* makes the following specific criticisms with respect to credit card networks in Australia:

- The profit margin for credit card acquiring is unjustifiably high (not "attributable to the need to earn a competitive return on capital").
- Likewise, the profit margin for credit card issuing is unjustifiably high.
- Interchange fees should not include any allowance for credit losses.
- The 'no surcharge' rule suppresses price signals and results in the cross-subsidisation of cardholders by consumers who do not use credit cards.

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[22] Reserve Bank of Australia and Australian Competition and Consumer Commission, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, October 2000. The *Joint Study* comments on credit card networks, debit card networks and ATM networks. This chapter provides comments only on the *Joint Study*'s analysis of credit card networks.

[23] Open credit card networks are Visa, MasterCard and Bankcard. They are open because the card issuer is not necessarily the merchant acquirer, for any transaction. These are to be contrasted with closed networks such as American Express and Diners Club, where the card issuer is also the merchant acquirer.

- Interchange fees should include only part of the cost of the interest free period (no more than half).
- There are good reasons to restrict card issuing to institutions that are financially sound, but this need not imply that issuers be deposit–taking institutions (as required under current Scheme rules).
- The restriction that acquirers also be issuers (and hence be deposit taking institutions) is not justified.
- High membership fees for Bankcard are restricting the entry of smaller deposit taking institutions into acquiring, since merchants want to be able to accept all cards.

Each of these points will be discussed in this chapter.

3.2 Apparent High Margins

Evidence presented by the Joint Study

The *Joint Study* examines industry-wide data for revenues and costs for credit card issuing and acquiring and concludes that the margins on each are too high. For issuing, it concludes that the average per transaction markup over costs is $0.76 or 39 per cent. The *Joint Study* excludes in toto the cost of loyalty programs in this calculation, because it argues that these costs are not a 'resource cost'. For acquiring, the *Joint Study* finds an average per transaction markup (after the payment of interchange fees to issuers) of $0.29 or 67 per cent.

ABA submits, that for several reasons, articulated below, the *Joint Study* has not, in fact, demonstrated that margins are excessive.

Separate analysis of issuing and acquiring margins is misleading

The *Joint Study* separately analyses and calculates the profit margins for credit card issuing and acquiring. When profit margins are analysed in this way, interchange fees are a revenue item for issuing, and an element of costs for acquiring.

ABA suggests that separate consideration of issuing and acquiring profits is misleading because it ignores the network character of credit card businesses and that profit margins when measured in this way become artificially distorted. The appropriate way to view profits in considering overall industry profit margins is to look at the *joint profits* of issuing and acquiring.

When profits are viewed in this way, interchange fees do not affect the overall profitability of the credit card networks, because the revenue from these fees accruing to credit card issuers is offset by the interchange fee costs incurred by acquirers. As a conceptual matter, this is quite legitimate, because interchange fees can be considered as an intra-network balancing item, which enable the benefits of the network to be distributed in a way that makes the network viable. However, interchange fees will not affect the profitability of the network as a whole. This analysis cannot be applied directly to individual participants, however, unless their issuing vs acquiring balances match the industry average. Clearly for interchange fee setting, each of the issuing and acquiring functions needs to be considered in its own right.

Based on the revenue and cost data in the *Joint Study* (including the cost of loyalty programs — see below), the profit margins for credit card issuing and acquiring considered jointly appears to be about 25 per cent, significantly less than either the issuing or acquiring margins separately reported in the *Joint Study*. A profit margin of this size at this time is not unreasonable given the economic losses that were incurred early in the lives of the credit card networks (see below).

Cost of loyalty programs should be included

The *Joint Study* argues (p 44) that the cost of loyalty programs ($0.46 per transaction) is not a 'resource cost' and so should not be counted in the cost of credit card issuing. ABA suggests that, on the contrary, loyalty schemes are a resource cost. Loyalty schemes are a means of promoting credit cards, differentiating the products and attracting and holding customers — cardholders in any one scheme being particularly open to offers to move to other schemes. Such activities are thus most important to maintaining and growing participation by both merchants and cardholders in each scheme — and thus maintaining the network externalities flowing to all participants, including in particular merchants. Real resources are paid to the partners of the card scheme members concerned, no different in principle to the resources paid to staff that administer the schemes.

The argument that loyalty programs (or given levels of such programs) may not be *essential* to the operation of credit card schemes does not invalidate the proposition that these programs consume real resources. On the *Joint Study*'s logic, all advertising expenditure, for example, is not a 'resource cost', which is plainly untrue. Indeed, much criticism of advertising expenditure is that it represents a waste of resources — i.e. involves excessive resource costs. Advertising might or might not be argued to be wasteful, but it is generally considered to be commercially important, and in any case resources are used up in its production. The same is true of expenditure by credit card issuers on loyalty programs — which are considered to be important in competing with other schemes, including closed schemes, and do incur resource costs.

More than one year of data is needed

The *Joint Study*'s conclusions that credit card issuing and acquiring generate revenues well above costs is flawed further as it is based on only one year of data (1999), and it does not take account of the losses incurred as the credit card networks were rolled out — not in the far past, but quite recently (well into the 1990s). Gaining wide acceptance from merchants and consumers for credit cards took many years. These early economic losses, believed to amount to many hundreds of millions of dollars by banks in Australia, were unambiguously an investment in the credit card networks.[24] Apparently large profits in later years in part represent a return on that investment and on the asset so created, but this cost of capital is not captured in current accounting data and so economic profits in recent years have been significantly smaller than accounting profits.

[24] Extrapolating the financial history of one of the major banks suggests that these early losses across the industry are likely to have amounted to many hundreds of millions of dollars. Reasonably reliable, confidential data made available to the ABA by one of the major banks shows this bank to have accumulated just over $100 million of net operating losses in its card business in the 8 years from 1983 to 1990.

Table 3.1 below, reproduced from Evans and Schmalensee (1999), shows economic and accounting rates of returns for the Discover Card 1985-95. It clearly shows that the Discover Card made large accounting losses early in this period (soon after it was introduced) and large accounting profits later on. However, economic rates of return, calculated by capitalising costs of new accounts, were much smoother, as well as being lower on average.

Table 3.1

ECONOMIC AND ACCOUNTING RATES OF RETURNS FOR THE DISCOVER CARD 1985-95

	Rates of Return (%)	
Year	Accounting	Capitalising costs of new accounts
1985	-96	22
1986	-79	44
1987	-42	38
1988	5	36
1989	20	34
1990	22	27
1991	24	21
1992	27	7
1993	37	16
1994	53	22
1995	37	26
1989-95 average	32	22
1985-95 internal rate of return: 22%		

Source: Evans and Schmalensee, *Paying With Plastic: The Digital Revolution in Buying and Borrowing*, Cambridge: Mass, MIT Press, 1999

The correct test for excessive margins

Another important measurement issue is that the costs reported in the *Joint Study* are incremental costs (the additional costs, both fixed and variable, that issuers and acquirers incur in the provision of card services) plus some allocation of shared costs.

While allocation of shared costs by a fully distributed cost or similar methodology is useful for accounting purposes it has no basis as a means for determining whether prices are high relative to economic costs. According to economic theory, the condition for efficiency in multi-product firms is *not* that prices should be equal to incremental costs. Rather, it is that price of a service should be *greater* than the incremental cost of its provision (to allow for the allocation of a proportion of shared costs) but less than the *stand alone cost* of its provision. Provided the price of a service falls within this range, it is efficient.

If the price of a service is below average incremental cost, then that service is said to be not *subsidy–free*. If the price is above stand alone cost, then that price is excessive and invites entry into the market by a firm that will produce the service alone at a price below that currently being charged (i.e. the new price will be at or below the stand alone cost).

Taking the cost and price data in the *Joint Study* at face value, it is clear that the *Joint Study* has not demonstrated that the prices charged by either acquirers (in the form of merchant service fees) or issuers (in the form of interchange fees to acquirers or fees charged directly to cardholders) are excessive. The *Joint Study* has shown that prices are greater than average incremental cost plus a share of common costs, which is entirely consistent with efficient resource allocation and competitive markets where firms produce multiple services. However, the *Joint Study* has not demonstrated that fees charged either by acquirers or issuers exceed stand alone costs — even excluding (as it does) any allowance for externalities from the calculations.

In summary, ABA suggests that the *Joint Study* should not have concluded that the profit margins in credit card networks are excessive because it has (i) incorrectly omitted the cost of loyalty programs in the cost of credit card issuing (ii) considered only one year of data, instead of a time series which takes account of the losses incurred early in the life of the credit card networks, when financial institutions invested heavily in recruiting merchants and marketing the cards to their customers and (iii) not demonstrated that the price of either credit card acquisition or issuing are greater than their respective stand alone costs. Moreover, while it is acknowledged that network externalities are difficult to measure, their undoubted existence should be taken into consideration at least in a qualitative sense.

3.3 Credit Losses

The *Joint Study* argues — without any substantive basis — that banks are "double dipping" by allowing for credit losses in both the interest rate charged to cardholders and the interchange fee, and advocates an alternative interchange fee that does not include any provision for credit losses.

The *Joint Study* also implicitly assumes that the only cardholders who default on their payments are those who also use credit cards for extended loans and so pay interest. According to this logic, the probability of default is built into the interest rate on the loans (charged directly to cardholders) and so there is no justification for also making provision for credit losses in the interchange fee.

However, a contrary argument is that some credit losses are legitimately recovered in the interchange fee because a proportion of these losses arises from cardholders who pay no interest — 'non revolvers', i.e. those people who make purchases using their credit card and simply do not make any repayment of the debt incurred, including interest accrued. Some of these people are those who normally pay off their cards in full each month and so do not pay any interest.

Presumably, credit losses are incurred by providers of closed scheme charge cards (e.g. American Express, Diners Club), where these cards do not include a long term credit facility. These charge card providers do not have the opportunity to recover credit losses through interest revenues, because these revenues do not exist for charge cards. These losses must be recovered by these schemes from one or several sources, including their merchant service fees, and hence through the interchange fees that are implicit in these schemes even where they have no third party issuers (as at least one of them apparently does in Australia, with what appear to be interchange fees).

ABA does not have data on the extent of credit losses suffered by these schemes, but presumes that they are not zero, even though (because they do not offer cardholders the option of a revolving facility) they are more selective than the open credit card schemes as to whom they provide with credit. No matter how rigorous the process of checking the credit worthiness of card applicants, there will be always be people who default on loans made to them, including the very short term loans that are integral to a charge card, or the charge card services that form part of the total service provided by a credit card. Thus, some allowance for credit loss in open scheme interchange fees is quite legitimate.

3.4 The 'No Surcharge' Rule and Cross Subsidisation

According to the *Joint Study*, the 'no surcharge' rule leads to a cross-subsidisation of credit card users by consumers who pay by other means. The *Joint Study* assumes that, in the absence of the 'no surcharge' rule, merchants would pass on the merchant service fee to credit card users, enabling them to face price signals that "reflect the costs of providing credit card services".

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. In many areas of sale of goods and services merchants would risk the near-certain reaction they would face from consumers if they attempted to charge more than posted prices for credit card transactions on their own — especially given that merchants can resort to cash discounts in particular cases although they rarely do. Implicitly this reflects the merchant benefit (in terms of extra sales) of accepting a 'buy now, pay later' form of payment. Merchants would be further reluctant to pass on the merchant service fee for credit card transactions because these transactions reduce cash handling and cheque processing costs. Survey evidence from the Food Marketing Institute in the United States suggests that the direct cost of using cash for the average FMI member is about 1.9 per cent of each transaction.[25] This excludes theft costs.

Aside from the adverse commercial implications for merchants who charge more for credit card users, the *Joint Study* seems to assume that economic efficiency would be enhanced if merchants obtained the same profit margin from sales to all classes of customers (specifically credit card users and others). As a matter of economics, this is not correct. Optimum economic efficiency (e.g. through Ramsey pricing) is often obtained when, for identical costs, different prices are charged to different consumers, or equivalently, when the same prices are charged to different consumers with different costs.

In the case of credit card networks, which generate positive network externalities, this conclusion is reinforced. The 'no surcharge' rule binds merchants to pricing behaviour that creates positive spillovers for the schemes as a whole by preventing merchants from free-riding on the benefits of credit cards. A merchant who charged a surcharge would share in the benefits of accepting cards (a population of cardholders) without also sharing the associated costs of card use. Indeed, if surcharging were allowed, the cost of providing credit card services would be passed back to cardholders, who would reduce their card usage below socially desirable (i.e. efficient) levels.

[25] Food Marketing Institute, *EPS Costs: A Retailer's Guide to Electronic Payment Systems Costs,* 1998. The range of costs for cash transactions from the survey conducted was 0.7 per cent to 2.2 per cent. Other data presented in that report, however, suggest that the results derived from the survey could be lower on an alternative methodology. Nevertheless, the report confirms that the costs of cash are well above zero.

In essence, the *Joint Study* ignores the important role that the 'no surcharge' rule plays in (implicitly) pricing the positive externalities from credit card use and acceptance.

Furthermore, the fact that few merchants offer discounts for cash (which is allowed under card scheme rules) indicates that for most merchants, the transaction costs of doing so exceed the benefits of any extra sales that might result.

Evidence for this comes from Europe, where the 'no surcharge' rule has in fact been abolished in the Netherlands and Sweden. Research commissioned by the European Commission on the effects of this abolition found that merchants in these two countries did not surcharge for credit card transactions even though they can.

> The main conclusions of the market studies are that most merchants do not use their right to surcharge cardholders for the use of the card. It is not established that the abolition of the ['no surcharge' rule] substantially improved the negotiating position of merchants, in particular not that it lead [*sic*] to decreased merchant fees. Cardholder's reaction to surcharging is in general negative.
>
> http://www.europa.eu.int/comm/competition/antitrust/cases/29373/studies/

As a result of these studies, the EC has decided that the 'no surcharge' rule is not anti-competitive.

> After a thorough investigation, the Commission believes that it can take a favourable view with regard to certain provisions in the Visa International payment card scheme, which has been notified for formal clearance. One of these provisions is the so-called no-discrimination rule, a rule which prohibits merchants from charging customers an additional fee for paying with a Visa card. The Commission will publish shortly a notice in the Official Journal of the European Union, inviting interested third parties to submit their observations within a month, before reaching a final conclusion.
>
> Although it had originally objected to this rule, the Commission has now concluded that its abolition would not substantially increase competition. This conclusion has been reached in the light of the results of market surveys carried out in Sweden and in the Netherlands, where the no-discrimination rule has been abolished following the intervention of national competition authorities.
>
> www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/00/11 64|0|RAPID&lg=EN

Surcharging is also permitted in Britain, but it rarely occurs there also, indicating that merchants do not want to create ill-will amongst their card paying customers, including possibly losing the business of cash-constrained customers who would choose to shop at a non-surcharging merchant if faced with the prospect of paying more when they pay by credit card.

'No surcharge' rule does not imply cross subsidy

Furthermore, the 'no surcharge' rule does not imply cross subsidisation, contrary to the claim made in the *Joint Study*. A clear definition of cross subsidy was given by Faulhaber (1975)[26]. On this definition, a service provides a cross subsidy if that service generates more revenue than the cost of providing it on a stand alone basis. A service receives a cross subsidy if the costs saved by removing it are greater than the revenues that would be lost. The *Joint Study* has not demonstrated, on this economic definition of cross subsidy, either that non-credit card paying customers provide a cross subsidy or that credit card paying consumers receive one.

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[26] G.R Faulhaber, "Cross Subsidization: Pricing in Public Enterprise", 65, *American Economic Review*, 1975.

The test of whether non-credit card paying customers generate a cross subsidy would be the presence of businesses who do not accept any credit cards. Since such businesses seem to be relatively uncommon in the Australian retail sector, it would appear that the revenues generated by such hypothetical businesses would be less than their stand alone costs i.e. this test is not passed.

The test of whether credit card paying customers receive a cross subsidy would be to ask what would happen to merchants who stopped accepting credit cards. In all likelihood these merchants would lose far more in revenue than they would save in costs, in which case this test would not be passed either.

Summary

International evidence suggests that if the ‘no surcharge’ rule were abolished, merchants would not surcharge their credit card–paying customers, because the transactions costs and business risks of doing so would be high. But even if this were not the case, the ‘no surcharge’ rule serves the important purpose of helping to ‘price’ the positive externalities (i.e. by aligning marginal network costs and benefits) generated by credit card use and acceptance.

The other feature of open credit card systems that aligns marginal network costs and benefits is the interchange fee paid by acquirers to issuers. The *Joint Study*’*s* analysis of interchange fees is considered next.

3.5 The *Joint Study*’s Indicative Interchange Fee Calculation

Conceptualisation of the interchange fee

The *Joint Study* identified two conceptual interpretations of the interchange fee in credit card transactions:

- the interchange fee is a means by which financial institutions recover costs from those who benefit from credit card networks (cardholders and merchants); or
- the interchange fee is a means of redistributing system revenues between issuers and acquirers, particularly if revenues fall short of costs for either one of these sets of stakeholders (before the application of the interchange fee).

With regard to the second approach, the *Joint Study* does not define how much redistribution should occur to define an efficient interchange fee. Indeed, implicit in the *Joint Study*’s analysis is the assumption that if acquirers and issuers each break even without an interchange fee, then the efficient interchange fee is zero. However, this assumption ignores the positive externality created by credit card networks. All parties — cardholders, merchants, issuers and acquirers — benefit from actions which grow the system as a whole. Because of this externality, efficiency is not reached when the interchange fee is such to equate private marginal benefits and private marginal costs (for either issuers or acquirers), but network marginal benefits and network marginal costs. The *Joint Study* does not provide any acknowledgement of this important point.

With regard to the first approach, the *Joint Study* calculates an indicative interchange fee by adding the cost of the interest free period ($0.00 to $0.13), fraud ($0.07), authorisation ($0.04) and processing ($0.17). By this methodology, it arrives at a total interchange fee of $0.28 to $0.41, much less than the current average interchange fee of about $1.00.

Resource costs of loyalty programs

As argued above, the cost of loyalty programs is a true resource cost and needs to be recovered either in the interchange fee or directly from cardholders. Furthermore, as argued above, a portion of credit losses should also be legitimately recovered in the interchange fee. The *Joint Study* also appears to have omitted important categories of costs, such as staff costs (averaging $0.39 per transaction), 'other' costs ($0.68) and the cost of production and issuing of cards ($0.06) in its calculation of an indicative interchange fee. These costs combined are very significant, amounting to more than half of total issuing costs. At least some (if not most) of these excluded costs would clearly be unavoidable even if the credit card networks were run purely as payment networks — i.e. without extended credit or other 'enhanced' features, save for their key 'buy now, arrange payment later' feature (in some form).

ABA is also concerned that the cost data used by the *Joint Study*, which it uses to make inferences about the efficiency of the credit card market, appear to be based on different definitions across the banks and (possibly for other reasons as well) exhibit wide ranges. It is ABA's view that, in order for any regulatory regime to be practically implemented, a comprehensive and consistent study of credit card issuing and acquiring costs by accounting experts is required.

3.6 Other Issues bearing on the Interchange Fee

Credit card networks are not 'mature'

The implicit argument in the *Joint Study* that interchange fees are no longer needed (or at least not needed at current levels) because credit card networks are now mature is not correct. According to the *Joint Study*, credit card usage in Australia is growing rapidly, which surely is the evidence *against* maturity. As business–to–consumer Internet commerce grows further, this will no doubt lead to even more credit card use, since most Internet transactions can effectively only be done by credit card, particularly credit cards that can be accepted internationally.[27] Moreover, US experience is that there is significant 'churn' of cardholders, requiring the schemes to constantly spend resources on maintaining and growing scheme participation — the source of the network externalities. Australian churn rates are lower but tending the same way.

[27] At present, only about one per cent of business revenues in Australia come from Internet transactions. Source: The Allen Consulting Group, *Measuring the Internet Economy*, forthcoming report to Cisco Systems.

Open credit card systems face competition from closed systems

Another reason the credit card networks cannot be considered mature, ignored by the *Joint Study*, is because they face competition from the closed credit and charge card systems (principally American Express and Diners Club), and of course from each other. In reality all the schemes suffer constant significant lapse rates and ongoing promotional efforts are required to maintain and grow the participation levels on which the network externality benefits to all participants depend. They are never 'mature'.

The interchange fee is the mechanism that makes the open credit card networks (Bankcard, Visa, MasterCard) viable. If the interchange fees were significantly lower (as advocated in the *Joint Study*) credit card issuers would be compelled to raise more revenue directly from cardholders. This would lead cardholders to substitute towards competitor closed system credit cards (e.g. American Express) whose price had not risen. Reductions in the number of open system cardholders will reduce the attractiveness of these cards to merchants, causing some to leave the systems. This will make the open cards even less attractive to cardholders, and a dynamic process could be set in train that undermines the viability of the open credit card networks.

Lower interchange fees could also, at the margin, act as a disincentive for smaller financial institutions to issue cards, leading to less competition and a worse deal for cardholders, also causing them to switch to the closed system cards.

Conversely, if the interchange fees were significantly higher, the acquiring banks would be compelled to recoup them through higher merchant service fees. This would reduce the attractiveness of the cards to merchants and the same destructive dynamic process could well take place.

The argument in the *Joint Study* (p 29) that merchants, as a whole, have no choice but to accept the open credit cards that are the subject of the *Joint Study* is incorrect. If the price to them of accepting these cards is too high, merchants will switch to alternatives like American Express — just as issuers can (e.g. AMP Bank). Indeed, merchants are free not to accept any cards at all. The fact that they do accept credit cards reflects the benefits that merchants receive from this form of payment.

Finally, it should be noted that interchange fees in Australia are low by international standards. This can be seen in Table 3.2, which compares credit card interchange fees for a number of countries.

Table 3.2

INTERNATIONAL COMPARISON OF INTERCHANGE FEES

Country	Visa		MasterCard	
	Standard rate	Electronic rate	Standard rate	Electronic rate
Australia +	1.20%	0.80%	1.20%	0.80%
New Zealand *	1.50%	1.10%	1.50%	1.10%
Hong Kong	1.60%	1.00%	1.67%	1.16%
Singapore	1.75%	1.15%	1.5%	1.15%
Japan	1.44%	1.00%	1.44%	1.00%
Taiwan	1.50%	1.50%	1.50%	1.50%
Canada	1.75% - $0.25	1.75% - $0.25	Not available	Not available
USA #	1.80% + $0.10	1.38% + $0.10	1.85% + $0.10	1.36% + $0.10
UK	1.3%	1.00%	Not available	Not available
France	1.25%	1.25%	Not available	Not available
Germany	1.25%	1.25%	Not available	Not available

Notes: MasterCard fees not available for some markets in North America and Europe.
+ Australian fees are net of GST. * NZ also has a specific supermarket rate at 0.8%.
# US has a number of interchange rates for specific merchant categories.

3.7 Access to Credit Card Schemes

According to the *Joint Study*, the requirement in the MasterCard and Visa rules that merchant acquirers must also be issuers and hence authorised deposit-taking institutions is "objectionable" and cannot be justified, because acquirers do not introduce settlement risk for other financial institutions in the system.[28]

The *Joint Study* appears to have misinterpreted the schemes' eligibility criteria. The Schemes do seek to attract members who will issue as well as acquire, but generally do not exclude would-be members intending to focus on acquiring. The schemes do, however, impose moderate financial loadings on those scheme members whose volume of acquiring business exceeds a pre-determined ratio of their volume of issuing business. The rationale for this rule is to promote manageability and effective governance in the schemes, given that the interests of acquirers and issuers (the latter bearing much of the scheme development burden) would otherwise not be as well aligned.

There exist very good reasons for acquirers to be financially sound, and to be seen to be financially sound. These reasons motivate the main Scheme eligibility rules for all members, including acquirers, which focus on prudential supervision status — thereby achieving a high degree of assurance that obligations to pay will be met, without inefficiently duplicating official prudential supervision. The *Joint Study* effectively argues that acquirers (as distinct from issuers) pose negligible settlement risk. While for many types of transactions, the settlement risks that acquirers pose to other parties (cardholders via their issuers for charge-backs, as well as merchants) may be small, they are not zero and in some cases are significant:

[28] MasterCard does not require its Scheme members to be authorised deposit taking institutions (ADIs). MasterCard does generally require them to be supervised financial institutions, a less onerous requirement. (GE Capital issues MasterCards in Australia and it is not an ADI.)

- Acquirers sometimes do have to settle with issuers e.g. when merchants collapse or do not otherwise deliver goods or services for which consumers have pre-paid. The amounts can be large e.g. if an airline collapses with many pre-paid tickets. This has occurred twice in Australia in the past decade, with the collapses of Compass I and II.

- Acquirers have to pay merchants. This occurs with a lag of up to a couple of days, depending on whether the merchant banks with its acquirer. Failure of an acquirer to pay could leave merchants in significant financial distress, especially if it occurred at a time of significant retail sales (e.g. the Christmas season).

- Furthermore, failure by an acquirer would leave all of its merchants unable to make credit card sales, which in itself would cause significant merchant distress.

Failure by an acquirer could thus have extremely serious consequences for merchants and would endanger confidence in the affected credit scheme as a whole (with possible contagion effects to other credit card schemes). Acquirers must not just be financially sound in fact, but all participants — merchants, consumers, other scheme members — in the credit card schemes must be confident that they are sound.

The eligibility rules for scheme members — not only issuers, in respect of whom the need is more obvious, but acquirers also — are thus designed to maintain confidence in the schemes. The card schemes themselves are not expert in assessing the financial soundness of their potential members.

As a practical matter, it should be noted that the Australian members of the international open card schemes (Visa and MasterCard) have very little influence over scheme rules. The Australian markets for Visa and MasterCard are very small compared to the world total, so Australian members of these schemes are rule 'takers', not rule 'makers'. The only credit card scheme whose rules can realistically be influenced by Australian financial institutions is Bankcard. Recently, the Bankcard Association of Australia resolved (see Chapter 5 below) that its scheme's membership be open to any entity that is:

- an authorised deposit-taking institution (ADI) in Australia supervised by the Australian Prudential Regulation Authority (APRA); or

- a financial institution supervised by an official prudential regulator in another country that is recognised by APRA; or

- an entity whose liabilities in respect of the Bankcard Scheme are guaranteed by an APRA supervised organization (or an organization supervised by a foreign prudential regulator recognised by APRA) under a guarantee that survive the commercial failure of the entity.

These decisions present liberal avenues for non-ADIs to become members, while still protecting the integrity of the Bankcard scheme — in addition to the existing liberal avenues for economic participation via co-branding or outsourced service or facility provision (see below). Bankcard also earlier reduced its entry fee to $66,000 (including GST), comparable with other open schemes.

Scheme rules are not a barrier to entry

Scheme eligibility rules are clearly justified, as they constitute no more than reasonable prudential measures (just as a prospective new entrant to the airline industry would need to demonstrate that it could fly safely and maintain aircraft). In any case, it is not true, as the *Joint Study* suggests, that these rules constitute a significant barrier to entry into the schemes.

Non-financial institutions can effectively participate in issuing via 'co-branding', i.e. by partnering with an eligible scheme member, on terms that are largely open to the parties concerned. Such partnerships e.g. Qantas and Telstra with ANZ have proliferated on the issuing side in recent years. While the scheme members take final responsibility for settlement, the credit cards are marketed by the non-FI partners.

Similarly, non-FIs can participate in merchant acquiring by providing terminals, communications and processing services to merchants, on behalf of member acquirers. In Australia, Coles Myer performs some such service provision for itself and specialist firms, such as First Data Resources, perform a similar role for other merchants. First Data Corporation (the US parent) is the largest player in the world in processing of card acquisition transactions, but is not an acquirer.

In summary, scheme eligibility rules exist to maintain confidence by all relevant parties in the credit card schemes. But they are a not a barrier to *effective economic participation* in the schemes.

Chapter 5 takes up the issue of how access (scheme participation) issues should be addressed in the current inquiry.

Chapter 4

Proposals for Reform: Pricing Principles for Interchange Fees

4.1 Introduction

Purpose of this chapter

The purpose of this chapter is to canvass what principles might be put in place to govern methodologies for the calculation of the cost of providing credit card interchange services and, consequently, for setting interchange fees — presuming that regulation will apply, and that any methodologies used for regulatory purposes should be essentially cost-based and transparent. A key organising philosophy for these principles is that they aim to ensure that interchange fees are set in a manner consistent with the *efficient functioning of credit card networks as a whole*, encompassing the inter-relationships between credit card holders, merchants, issuers and acquirers. (Here 'network' refers to that complex of inter-relationships, not to physical inter-connections.)

An efficiently determined interchange fee thus facilitates an *efficient payments network*, and should be analysed at that level — not at the level of the costs involved in processing a transaction.

ABA considers that pricing principles that may be ultimately determined in the present process should, to the maximum extent, allow room for commercial judgement to be taken into account in their application, based on competitive requirements. There is no one 'right' methodology, and it would be inappropriate for a single, specific methodology to be prescribed by regulation for use by all. *Rather, regulation should be concerned with defining the acceptable 'envelope' within which the commercial parties to each scheme would be able to determine a methodology suitable to that scheme*. In effect, regulation would govern maximum, or maximum average, fees — e.g. leaving schemes flexibility to differentiate by segment or, of course, to set lower than regulated fees overall.

A number of well tried methodologies exist, e.g. the 'Baxter'-type (Visa) approach which takes into account the *demand* for payment functionality, i.e. issuer and acquirer revenues, as well as the *supply* side, i.e. issuer and acquirer costs; and which provides for commercial judgement in setting interchange *fees* once interchange *costs* are calculated. While this is in many ways an excellent methodology, it well illustrates the distinction between a sophisticated commercial approach taking demand and market factors into account, and a suitable approach to defining the acceptable 'envelope' in official regulation. In the latter context, a high level of importance is placed on transparency, and on the ability to straightforwardly justify the arrangements to the public. It is those requirements that point to a *cost-based* approach for regulatory purposes.

The principles here described reflect ABA's view that any regulated 'envelope' governing the setting of interchange fees should be based on *avoidable costs* — i.e. the costs that are unavoidable if an issuer provides (on an ongoing, sustainable basis) *only* credit card ('buy now, pay later') payment services. This is consistent with the desire expressed in the *Joint Study*, in earlier communications between the ACCC (consulting the RBA) and banks, and in recent discussions between banks and the RBA directly, that:

- interchange fees be cost-reflective;
- the components of cost which sum to the cost of producing payment services relate to benefits for participants (merchants and cardholders) in the payments network, and in particular that they do not include the cost of services which are unrelated to payment services provided by credit card networks; and
- that the interchange fees so determined satisfy the public interest test of efficiency, as set out in the Payment Systems (Regulation) Act 1998 (PSRA).

A methodology for determining the interchange fee 'envelope' based on *avoidable costs* would be similar to the first methodology identified in the *Joint Study*, whereby the interchange fee is one means by which financial institutions recover costs from those who benefit from credit card networks — cardholder fees being another.[29] However, unlike the 'indicative' basis calculation discussed in the *Joint Study*, which took an inappropriately narrow and arbitrary view of what costs could 'legitimately' be charged to acquirers, and thence merchants, such a methodology is rigorously grounded in economic theory.

Under the avoidable cost principle, the cost of producing payment services (for the benefit of network participants) by issuers is defined as the total costs incurred by issuers in providing all credit card services less the costs that would be avoided if they did not provide services unrelated to payments network services. Economic efficiency, and the avoidable cost principle specifically, do not prescribe any arbitrary allocation of particular elements of issuers' costs as between merchants (via acquirers) and (implicitly) cardholders. Rather, it is consistent with those principles (see below) for interchange services to be priced in a range between the *incremental* and *stand alone* costs to the issuer of providing the 'buy now, pay later' payment functionality.

The RBA's Statutory objectives

The statutory objectives of the RBA are drawn from the relevant parts of the PSRA governing the imposition of standards and/or an access regime.[30] As discussed in earlier chapters, the RBA is to take into account the public interest in considering whether an *access regime* or *standards* are appropriate (it is the only consideration for determining standards). Essentially, the RBA is to determine the most appropriate regulatory framework in terms of maximising economic efficiency and competition, and balancing stakeholder interests, subject to ensuring the safety of the credit card system and that

[29] The RBA stated in its 12 April 2001 designation announcement, inter alia, that it will not be reviewing cardholder fees — which are not set collectively in card schemes but by the many individual issuers, in competition with each other, both within and between schemes, including with closed schemes. Clearly, however, to the extent that issuers do not recover their costs through the interchange fee, they can seek to do so that way. The 'indicative' interchange fee calculations set out in the *Joint Study* implied that issuers would need to attempt to recover a substantially larger part of their costs from cardholders than now.

[30] Those relevant parts of the PSRA are: the criteria in imposing an access regime in s. 12; the factors to consider in determining standards in s. 18; the meaning of the public interest in s. 8 and the meaning of access in s. 7.

there is no increased risk to the wider financial system. As argued in Chapter 1 above, ABA considers that a broad and dynamic concept of economic efficiency must be applied — in particular ensuring that incentives for further development and innovation are kept strong.

In imposing an *access regime* the RBA must also take into account the interests of current participants in the system, the interests of those who may want access to the system in the future and any other relevant matters. In defining ‘access’ under an access regime the PSRA states that it should be on a commercial basis on terms that are fair and reasonable.

It is also important that in respect of interchange fee setting, the subject of this chapter, the RBA has indicated that, at present, it has in mind imposing *standards*, whereas in respect of membership rules (Chapter 5 below) the RBA has indicated that an *access regime* would apply. As discussed in Chapter 2, ABA considers that pricing principles too should be expressed within an access regime, principally because the pricing principles govern access pricing and the special access regime power affords stronger protections as regards consultation and procedural fairness — given that there may well be material commercial impacts.

In this context the relevant broad objectives for the RBA are to ensure that its actions:

- encourage economic efficiency in the broadest sense, and a competitive environment;
- ensure the safety and security of the credit card system and avoid increased risk to the wider financial system;
- take into account the interests of current participants in the system, and the interests of those who may want access to the system in the future; and
- ensure that access regulation is on a commercial basis and its terms are fair and reasonable.

This Chapter

The remainder of this chapter is set out as follows. Section 4.2 provides an overview of desirable features for an appropriate interchange fee setting methodology — as a starting point for distilling principles or criteria that could be enshrined in an access regime governing the ‘envelope’ within which the commercial parties to each scheme could adopt their own approaches. Section 4.3 then provides a more comprehensive analysis of how appropriate criteria for a good methodology can be derived from the public interest criterion of the PSRA, with its emphasis on economic efficiency and competition. Section 4.4 describes the interchange methodologies that have been applied in the past, and their advantages and disadvantages in the light of that analysis. The avoidable cost principles are described and assessed in Section 4.5. Implementation issues and how any principles might govern them are touched on briefly in Section 4.6. Section 4.7 provides a summary of appropriate principles.

4.2 Overview of Desirable Features

The key features of any appropriate methodology used for regulating interchange fee setting include:

- it should provide a *cost-based* justification for the level of interchange fees that is *transparent* to merchants, cardholders and the community in general. (Here, 'cost' is used in the economic sense, including a normal return on capital — including, for example, investments in new technology as well as capital invested in the existing systems.) Generally, the methodology should address the effect of the level of interchange fees on the *efficient pricing* of credit card services to both cardholders and merchants;

- it should encompass *only those costs related to the payments network services* provided to merchants by the credit card systems, with their distinctive 'buy now, pay later' feature. (While the *option* of accessing revolving i.e. extended credit is important to that feature of these networks, and to the externalities merchants enjoy, costs associated with its use are not counted. Here '*network*' refers not to physical networks, but to the overall system of mutual participation by merchants and consumers which the credit card schemes intermediate through their issuers and acquirers.) A methodology should be consistent with *avoidable costs*, i.e. exclude costs and revenues not related to those payment-enabling services provided by the credit card network;

- it should govern fees by limiting recovery to *stand alone cost,* as a maximum, permitting *commercial flexibility* up to that level; and

- it may make provision for *differential interchange fees*, where appropriate on the basis of objective and significant differences in cost among classes of transactions;

- it should be *forward looking*, so that any anticipated factors significantly affecting cost are taken into account;

- it should incorporate effective procedures to ensure the *integrity of data* used in the interchange fee calculation; and

- it should be *reviewed at intervals* which strike a reasonable balance between certainty and keeping pace with changes affecting costs, unforeseen events etc.

The above desirable features are all expressed at a moderate level of generality. In what follows, more detailed principles are described for an interchange fee methodology, consistent with these features — first, in terms of the relevant concepts of economic efficiency; and second, in terms of which types of costs should be legitimately counted in determining the cost of providing interchange services, and hence the determination of interchange fees. Once again it is noted that regulation should only govern maximum fees, with schemes able to respond to competitive requirements within that.

4.3 Criteria for a Good Methodology

There are many detailed methodologies through which interchange fees could be determined; indeed several alternatives are already in existence. These are described in Section 4.4 below. But before deciding on an existing or new methodology, the criteria for making this decision need to be established.

In ABA's view, in order to satisfy the public interest (as set out in the PSRA) credit card interchange fees should satisfy a number of desiderata, as broadly discussed in Chapter 1. The methodology for determining interchange fees for regulatory purposes should:

- promote *economic efficiency* in the broadest sense (consistent with safety etc);
- be *simple*, *transparent* and provide *certainty* to network participants;
- provide *commercial flexibility*, particularly if there is a material change in circumstances.

These desirable attributes are elaborated below.

Efficiency

Three concepts of economic efficiency are relevant to the methodology for setting interchange fees: allocative efficiency, productive efficiency and dynamic efficiency. These are standard concepts in economics and in regulatory settings.

Allocative efficiency

The price of a good or service is allocatively efficient if it is equal to the cost of producing that good or service — where cost has a particular meaning (see below). In such circumstances, incentives exist in a decentralised market of buyers and sellers to produce just enough of that service so that the value placed upon the last unit purchased by buyers is equal to the value of resources used in its production.

Following this principle, economics textbooks usually define an allocatively efficient price (P) as equal to the marginal cost (MC) of production. However, while marginal concepts can be useful in theory, they can are of little practical assistance in regulatory settings, since a marginal change is, in theory, infinitesimally small. Moreover, the rule P=MC ignores the fixed costs of production (e.g. systems, facilities and other overheads) and further ignores costs which are shared in the production of multiple services (shared or common costs).

Best practice regulation of pricing

To overcome these practical difficulties, regulatory economists have devised alternative pricing rules which are also consistent with allocative efficiency. 'Best practice' regulation aims for prices that are 'subsidy free'. Credit card payment services can be thought of as being produced jointly with other credit card–related services, such as extending credit beyond the payment due date, or cash advances. This means that the price of a particular credit card–related service should be at least as high as the *incremental cost* of adding that service to the producer's product line, but not so high that a hypothetical alternative producer could profitably enter the market and produce that service alone — i.e. no higher than *stand alone cost*.

In other words — with one caveat — interchange fees should be *no higher than the stand alone cost* of providing the 'payment functionality' (otherwise an efficient payments service provider could enter and provide the service at a lower price). Equally, interchange fees should be no lower than the incremental costs that would be incurred by an issuer if a credit card payment functionality was added to the range of services it offers its customers (otherwise this service is not recovering in revenues the resource costs of its operation). For example, a bank might just offer electronic debit card services and then incrementally add credit card payment functionality to its cards. The floor for interchange fees would be the incremental costs of adding the credit card payment functionality.

The importance of externalities

The caveat is that the above rules for allocative efficiency take no account of the positive externalities generated in credit card networks. (Higher rates of acceptance by cardholders are likely to lead to higher rates of acceptance by merchants, in turn leading to even higher acceptance by cardholders, and so on.) The presence of externalities mean that, optimally, prices should not be aligned to the private costs of production, but instead to the social costs of production (which, with externalities, are different).

The externality means that the floor for *interchange fees should optimally be above incremental cost*. If interchange fees for the payment services associated with a particular credit card were set just at incremental cost, issuers would be compelled to recover fixed costs and common costs from fees levied directly on cardholders. Ordinarily, this solution would not be problematic; indeed in conventional economic analysis, non-linear prices of this type are a common solution to the problem of how a firm with high fixed costs, but low marginal costs, can set efficient prices while still recovering enough revenue to cover all of its costs.

However, in the presence of the fundamental, positive credit card network externality, this solution will not work. High direct fees on cardholders will make holding and using the credit card unattractive to them; this in turn will make acceptance of the card less attractive to merchants. In time, both cardholders and merchants would migrate to competitor schemes (such as the closed card schemes) and the credit card scheme in question could fail, or at least lose significant market share.

The stand alone cost benchmark

In summary, to be consistent with economic allocative efficiency, the ceiling for the interchange fee should be the *stand alone cost* of providing credit card payment services. The theoretical floor should be an amount higher than the incremental cost of providing those services, to take account of the credit card externality. This 'cushion' reflects another important allocative efficiency issue — that the relative prices of open and closed card schemes should not be distorted.[31]

[31] While the closed schemes do have in Australia what appear to be interchange fees only in respect of the (few) independent issuers that they have enlisted (for particular cards) in recent times, conceptually such fees have always existed implicitly as internal prices within those schemes.

The greater the competitive threat posed by alternative credit card payment schemes, the larger this ‘cushion’ above the floor should be. Because they are close substitutes, even a small distortion in relative prices will have large effects i.e. the closed schemes will rapidly gain market share at the expense of the open schemes. Thus, relative prices which were distorted by regulation would distort competition in the market for credit card payment services, contrary to the stated meaning of public interest in the s.8 of the PSRA.

By contrast, setting interchange fees according to the principles described above would be consistent with the public interest objectives of the PSRA.

Productive efficiency

Productive efficiency occurs when production takes place at minimum cost. In many regulated industries, price regulators like to set efficiency benchmarks to avoid cost padding, or otherwise inefficient production practices, being reflected in prices. This is a reasonable objective but care should be taken in setting this benchmark. In particular, given the vast differences in scale between the largest and smallest credit card issuers in Australia, it is not obvious how this benchmark should be set.[32]

Large issuers will tend to have lower costs than small issuers because they can take advantage of economies of scale, particularly in processing, and credit card issuing is a particularly processing-intensive banking activity. Setting cost benchmarks equal to those of the largest institutions could cause significant distress to the small issuers, not because they are technically inefficient at their scale, but because they are not large enough to take advantage of scale economies. This issue will require careful consideration by the RBA, lest it put in place a system of interchange fees that causes small issuers to leave the market, and a lessening of competition in the market. This would also be inconsistent with the meaning of public interest in the PSRA.

Following modern practice, productive efficiency should be encouraged by a system of incentive regulation. This means that, under the regulatory arrangements that emerge, interchange fees (or their path over time) would be fixed at the beginning of the regulatory period, and issuers would be encouraged to pursue production efficiency gains by allowing them to retain any gains made during the regulatory period. This would be entirely consistent with the objectives of the PSRA.

As noted in Chapter 1, commercial flexibility would be maximised by allowing fees to be varied (across transaction or merchant categories), with regulation governing the average — and of course allowing reductions from the regulated overall level.

Dynamic efficiency

Interchange fees should not be set so low that they dampen incentives by issuers to invest and innovate. This does not mean that the way to encourage such activity is to set interchange fees significantly above costs. But it does mean that the risks inherent in undertaking innovative activity should be recognised and properly included in the cost base. If the regulatory structure cannot reward the undertaking of risky, but potentially very useful, innovation, then that innovation will not take place.

[32] One possibility would be to set an external benchmark i.e. interchange costs of a similar country, such as Canada, adjusted for differences in the economic environment.

The consequences of this would be very serious. Financial services, including to consumers, have been a growing share of the economy. Anything that harms the growth prospects of an otherwise fast-growing industry will have cumulatively negative effects on the economy, the sum of which could be very large. Conversely, anything that enhances the prospects for a fast growing industry will have cumulatively large positive effects on the economy.

Thus, to be consistent with the public interest objectives of the PSRA, regulated interchange fees should set provide sufficient incentives for investment by issuers in innovative credit card services. In particular, returns on past investments (as well as future ones) should in principle be allowed for as part of costs. In other words, the return on capital employed should reflect the life cycle of the business.

Simplicity, transparency and certainty

The costs of applying a methodology for determining interchange fees could be significant if that methodology is complex. These costs would be high both for regulators and regulated entities. A complex methodology would also prone to error in its application.

Transparency is also important. Since the general public are the intended beneficiaries of credit card scheme designation, the process by which interchange fees are determined should be clear and open, so that the public can be confident that the outcome is the result of an objective application of a known methodology. Merchants should likewise be able to obtain comfort from a transparent process.

The regulated financial institutions who issue credit cards are entitled to expect that the methodology, once in place, will not be altered capriciously by regulators at some future time, should the regulators decide that a future outcome is not to their liking. This has happened in other regulated industry settings and is inimical to business planning. In the absence of regulatory certainty, i.e. certainty of the process, financial institutions will be very reluctant to invest in new payments technologies.

This does not mean that the regulatory framework, once imposed, should remain in place unchanged indefinitely regardless of circumstances. Rather, as suggested in Chapter 1, there should be a scheduled, zero based review of the framework itself after a sunset period (after say two review cycles of 3 years), as a matter of good regulatory practice. Such a review should again allow all parties to put their views.

Dealing with unforeseen developments

Despite all the best intentions, at times circumstances may demand a reopening of the regulatory process part way through a scheduled regulatory period. On occasion, *force majeure* simply necessitates such flexibility, and such provisions are common in commercial contracts. The framework to be developed needs to address what kinds of circumstances would warrant reopening of the price setting process (e.g. an unforeseen requirement to implement new technology across the network, say for security purposes). Generally, however, future developments should be factored in to each review as far as they can reasonably be anticipated.

4.4 Existing and Proposed Interchange Fee Methods

Each methodology described below produces interchange costs based on the average costs of all participating issuers (and acquirers where applicable). The interchange *costs* provide a basis for determination of the interchange *fee*, with other factors (e.g. demand, competitive requirements etc) also being considered as part of each of the commercial methodologies.

Specific Cost Recovery methodology

The Specific Cost Recovery methodology (also known as the MasterCard methodology) is based on the issuer recovering specific costs incurred in conjunction with the issuer making a payment guarantee to the acquirer and immediate settlement (even though payment from the cardholder is deferred).

Costs that are included in the interchange cost calculation are *(1) risk costs* related to credit losses and fraud losses; *(2) funding costs* for funding the transaction from the purchase date until the payment due date; and *(3) transaction processing* costs related to presentment of the transaction for payment.

Interchange *costs* are determined by (a) calculating the risk and funding costs for the Issuers, stated as a percentage of transaction value and (b) calculating the processing costs on a per transaction basis. The total interchange *cost* is represented as x% of the transaction value plus $y per transaction.

Interchange *fees* are set taking into account other factors, such as competing schemes' fees, the need to provide incentives to participants to adopt new technology and the need to improve merchant acceptance in specific segments.

'Baxter' or Visa methodology

The 'Baxter' methodology (also known as the Visa methodology) is based on the issuers recovering that portion of their actual costs that are in excess of their 'fair share' of the total network costs.

Costs that are included in the interchange cost calculation are the total issuers' and acquirers' costs that are attributed to the payment functionality of the credit card. A number of allocation algorithms are used to allocate total costs to the payment functionality.

The end-to-end purchase functionality costs of the issuers and acquirers are calculated. The costs are allocated between the issuer and the acquirer based on cardholder and merchant demand for the (payment) product functionality. Interchange costs are the difference between the Issuer's actual costs and their allocated portion of total network costs.

This sophisticated methodology has the advantage of taking account of demand-side factors (acquirers' and issuers' revenues) and explicitly recognises the network characteristics of a credit card system. Like the specific cost recovery methodology, it incorporates, as a necessary step between cost calculations and fee setting, commercial judgement (and discretion). These aspects are desirable from a market perspective but make any commercial methodology problematic as a basis for a publicly regulated, transparent price setting framework.

Residual Cost Recovery methodology

The Residual Cost Recovery Methodology is based on the issuers recovering their costs that are not recovered from other revenue sources.

Costs that are included are total issuers' costs. The revenues included are total issuer revenues.

The approach implicitly assumes that issuing is a competitive activity and that therefore the optimal amount of revenue is recovered from cardholders; hence all that is required is to calculate the amount of revenue which needs to be recovered as interchange fees. This is calculated as total issuer costs less all revenues obtained from other sources (cardholders).

4.5 Preferred Interchange Fee Methodology and Principles for Regulatory Purposes: the Avoidable Cost Basis

Definition of avoidable costs

While all of the methodologies described above have their advantages in the commercial context, none is completely satisfactory as an approach to defining the acceptable 'envelope' for regulatory purposes. In this section ABA proposes an *avoidable cost* methodology, as the basis for calculating interchange *costs*, and further proposes that the key principles which it embodies be the basis for any access regime governing the setting of interchange *fees* — i.e. for defining the 'envelope' within which the commercial parties could adopt their own detailed approaches. The concept of avoidable costs is based on the following question:

"what costs would issuers avoid if they were no longer to provide the services that are not necessary for the operation, maintenance and growth of the credit card system as a payment system?"

Or, the following question could be posed: *"what costs would be unavoidable if an issuer were to provide (on a sustainable basis) only credit card payment services?"*

In this context the payment service in question is the ability of the cardholder to transact with the merchant on a 'buy now, pay later basis' — i.e. to make immediate payment to the merchant but to have some reasonable time afterwards to arrange the funding of the payment. This feature is the distinctive hallmark of this payment product (as also of equivalents such as plain charge cards and store cards), and is separable for costing purposes from other features — notably the option of revolving (extended) credit, important though the presence of that option is.

Advantages of the avoidable cost basis

A methodology based on avoidable costs would be closely related to the Specific Cost Recovery Methodology which was discussed above and formed the basis of the indicative interchange fee derived in the *Joint Study*. It is least like the Baxter or Visa Methodology because it makes no reference to demand-side considerations.

Unequivocally consistent with economic efficiency

Unlike the Specific Cost Recovery Methodology, a model based on avoidable costs would be grounded firmly in regulatory economics and the outcomes from the model can be confidently predicted to be efficient, as required by the PSRA.

Under such a model, all issuer costs necessary to the payment functionality of the credit card would be counted in the calculus for determining interchange costs, because they would not be avoided if 'ancillary' services (such as extended credit) were discontinued. No arbitrary division of costs, with one portion going to interchange and the rest direct to cardholders, would be required, and it would be inconsistent with efficiency to prescribe such a division.

Such an outcome would be consistent with efficient resource allocation, as discussed in Section 4.2 above, because the maximum interchange fee would equal to the 'stand alone cost' of providing credit card payment services. The appropriate minimum interchange fee would be the incremental cost to a card issuer of providing credit card payments services (adjusted upward to take account of the credit card network externality), but need not be regulated.

A further, but related, consideration is that the interchange fee so determined should not distort merchant decisions on whether to accept particular types of credit cards e.g. open system versus closed system cards, or one open scheme's versus another's. Indeed, it should not distort merchants' decisions about accepting credit cards in general or other forms of payment. Likewise, consumer decisions about which cards to hold and which to use, should not be distorted.

A methodology based on avoidable costs has the following advantages for regulatory purposes:

- it largely, if not entirely, would obviate the need to make arbitrary and subjective cost allocations and so should be both highly transparent and relatively easy to implement; and
- above all, it would be fully consistent with economic efficiency, a key concern of the *Joint Study* and the PSRA.

Key Principle

In defining specific principles that could be expressed as part of a regulated access regime, the key criterion which should be expressed in such a regime is this:

- to be consistent with economic efficiency and the public interest, *any methodology for interchange fee setting should recover no more than the stand alone cost of sustainably delivering a buy now, pay later payment functionality.*

(There is no need to regulate schemes to ensure that interchange fees recover at least the incremental cost of providing that payment functionality — so long as regulation allows recovery of costs up to stand alone cost.)

Once again it should be noted that this is a *conservative* principle, because it excludes any specific allowance for network externalities, except insofar as costs associated with generating and maintaining them are part of stand alone costs. It is important to note that, as part of an access regime, this principle would *allow* the commercial parties to set an interchange fee less than stand alone cost but it would *not prescribe* that, since there is no public interest (efficiency) basis on which this would be justified. In fact, however, the card schemes do — on competitive market grounds — commonly set fees below the full calculated level. (For example, Visa representatives have stated that in every region where the scheme has applied its methodology, the members in the region have — in the second stage of the methodology — set an interchange fee below the total calculated interchange costs.)

4.6 Implementation Aspects: Implications for Regulated Pricing Principles

What have been described above are key cost principles, based on the overarching principle in the public interest test of economic efficiency. What has *not* been described is how these principles would be applied in detail, given the cost categories that credit card issuers actually incur. The Attachment to this submission describes in some detail the way that ABA would currently see them being implemented in practice. ABA does *not* suggest that such detail be enshrined in regulated pricing principles. Rather, such principles should *govern*, but not prescribe, the resolution of a number of issues that need to be worked through in any practical implementation within the schemes, including these:

- Among the costs incurred by issuers, which would be unavoidable if a stand alone credit card payment functionality were offered, and which would be unavoidable if an incremental credit card payment functionality were offered?
- In comparing costs of different issuers, how would the cost benchmark be determined so as to promote best practice production efficiency?
- What would be the frequency of review of costs, taking account of new investments and new technologies that may emerge for credit card payments?
- How could incentives be set for issuers to lower their costs over the regulatory period below the benchmarks?
- How could the methodology accommodate different interchange fees for different transaction types?
- How could the methodology allow sufficient commercial flexibility in the setting of interchange fees in the presence of unforeseen, significant, events?

Principles rather than prescription

In short, ABA believes that an access regime, insofar as it governs the setting of interchange fees should *not* prescribe the answers to those questions, but allow the parties to each competing credit card scheme to determine them under principles expressed in the regime. For example, a number of ABA members see about 3 years as an appropriate 'normal' length for the review cycle, but the relevant principle enshrined in a regulated access regime could be confined to something like the following:

- *an interchange fee setting methodology should provide for review and re-calculation at intervals which provide a measure of certainty while being frequent enough to avoid substantial discrepancies opening up between actual costs and those calculated at last review.*

Similarly, ABA believes that an access regime should not prescribe a specific means of encouraging best practice productive efficiency (e.g. omitting the top quartile of the cost distribution), but should articulate a *principle* which the parties are free to respond to in their own way in each scheme.

Neutral competition among schemes

Finally, ABA sees no reason why *any* four party credit card scheme with interchange fees should not be subject to the same regulation. ABA argues that it is irrelevant for the purposes of the PSRA whether interchange fees are set centrally by such a scheme or by some or all of its members collectively. It was noted above that at least one of the main closed schemes is apparently operating in Australia a four party scheme — independent issuers for it receiving what appears to be an interchange fee. The public interest criteria whose application has been discussed above are founded on efficiency and competition, and surely require that regulation be neutrally applied to all, so as not to tilt the terms of competition among (or within) schemes, and vis-à-vis other payment systems.

4.7 Summary of Appropriate Regulated Pricing Principles

Following from the above analysis, Box 4.1 below summarises the *pricing principles* governing interchange fee setting that could be expressed in an access regime under the PSRA, to apply to all four party schemes.

Box 4.1

APPROPRIATE PRINCIPLES TO GOVERN CREDIT CARD SYSTEM INTERCHANGE FEE SETTING

A credit card scheme's rules governing interchange fee setting would be regarded as appropriate if they conform to the following principles:

(i) The rules apply a clear, *transparent and objective* methodology which is consistent with *economic efficiency*, having regard to *externalities* and *competitive* impacts;

(ii) The methodology is *cost-based*, consistent with *rewarding investment*, having regard to its risks; and to recouping sunk costs of past investments;

(iii) The methodology is designed to recover in aggregate *no more than the stand alone economic costs* of sustainably delivering the 'buy now, pay later' payment functionality only — with *differentiation* of fees allowed where appropriate on the basis of significant cost differences among classes of transactions;

(iv) The methodology has specific means (e.g. benchmarking) to encourage *best practice efficiency* and allows for anticipated future *developments* significantly affecting costs;

(v) The rules set a *review cycle* which strikes a reasonable balance between giving *certainty* and avoiding significant discrepancies as best practice costs change; while allowing for major unforeseen developments; and

(vi) The rules otherwise leave maximum *commercial flexibility* to scheme participants.

'Sunsetting' of regulatory regime itself

Any regulated regime should itself be subject to a zero-based review after a sunset period.

Ensuring no regulatory duplication

Any regulated regime under the PSRA for interchange fee setting should be framed to ensure that conduct by scheme members which complies with the regime is not subject to review or challenge under the TPA. The RBA has advised the members of the schemes that any action it may take under the PSRA following designation will take into account the fact that there is a Memorandum of Understanding (MOU) between the RBA and the ACCC. The RBA has assured the scheme members that its intention is to ensure, by utilising the processes provided under the MOU, that the outcome of any regulation by the RBA produces regulatory certainty with regard to both the PSRA and the TPA. The ABA expects that the consultation document to be issued by the RBA in the course of this inquiry will outline the way in which this regulatory certainty will be achieved.

Chapter 5

Proposals for Reform: Access Regime

5.1 Context and General Principles

Background

The *Joint Study* expressed concerns about restrictions on participation in the international open credit card schemes (i.e. Visa and MasterCard), while being "particularly concerned about the lack of transparency and objectivity in the membership procedures for Bankcard".[33] The *Joint Study* concluded that "restrictions by credit card systems on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed".[34]

Reflecting these concerns, the question of credit card scheme membership was included in the agenda for the review commenced in the second half of 2000 in response to the challenge by the ACCC to interchange fee setting arrangements. An *Economic Review* of membership and related rules was conducted.[35] In essence, this review found that the relevant rules did not have significant restrictive effects going beyond those inherent in achieving their essential (and valid) purpose of protecting the safety and integrity of the schemes — the basis for public confidence in them. Nevertheless, in subsequent discussions with regulatory officials, efforts continued to identify any possible alternatives which would further liberalise participation without compromising scheme safety and integrity. ABA notes that Bankcard has subsequently taken significant steps to achieve this.

This chapter addresses desirable principles relating to the imposition of an access regime governing rules for participation in these schemes in the Australian context — in relation to the PSRA's public interest criterion, and particularly its core objective of promoting efficiency and competition.

In this regard, the RBA again expressed in its 12 April 2001 media release the view that the rules may be more restrictive than necessary, at least in the international open schemes (as distinct from Bankcard):

> "membership of the international card systems (MasterCard and VISA), either for credit card issuing or acquiring, is restricted in Australia to authorised deposit-taking institutions. Such membership rules based on institutional status may be more restrictive than necessary to protect the safety and integrity of the systems. Bankcard is currently reviewing its membership rules."
>
> Reserve Bank of Australia, 'Designation of Credit Card Schemes in Australia', *Media Release — 2001-09,* 12 April 2001

[33] Australian Competition and Consumer Commission (ACCC) and Reserve Bank of Australia (RBA), *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access,* October 2000.

[34] Reserve Bank of Australia, 'Designation of Credit Card Schemes in Australia', *Media Release — 2001-09,* 12 April 2001, p 2.

[35] The Allen Consulting Group, *Economic Review of Credit Card Scheme Membership Rules*, report to the 'Review Banks' ('Economic Review') January, 2001 — released by ABA on 11 May 2001 and posted on the ABA website.

Scope of access regulation: Overview

While that statement refers to "membership" of credit card systems, it is important to distinguish among:

(i) *effective economic participation*, which is most relevant in considering whether rules restrict competition. Apart from membership of the schemes *per se*, they all have liberal additional avenues for economic participation (e.g. co-branding on the issuing side, or facility or service provision in acquiring);

(ii) *membership* in the full sense of having rights and entitlements in respect of scheme intellectual property, governance, scheme profits etc; and

(iii) *participation as a user* of a credit card system, as either acquirer or issuer — i.e. being effectively connected into the system and able to transact.

The PSRA defines the term 'access' in the third sense above. It is ABA's strong view that the RBA should not, and under the PSRA can not, regulate in respect of intellectual or other property rights or rights in respect of scheme governance (i.e. voting rights) or participation in scheme profits, notwithstanding that schemes may *choose* to confer some such rights on participants. It should regulate only *use* of the system in the third sense above, i.e. *effective functional participation as a user*, and *not* in the sense of ownership and/or governance rights etc. Moreover, ABA believes that an access regime under the PSRA should only set out the *principles* to be adhered to, and not prescribe the specific rules that schemes may adopt in complying with them.

In light of this, this chapter outlines desirable principles for an access regime which might be applied to the designated schemes, in so far as it governs participation in acquiring and/or issuing, as a user of the system

Domestic and international schemes

The chapter gives particular emphasis to the concrete reforms that have already been adopted by the Bankcard Association of Australia (Bankcard), as in ABA's view they embody appropriate principles which could be reflected in a regulated regime governing access by third party users of the card systems *in Australia*. ABA stresses the dangers in extrapolating to the institutional contexts of other countries, and hence to those rules of the international open schemes which apply generally across regions. That is, Bankcard's new membership rules may not be appropriate for an international scheme which has to manage payment systems throughout the world and must maintain consistency in application of membership rules. In addition, it would impose burdens on the international schemes if they were required to tailor membership criteria to particular countries in which they do business.

ABA emphasises that the Australian banks which are members of the international open schemes in question (MasterCard and Visa) do not control the membership rules of those schemes and have only limited influence in respect of those schemes' operations. The RBA's comment quoted above indeed distinguishes the position with Bankcard, commenting that it is " … currently reviewing its membership rules". Bankcard has in fact, as previously noted, already made decisions on its reforms.

The changes made by Bankcard were designed to ensure that the access requirements of the scheme are as objective and transparent as practicable, liberalising entry of users while ensuring that the financial integrity and stability of the Bankcard payments system is not compromised. In addition, changes to the Bankcard fee structure substantially reduce the fees faced by new prospective participants.

The Bankcard reforms directly address the core concern expressed by regulatory officials that the rules, and in particular the concern making authorised deposit-taking institution (ADI) status a membership prerequisite, may be "more restrictive than necessary". As canvassed in the *Economic Review*, it is a highly efficient solution for credit card schemes to avoid costly duplication of what official prudential regulators do in providing a high degree of assurance of institutions' ability to settle. Nevertheless, Bankcard considered alternatives that would allow non-ADI entry while satisfying both safety and efficiency concerns, and found an alternative that effectively met these concerns.

ABA considers that Bankcard's rules now offer a benchmark, *in the Australian context*, for allowing third party access, while still protecting scheme safety and stability — although they go further in respect of membership (voting etc) rights than can a regulated access regime under the PSRA.

5.2 Membership vs Participation

While the RBA's designation announcement refers to '*access'* (and *'membership'),* it is relevant for the purposes of any economic review to consider not membership *per se*, but other avenues for *effective economic participation* in the aspects of the relevant schemes, their benefits and obligations.

Participation in issuing: Existing commercial arrangements

For example, it is open to a non-financial institution to become a *co-brand partner* of a member of one of the schemes and to have the member issue one of these schemes' cards with the partner's 'livery' predominating, the partner having a major influence over features, promotion avenues, the application process etc — and the partner sharing the revenues and/or profits under whatever terms are agreed bilaterally. Each of the schemes allows great flexibility in these respects. While the member still carries the formal obligations of issuance and owns the receivables, this may be transparent to the cardholder.

The only possible constraint on co-branding is the ability of potential co-branders to find willing partners among the schemes' members. This has not proven to be a problem so far, in Australia in particular. In fact, it has been relatively easy for co-branding initiatives to be established and there are no restrictions on the number of co-branders with which a scheme's members can form partnerships, or any significant restrictions on the terms of the 'deal' between partners. In Australia, not only large corporates such as Telstra and Qantas, but also organisations of considerably smaller scale (such as sporting organisations) have been able to conclude apparently satisfactory agreements effectively (in economic terms), giving them participation in issuance — if not actual membership.

In addition, many issuers are non-banks, including credit unions, building societies and finance companies. For example, the Credit Union Services Corporation of Australia Limited (CUSCAL) is an issuer for both the Visa and MasterCard schemes.

Participation in acquiring: Existing commercial arrangements

On the merchant acquisition side, there appears to be confusion in some quarters about the fact that this is at core *not* a network provision and operation function but a *banking function*. The primary obligations are delivery of payment to merchants, and monitoring and enforcement of merchant standards (including their delivery of paid-for goods and services to cardholders); in this regard, merchant acquirers carry initial responsibility for charge-backs (generally speaking).

The facilities provision, operation and processing functions going with acquiring and forming part of the acquiring business are, however, open to others. There is no real barrier to non-acquirer ownership and operation of the physical terminals (e.g. by a merchant, as in the case of Coles Myer), for example communications links, switches and processing facilities. (First Data Resources Australia is a significant third-party processor but not an acquirer in the Australian market, and its US parent is a major player in virtually all aspects of acquisition although it is understood not to be a scheme member itself.) The terms on which non-banks can participate in functions within the acquisition process are set bilaterally. Furthermore, it is understood that the schemes do not prohibit merchants from participating through bank (or bank-like supervised institution) subsidiaries. Bankcard certainly does not.

It is understood, for example, that CUSCAL has been an acquirer of Visa transactions for Coles Myer. This is a concrete indication that 'non-bank' financial institutions can be scheme members and compete effectively.

In making an economic assessment of the access arrangements of the relevant schemes, it is important to have regard to these other avenues for access and economic participation, which are more germane to the objective of promoting efficiency and competition than the terms of 'membership' narrowly defined.

5.3 Third Party Access and Desirable Access Principles

In making an economic assessment of the access arrangements of the relevant schemes, it is useful to start by considering the criteria that generally must be met before third parties can be granted access to the services provided by facilities developed by others. Relevant criteria are set down in the PSRA and were discussed in Chapter 2 above. This legislation establishes powers whereby the RBA may determine a right of access to a payments system, where access in relation to a payment system is defined to mean "the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable".[36]

As already discussed, the RBA may only impose access conditions on a payments system if it considers that doing so would be in the public interest.[37] In determining whether such action would be in the public interest, the RBA must have regard to the desirability of payment systems being financially safe for use by participants, efficient and competitive. Moreover, the RBA's actions in this respect should not materially cause or contribute to increased risk to the financial system.[38]

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36 *Payment Systems (Regulation) Act, 1998*, section 7.
37 *Payment Systems (Regulation) Act, 1998*, section 11(3).
38 *Payment Systems (Regulation) Act, 1998*, section 8(b).

The criteria suggest that at a minimum, access should not be provided unless the current access criteria are inefficient or unduly restrictive of competition, and where there are alternative criteria which would better deliver the objectives of economic efficiency and competitiveness, without causing increased risk to the schemes' existence and commercial stability.

Third party access

Consistent with other access regimes, access to the open credit card schemes should be conceived in terms of providing entities with access (as users) to the schemes' *services,* i.e. in terms of effective functional participation. In the context of the credit card systems, the implication is that while under the PSRA the RBA may regulate access to the services necessary to acquiring and or issuing, there is no basis for imposing any transfer of property rights.

Under Parts IIIA and XIC of the *Trade Practices Act,* access is provided where competition fails to discipline anti-competitive behaviour. Their purpose is to regulate the terms and conditions of access to infrastructure to prevent the owners from leverage their power into other markets (i.e. upstream and/or downstream markets).[39] In the case of the open credit card schemes, access provides entities with the ability to *use* the schemes' services in being connected into their systems and being able to issue and/or acquire and settle on the same basis with other entity members. It should not connote any right to *membership*; nor imply any rights in respect of ownership facilities, brands and other intellectual property or in respect of participation in *governance* (including e.g. voting rights in the schemes) or scheme profits.

Principles for access

Rather than stipulating specific, detailed access rules and criteria, which all of the schemes would be required to adopt, the ABA proposes that the RBA, if it regulates in this area, should limit its regulation to desirable access *principles* that govern the bases on which the schemes allow a third party to participate, as a user. A set of particular access rules and criteria should demonstrably satisfy the following:

1. Maximise opportunities for entities to obtain access to the services necessary to participation in credit card acquiring and/or issuing without undermining the schemes' safety and stability.

While the schemes currently have somewhat different eligibility criteria focusing on prudential supervision status, the primary rationale (or motivation) for each set of criteria is essentially the same: to provide a high degree of assurance to entities party to the schemes that each party to a credit card transaction will be paid the amount owing to it. That is, the criteria should ensure that settlement risk in a scheme is minimised while providing for maximum opportunity for access. All members of a scheme benefit from the financial stability of the scheme so that both issuing and acquiring parties to the schemes are required to contribute to their stability. Issuers need to be financially sound so as to settle credit card transactions promptly, while awaiting payment from their cardholders, and acquirers must also be financially sound so that they can settle merchant transactions promptly while bearing the risk of merchant fraud and other causes of charge-backs.

[39] Corones, S.G, *Competition Law In Australia,* Second Edition, LBC Information Services, Sydney, 1999, p 413.

To assess the opportunities for access to a scheme, it is also necessary to have regard to the nature of the schemes in relation to effective economic participation. As noted in Section 5.2, the eligibility criteria imposed by the schemes allow wider effective economic participation than simply provided via membership per se.

2. Be objective, non-discriminatory and transparent in respect of eligibility, with discretion in respect of admission confined to substantial grounds relating to the vital interests of the schemes.

Desirable objective criteria should not allow unlimited discretion to existing members in respect of granting access to eligible entities, although it would make no sense to remove all discretion. Transparent, objective and non-discriminatory eligibility criteria should however reduce the need for judgemental interpretation of the criteria by existing members, with admission normally following.

Nevertheless the satisfaction of eligibility criteria should not be required to result in automatic access, and having an extra step between eligibility and access is a reasonable requirement, allowing any material factors bearing on the schemes' legitimate interests to be taken into account. For example, an access seeker may satisfy the eligibility criteria, but there may be an unacceptable associated settlement or reputation risk for the scheme if access is allowed. Discretion in such cases, for the schemes' protection, is analogous to the current situation where the Australian Prudential Regulation Authority (APRA) has the discretion to refuse ADI status, even though a prospective entity satisfies the minimum criteria.[40] Such discretion is an additional safeguard preserving the security and stability of the schemes.

3. Minimise the transaction costs related to the making and enforcement of access arrangements.

Transaction costs are incurred by the schemes every time an access seeker applies for access, as well as after they are admitted. Seeking to minimise the transaction costs associated with access and enforcement of access will contribute to the efficiency of the schemes' overall operations. However, this principle will need to be subject to assuring the schemes' overall stability.

The key way for the credit card schemes' eligibility criteria to minimise transaction costs is to rely on official prudential supervision. This approach has the advantage that it does not duplicate what official prudential regulators already do in providing a high degree of assurance as to an institution's ability to settle. Bankcard's new rules, allowing a non-ADI to enter under an ADI's guarantee, retains this efficiency with safety feature.

In relation to open credit card schemes, such as Visa and MasterCard, consideration must be given to their international nature when assessing whether principles applied to access to them which are acceptable in the Australian context would deliver the same level of efficiency *and* safety if applied elsewhere.

4. Relate solely to access to relevant services, not to ownership of the schemes' intellectual or other property or to participation in their governance (e.g. voting rights).

As outlined earlier, regulation designed to provide for 'full' participation (as distinct from effective participation via commercial arrangements such as co-branding) should be

[40] Australian Prudential Regulation Authority, *Guidelines on Authorisation of ADIs*, May 2000. Available from http://www.apra.gov.au/ADI/ on 28 May 2001.

couched in terms of *access to the relevant services*. The access rules should not, and need not, prescribe in respect of *ownership* of facilities, brands and other intellectual property or in respect of participation in *governance* (including e.g. voting rights in the schemes).

ABA considers that any imposed access regime should not go beyond setting principles at about the above level of specificity. It should not, for example, prescribe that a scheme must accept collateral or must adopt any other *particular* method for addressing the need for assurance of ability to settle.

The ABA considers that the recent reforms to Bankcard's eligibility criteria do satisfy these principles. Other schemes may satisfy these principles through different rules. This is a particularly relevant point in the case of the international open credit card schemes. An approach to access in their case that produced acceptable outcomes in Australia might pose unacceptable risks for the schemes if applied in other countries.

5.4 Rationale for Eligibility Criteria

This section elaborates the rationale for the principles proposed — i.e. for criteria which seek to maximise participation by efficient means which above all protect safety and stability. In all open credit card schemes, the maintenance of a high degree of confidence that each party to a credit card transaction will be paid the amount owing is the core purpose of eligibility criteria — see Box 5.1 which outlines how it is in the interest of all members and users, and the schemes in general, that all parties can settle their payment obligations as and when they fall due, with a high degree of assurance.

Box 5.1

THE NEED FOR ENSURING A CARD SCHEME'S FINANCIAL SOUNDNESS

Cardholders need to be confident that:

- Their card (typically issued by their bank) will be accepted by any merchant that accepts cards of the particular scheme, even if that merchant has never heard of the issuing bank.
- The merchant will deliver the good or service for which they have used the card as payment, or they will receive redress.
- They will be protected from fraudulent use of their card or card number.
- Their accounts will be administered efficiently by the card issuer.
- Any funds that the cardholder has in credit (in effect, 'on deposit') will be honoured.

Merchants need to be confident that:

- They will be paid (promptly) by their acquirer for the goods they have sold on credit, accepting the card for payment, subject to meeting their own obligations to the cardholder.
- They will be protected from fraudulent use of credit cards or credit card numbers.
- The infrastructure installed by their acquirer(s) will work and so enable them to make sales by credit card.
- Their accounts will be administered efficiently by the acquirer.

Acquiring institutions need to be confident that:

- They will be paid (promptly) by card issuers.
- (Acquirers themselves are responsible for their merchants meeting obligations to them, e.g. in the event of charge-backs.)

Issuing institutions need to be confident that:

- They will be paid by acquirers in the event of merchant failure or fraud when goods are sold in advance with payment by credit card.
- They will be paid by acquirers in the event of charge-backs.

(Issuers themselves are responsible for securing repayment from cardholders.)

Schemes need to be confident that:

- The risk of member failure is minimised.

(The schemes themselves are responsible for guaranteeing their members' obligations.)

Source: The Allen Consulting Group

Bankcard's eligibility criteria

Recently Bankcard adopted open, transparent and liberal eligibility criteria which can be applied in a simple and cost-effective manner, while providing a high degree of financial assurance to all scheme participants. Specifically, Bankcard makes eligible for membership any entity that is:

- an authorised deposit-taking institution (ADI) in Australia supervised by the Australian Prudential Regulation Authority (APRA); or
- a financial institution supervised by an official prudential regulator in another country that is recognised by APRA; or
- an entity whose liabilities in respect of the Bankcard Scheme are guaranteed by an APRA supervised organization (or an organization supervised by a foreign prudential regulator recognised by APRA) under a guarantee that survive the commercial failure of the entity.

Essentially, any institution can enter the Bankcard Scheme if it is either an ADI (not necessarily regulated in Australia, so long as appropriately regulated) or obtains a lasting guarantee from an ADI.

At a superficial level, it could be argued that the requirement that a prospective member be an *ADI or equivalent* acts to restricts competition between members of the schemes by limiting entry. However, ensuring the confidence of all parties to the schemes that financial obligations will be satisfied is not, in itself, anti-competitive. On the contrary, such reforms *liberalise entry for non-ADI's* — particularly in relation to the acquiring side where in many cases there is not a significant settlement risk — but crucially retains, at the level of the guarantor, the efficient feature of reliance on official supervision, by requiring the guarantor to be an ADI.

In addition to the chosen guarantee approach, Bankcard considered other alternatives, including the posting of collateral directly with schemes and (in Australia) the holding of an Exchange Settlement Account, but found them unworkable in key respects in relation to the objectives of safety and stability plus efficiency. It is conceded that the guarantee (or any other workable) approach may inherently be onerous for a prospective non-ADI *issuer* — reflecting the objective fact that issuers may pose significant potential settlement risk — but it is on the issuing side that existing non-membership avenues for effective economic participation under commercial arrangements are already the most liberal.

Other reforms

Bankcard also abolished the requirement that members submit a business plan upon application for membership and revised its voting arrangements by replacing its two-tiered voting requirements with special rights for Founding Members with a single voting structure with voting weighted in accordance with total Bankcard turnover. This has resulted in transparent arrangements under which all eligible prospective participants who apply are likely to be accepted, unless there are substantial grounds for declining to grant them access.

ABA notes that Bankcard has also replaced its historically determined formula-based entry fee with a flat entry fee of $66,000 (GST inclusive).[41] This fee is fair and reasonable, and is now comparable with the entry fees charged by the other schemes, so addressing the concern expressed in the *Joint Study* that the Bankcard entry fee was prohibitive.[42] (Bankcard has also abolished some other miscellaneous fees.) In short, ABA considers that Bankcard's revised access-related fees now clearly meet the test of being 'fair and reasonable'.

Summary

In summary, ABA considers that Bankcard's new eligibility criteria and other changes address the regulators' concerns and satisfy the principles outlined in Section 5.3. They:

- are simple, transparent and objectively-based and apply equally to all access seekers;
- minimise settlement risk to the Scheme, efficiently relying on official prudential supervision of ADIs while providing a more liberal avenue for access — so helping maximise participation in the Scheme while preserving its safety, integrity and commercial stability;
- relate primarily to access to the Scheme's relevant services, rather than to ownership rights in respect of Bankcard intellectual property; and
- minimises the transaction costs related to the making and enforcement of access decisions.

5.5 Policies on Self Acquisition

The Visa and MasterCard schemes are understood to have (and Bankcard until recently had) policies (not rules *per se)* against *self acquisition*, designed particularly for a situation where an acquirer is also a merchant, or is closely affiliated with a merchant.[43] Incidental self acquisition is typically permitted in schemes (e.g. where a bank has an insurance subsidiary and allows credit card payment of premiums), where self-acquired volumes are small in relation to total volumes. However, under these policies, the schemes would not generally allow a large non-financial merchant to control a small financial institution and acquire its own transactions via that institution as a scheme participant.

The valid rationale for these policies is that if a participant were to be a significant acquirer and merchant, a classical principal-agent conflict of interest risk can arise — given that the acquirer must enforce merchant compliance with obligations and scheme rules, and ensure that appropriate checks are made before merchants are signed up. The acquirer must itself be responsible for paying issuers in some circumstances (i.e. charge-backs, non-delivery of prepaid goods and services etc).

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[41] This change was approved by the Bankcard Board of Management on 1 December 2000.

[42] Australian Competition and Consumer Commission and Reserve Bank of Australia, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access,* October 2000, p 58.

[43] Within the Visa system there are understood to be a number of rules which impact upon the issue of self acquisition, including some of the membership rules, but are not rules *per se* against self acquisition. It is understood that the impact of such rules can only be assessed in the context of specified factual situations and that with respect to Visa the issue of a self acquisition policy has not arisen for concrete consideration in the Australian context.

The most likely case where there is potential risk associated with self acquisition is where a major merchant acquires a financial institution to undertake acquisition of its own retail merchant transactions. The risk is most likely to crystallise in relation to pre-paid but not delivered goods or services and the inability of consumers to obtain credits for properly returned goods, etc — in the event of failure of the merchants. Where the risk crystallises, it is borne by the schemes and ultimately by the schemes' members.

Despite the principal-agent risk associated with allowing members to self acquire, Bankcard recently resolved to abolish its policy prohibiting members from acting as self acquirers. This liberal reform to the Bankcard scheme was made on the basis that there was no longer the need for this policy if accompanying reforms to its eligibility criteria, essentially providing entry to ADI entities (not necessarily regulated in Australia so long as appropriate regulated) and to those entities that obtain a lasting guarantee from an ADI, were introduced. This was because the new eligibility rules were seen as effectively addressing the key issue of the scheme's financial stability by relying on the official prudential regulator of an ADI member, or an ADI guarantor of a member, to ensure the ability to meet all obligations arising in self acquisition.

On the same grounds, Bankcard also concluded that it was no longer necessary to introduce rules in relation to pure acquiring (that is, in relation to the balance of member's acquiring and issuing) other than to ensure that they make an appropriate contribution to the development of the schemes through the application of an incentive/imbalance fee, which is discussed in the next section.

In summary, ABA emphasises that although self acquisition does pose a real principal–agent problem that needs to be addressed in open credit card schemes, the Bankcard approach offers a *non-restrictive* way of addressing this risk, in the Australian context. ABA stresses again that the Bankcard approach on these issues should not be extrapolated to the international open schemes.

5.6 'Net Issuer' Requirements

All of the schemes currently have a type of 'net issuer' requirement, although in various forms. After entry to the schemes, members face a type of additional loading if their issuing activity becomes too low relative to their acquiring activity. For example:

- MasterCard is understood to have a rule which requires prospective members to issue a 'reasonable number of cards', an obligation which is assessed upon application for membership. Where a member fails to later satisfy the requirement, the member incurs a loading. MasterCard, in the Asia/Pacific Region (including Australia) charges an Acceptance Development Fee (ADF) to members, recognising the importance of a contribution by both issuing and acquiring members to the continued development of the brand. The ADF is calculated on the basis of each member's ratio of merchant volume to total volume. The ADF will no longer apply when a member has successfully grown its card basis so as to reduce the disparity between its acquiring and issuing volumes.

- Visa is understood to have a rule under which if domestic merchant Visa sales volumes are more than twice as large as total issuing Visa volumes for a member, then an 'imbalance fee' is imposed on the member.

- Bankcard also has a net issuer rule, which also imposes a small 'Incentive Fee' where there is a disparity ratio of two between acquirer and cardholder volumes, but as noted, no longer excludes participants who propose only to acquire, or to do little issuing. The only requirement is that they pay the Incentive Fee.

The rationale for such rules (see the *Economic Review*) is that the externalities from maintenance and growth of a scheme are seen to be associated with issuing more than acquiring, and inherent asymmetries in the commercial interests between these functions are minimised or avoided if members are typically *substantial issuers and acquirers.* The loadings are therefore designed to address this asymmetry of interest between issuers and acquirers by requiring acquirers to make an appropriate contribution to the schemes' development that they otherwise would not make. In addition, by addressing this asymmetry of interests between issuers and acquirers, this rule helps to promote the expansion of the schemes, which depends more on issuing effort than acquiring effort.

Role of interchange fee

In an open credit card scheme, the role of the interchange fee is important in internalising the network externalities. It could be argued that, if the interchange fee is set appropriately, including in respect of the externalities involved, all the necessary incentives are in place for members of the schemes to issue cards, and no further inducement from net issuer requirements is necessary. However, establishing the right interchange fee so as to create all of the necessary incentives is problematic due to the existence of the difference in sunk costs incurred by issuers and acquirers, which is at the source of the asymmetry between acquirer and issuer interests.

Moreover, if the interchange fee is set relatively too high, it can be considered to be a barrier to acquiring. As opposed to dealing with the asymmetry of interests by *excluding* prospective members proposing to focus on acquiring, Bankcard therefore, resolved that a very modest 'Incentive Fee' (based on 0.03 percent of the acquisition volume) would be the sole means of addressing this issue in future, and that it would not have 'net issuer' requirements as such. This fee is considered to reflect the appropriate economic cost on members whose issuing activity is small relative to acquiring.

Bankcard continues to apply the fee where a member's total acquisition volume is more than double its issuing volume, although its application was recently changed so that it would not be applied until the second full financial year of an entity's membership. This transitional period is designed to reduce any inhibition to entry associated with loadings, i.e. the incentive fee, which may otherwise be applied as a member is building both its issuing and acquiring businesses. Nevertheless, its modest amount is not considered to confer an unreasonable barrier to entry to the Bankcard Scheme.

ABA considers that the Bankcard approach in relation to acquiring and pure acquirers is a liberal one, while also believing that these types of rules have a valid place in open credit card schemes. Indeed by providing more appropriately balanced incentives to members, by optimally shaping respective rights and obligations, more effective competition within schemes and between schemes is facilitated. In summary, ABA considers that Bankcard's self acquisition and net issuer rules embody the appropriate principles while simultaneously addressing the regulators' previously expressed concerns.

In summary, ABA believes that in the Australian context it is possible to liberalise 'full' participation in acquiring and issuing without materially compromising scheme safety and stability. However ABA cautions against prescribing specific methods of liberalising entry to the international schemes which could be unsafe in other contexts. Moreover ABA sees no case to regulate scheme membership fees or self acquisition and 'net issuer' policies, other than to require that rules or policies in respect of these are transparent and have an objective basis.

5.7 Conclusion

Rather than proposing desirable specific access rules and criteria, in this submission ABA has canvassed appropriate *principles* that the schemes' access rules should conform with. A summary of appropriate governing principles that could form the basis of an access regime under the PSRA is as follows (Box 5.2).

Box 5.2

APPROPRIATE PRINCIPLES TO GOVERN CREDIT CARD SYSTEM ACCESS RULES

A credit card scheme's rules governing access would be regarded as appropriate if they conform to the following principles:

(i) *Access is in terms of the services required for effective functional participation* in credit card issuing and/or acquiring i.e. effective connection into the system, as a user, and ability to transact. Any conferring of rights in respect of intellectual or other property or governance is solely at the discretion of the scheme.

(ii) *Eligibility criteria are transparent and objective*, and are no more onerous than required to protect the legitimate interests of the scheme, including in respect of safety and security, scheme stability and protection of brand and reputation. *Exercise of discretion* in relation to the granting of access is confined to substantial grounds impinging on those legitimate interests.

(iii) *Eligibility arrangements minimise costs* of administration and compliance, for both the scheme and access seekers.

(iv) *Access related fees* are fair and reasonable.

While the schemes currently do have slightly different access criteria, in every case focusing on prudential supervision status, the primary rationale for the schemes' criteria is essentially the same. The criteria are designed to maintain and encourage the financial soundness, stability and integrity of the schemes. It is ABA's view that Bankcard's access criteria embody the appropriate principles outlined (in Box 5.2) and that the Bankcard reforms illustrate that it is possible to liberalise membership criteria without losing the essential features – the financial soundness, stability and integrity of the scheme.

ABA notes that existence of the wider avenues for effective economic participation that are already available under commercial arrangements in the various schemes further reinforces this view.

ABA considers that new Bankcard rules on access well exemplify the proposed principles for access, which are also relevant for other open credit card schemes in the Australian context. However these other open credit card schemes might well satisfy these principles via different specific access rules. It is particularly important to emphasise again that it would be very difficult for the global open schemes to accept rules governing access in Australia, which if applied elsewhere might pose unacceptable risks for those schemes.

Chapter 6

The 'No Surcharge' Rule

6.1 Introduction

The 'no surcharge' rule typical of all credit card schemes prohibits merchants from charging consumers an additional amount when using a credit card to make purchases i.e. from explicitly passing on the merchant service fee to credit card purchasers. However, merchants are free to offer discounts to consumers who pay by cash, though relatively few choose to do so. This fact is significant when evaluating the merits of abolishing the 'no surcharge' rule, as it reflects the existence of relevant externalities.

The *Joint Study* criticised the 'no surcharge' rule, arguing that it distorts price signals (i.e. the relative price of purchases made by credit card and made by other means) and hence is inefficient. The *Joint Study* also argued that the 'no surcharge' rule leads to a cross subsidy from non-credit card paying consumers to credit card-paying consumers.

ABA's view is that the *Joint Study*'s conclusions on this subject were, at best, unproven. The *Joint Study* did not take into account the valid rationale for the 'no surcharge' rule, which is to reflect the fundamental positive externality of credit card networks (see below). There is a valid rationale for the 'no surcharge' rule when that externality is properly considered.

Although in practice removing this rule might not make much practical difference, which has been the experience in Europe, ABA's view is that the RBA needs to demonstrate that the 'no surcharge' rule is harmful to competition and welfare, and that removing it would lead to tangible benefits. In ABA's view, the RBA has not done this, and unless it does, under the principles of good regulation there is no case for regulatory intervention here, and the 'no surcharge' rule should be allowed to remain in place as a reasonable commercial practice.

6.2 'No Surcharge' in Practice

What would happen if the 'no surcharge' rule were removed?

The *Joint Study* assumes that, in the absence of the 'no surcharge' rule, merchants would pass on the merchant service fee to credit card users, enabling them to face price signals that "reflect the costs of providing credit card services".

This claim is not obviously true. If only some merchants passed on the merchant service fee, consumers would switch their purchases to merchants who did not. In many areas of sale of goods and services, merchants would face near certain hostility from consumers if they attempted to charge more than posted prices for credit card transactions on their own — especially given that merchants can resort to cash discounts in particular cases. No rational merchant would deter the very consumers whose 'prospectivity' as purchasers (of more expensive items, sooner) is enhanced by the 'buy now, pay later' functionality (except in the very few cases where the market structure is such that consumers would, albeit reluctantly, pay the surcharge). In other words, merchants sense the externality and reflect this by *not* surcharging.

There are other reasons why merchants might well be reluctant to pass on the merchant service fee in a surcharge. If the merchant service fee varied by credit card, then surcharging would lead to different prices not just for credit card versus non-credit card transactions but also according to the type of credit card used. This type of price discrimination would most likely be very unpopular with consumers, who would not know the price they were paying until they reached the cash register and chose their payment instrument. For example, cash and cheques too have significant costs to merchants, but the negative reaction of consumers to any suggestion that there be a surcharge for using those means of payment can readily be imagined — and understood.

It is significant that the ACCC, in its enforcement of GST implementation, has insisted that merchants display only a GST-inclusive price. The ACCC has stated that "Failing to disclose the total price to be paid is likely to mislead consumers and breach the *Trade Practices Act 1974* (Cth) (TPA)."[44] In short, it is in consumers' interest that they know with certainty the price they will pay for goods and services. This certainty would be undermined if the final price paid by consumers were to vary according to how they pay, and transactions costs would actually increase.[45]

Merchants would be further reluctant to pass on the merchant service fee for credit card transactions because these transactions reduce cash handling and cheque processing costs. As noted earlier, evidence from the Food Marketing Institute in the United States suggests that the direct cost of using cash for the average FMI member is about 1.9 per cent of each transaction.[46] This excludes theft costs. Given that every payment instrument entails transactions costs, the logic of an argument for applying surcharges for these to any one instrument is that a surcharge should apply to *every* payment instrument, or to all but a benchmark instrument. Indeed if cash is the benchmark, this could imply discounts for use of some other instruments, given that cash is quite costly for merchants. Obviously this 'logic' makes little practical sense — following it would only increase transactions costs and potentially mislead consumers — for no obvious real gain.

The *Joint Study* also appears to assume that economic efficiency would be enhanced if merchants obtained the same profit margin from sales to all classes of customers (specifically credit card users and others). As a matter of economics, this is not correct. Optimum economic efficiency (e.g. through Ramsey pricing) is often obtained when, for identical costs, different prices are charged to different consumers, or equivalently, when the same prices are charged to different consumers with different costs.

Externalities are important

This conclusion is reinforced in the case of credit card networks, which generate positive network externalities. The 'no surcharge' rule constrains merchants to pricing behaviour that creates positive spillovers for the schemes as a whole by preventing merchants from free-riding on the benefits of credit cards. A merchant who — rationally or otherwise (in

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[44] ACCC, GST Bulletin No. 13, 15 September 2000. Also, section 75AYA of the TPA prohibits conduct which falsely represents, or misleads or deceives a person about, the effect of the GST. Moreover, section 53(e) of the TPA prohibits false and misleading statements with respect to the price of goods and services. If the final price asked were to vary according to the form of payment tendered, merchants would risk contravening that section unless they posted a schedule of full prices for each item on sale — one for each type of payment instrument.

[45] It is true that, within the credit card schemes' rules, merchants can offer discounts for cash or debit payments (though few do). While such a possibility also undermines consumer certainty about final prices, offering discounts off posted prices is of benefit to consumers, as opposed to surcharges which cause them to pay more, perhaps unexpectedly more.

[46] Food Marketing Institute, *EPS Costs: A Retailer's Guide to Electronic Payment systems Costs,* 1998.

self interest terms) — charged a surcharge would share in the benefits of accepting cards (a population of cardholders) without also sharing the associated costs of card use. Indeed, if surcharging were allowed, the cost of providing credit card services would be passed back to cardholders, who would reduce their card usage below socially desirable (i.e. efficient) levels. They would no longer be certain about whether or not they would pay only the posted price, and obviously would prefer to avoid facing a higher price, certain or otherwise, and so tend not to use a credit card, and the credit card brand would be affected. If a merchant, individually, violated the 'no surcharge' rule, this would not undo the positive externality created by credit card networks. However, if they all violated the rule, this would have a negative social effect by negating the positive externality.

In effect, the *Joint Study* ignores the important role that the 'no surcharge' rule plays in (implicitly) pricing the positive externalities from credit card use and acceptance.

Transactions cost issues

Furthermore, the fact that few merchants offer discounts for cash (which is allowed under card scheme rules) indicates that for most merchants, the transaction costs of doing so exceed the benefits of any extra sales that might result.

The transaction cost argument is significant. The *Joint Study* discusses only the relative costs of payment by credit card versus payment by other means. But, in fact, each different method of payment imposes different costs on merchants. As argued above, the costs of handling cash are significant, but merchants don't charge differentially for cash transactions. If merchants accept a cheque, they take the risk that the cheque will bounce. Even within the general class of credit card payments, costs are different (merchant service fees are significantly higher for American Express and Diners Club than for the open scheme cards).

Yet, despite these differential costs, merchants rarely charge different prices for different customers depending on how they choose to pay. Abolishing the 'no surcharge' rule would thus be unlikely to lead to higher prices for credit card paying customers.

European evidence

Evidence for this comes from Europe, where the 'no surcharge' rule has in fact been abolished in the Netherlands and Sweden. Research conducted by the European Commission on the effects of this abolition found that merchants in these two countries did not surcharge for credit card transactions even though they can.

> "The main conclusions of the market studies are that most merchants do not use their right to surcharge cardholders for the use of the card. It is not established that the abolition of the ['no surcharge' rule] substantially improved the negotiating position of merchants, in particular not that it lead [*sic*] to decreased merchant fees. Cardholder's reaction to surcharging is in general negative."
>
> http://www.europa.eu.int/comm/competition/antitrust/cases/29373/studies/

As a result of these studies, the EC has decided that the 'no surcharge' rule is not anti-competitive:

> "After a thorough investigation, the Commission believes that it can take a favourable view with regard to certain provisions in the Visa International payment card scheme, which has been notified for formal clearance. One of these provisions is the so-called no-discrimination rule, a rule which prohibits merchants from charging customers an additional fee for paying with a Visa card. The Commission will publish shortly a notice in the Official Journal of the European Union, inviting interested third parties to submit their observations within a month, before reaching a final conclusion.
>
> Although it had originally objected to this rule, the Commission has now concluded that its abolition would not substantially increase competition. This conclusion has been reached in the light of the results of market surveys carried out in Sweden and in the Netherlands, where the no-discrimination rule has been abolished following the intervention of national competition authorities."
>
> www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/00/11 64|0|RAPID&lg=EN

Surcharging is also permitted in Britain, but it rarely occurs there also, indicating that merchants do not want to lose the business of their card paying customers, including possibly losing the business of cash-constrained customers who would chose to shop at a non-surcharging merchant if faced with the prospect of paying more when they pay by credit card.

In summary, it is unlikely in practice that many merchants would charge extra for credit card purchases, even if they were allowed to, because this would be bad business for them. But suppose that individual merchants could charge extra without generating a negative reaction from their own customers. Individually, no single merchant, by charging more, would negate the positive externalities of the credit card network. Thus, no individual merchant would take this negative effect into account and so would not be restrained from charging more for credit card purchases. However, collectively, if a sufficiently large number of merchants did charge extra, they would create a negative effect. Hence, there is a good case to be made for a rule which constrains all merchants from charging consumers more if they pay by credit card.[47]

'No surcharge' rule does not imply cross subsidy

Furthermore, the 'no surcharge' rule does not imply cross subsidisation, contrary to the claim made in the *Joint Study*. A clear definition of cross subsidy was given by Faulhaber (1975).[48] On this definition, a service provides a cross subsidy if that service generates more revenue than the cost of providing it on a stand alone basis. A service receives a cross subsidy if the costs saved by removing it are greater than the revenues that would be lost. The *Joint Study* has not demonstrated, on this accepted economic definition of cross subsidy, either that non-credit card paying customers provide a cross subsidy or that credit card paying consumers receive one.

The test of whether non-credit card paying customers generate a cross subsidy would be the presence of businesses who do not accept any credit cards. Since these are apparently relatively uncommon in the Australian retail sector, it would seem that the revenues generated by such hypothetical businesses would be less than their stand alone costs i.e. this test is not passed.

[47] These kinds of rules, motivated by the same concerns, occur in other settings. For example, quotas are set for individual fishermen (especially professionals) which constrain the number of fish they can catch. Without such quotas, fish stocks would be depleted, to the detriment of all. Regulations are necessary because individual fishermen will not affect the aggregate stock, and so each lacks the incentive not to catch too many fish. These regulations are not considered to be distortionary or anti-competitive; on the contrary, they are market-enabling.

[48] G.R Faulhaber, "Cross Subsidization: Pricing in Public Enterprise", 65, *American Economic Review*, 1975.

The test of whether credit card paying customers receive a cross subsidy would be to ask what would happen to merchants who stopped accepting credit cards. In all likelihood these merchants would lose far more in revenue than they would save in costs, in which case this test would not be passed either.

In essence, the fact that credit card paying customers and non-credit card paying customers pay the same price for goods or services (absent any discount for cash or debit card) does not, in itself, point to the existence of any cross subsidies, distorted prices, or inefficiencies. There are many instances in commerce where customers are charged different prices even though the costs for businesses of serving them are identical (e.g. adult and children ticket prices in cinemas, men's and women's haircuts). Equally, there are many instances where the same prices are charged to different customers when the costs of serving them are different.

In few of these instances are there genuine cross subsidies and, even if cross subsidies were present, they could not be sustained in the face of free entry into the relevant industry. Indeed, the experience in Australian banking over the past 15 years or so is a good example of relatively free market entry undermining cross subsidies. For many years, when interest rates and charges were regulated, borrowers (who paid high interest rates) cross subsidised users of transactions accounts (who paid few if any fees). These cross subsidies were sustained by restrictions on entry into banking. But with relatively free entry into banking, these cross-subsidies have had to be unwound. For example, the entry into the market of home loan providers (RAMS, Aussie Home Loans etc) who provide a stand alone service, has meant that banks can no longer subsidise other services through higher interest rates on their home loans. Consequently, the structure of home loan interest rates has fallen dramatically, and there is no significant difference in the interest rates charged by stand alone home loan providers, and providers of multiple banking services.

The same principle applies in retailing. There is nothing to stop the entry of cash or debit card only retailers from entering the market and competing away the cash and debit card paying customers of merchants who allow credit card payments. If cash/debit card customers really are cross subsidising credit card customers, they should be easily lured away. The fact that this phenomenon is not readily observed suggests that these cross-subsidies do not exist. And if these cross subsidies did come to exist, the problem would be resolved in the market place, without the need for regulatory action.

Just as cash/debit card only merchants are free to enter the market place, no existing merchants are compelled (by law or regulation) to accept credit cards. Yet most do, despite the merchant service fees. Presumably, this voluntary decision reflects competitive forces are work. If they didn't accept credit cards, they would lose customers to their competitors, and likewise if they charged more credit card sales than cash/debit card sales.

The question remains: why not let merchants voluntarily choose whether or not to surcharge, letting market forces dictate whether or not surcharging occurs. The answer to this question lies with the externality discussed above. Voluntary decisions to surcharge by individual merchants would impose a social cost on others (the other participants in the credit card payments networks) or more accurately, would remove a social benefit. The ‘no surcharge’ rule can be thought of as the equivalent of a Pigouvian tax on merchants, a common and efficient solution to the problem of aligning social benefits and costs in the presence of externalities.

Summary

International evidence suggests that if the 'no surcharge' rule were abolished, merchants would not surcharge their credit card–paying customers, except in very special cases,[49] because the transaction costs and business risks of doing so would be high. But even if this were not the case, the 'no surcharge' rule serves the important purpose of helping to 'price' the positive externalities (i.e. by aligning marginal network costs and benefits) generated by credit card use and acceptance.

6.3 ABA Position

ABA submits that a valid rationale exists for the 'no surcharge' rule. This rule stops merchants from 'free riding' on the externality benefits created by the credit card schemes i.e. the schemes create a large class of customers who would not otherwise purchase with merchants (or would buy less and later); and the rule stops merchants from 'free riding' on the benefits created by the schemes. Indeed, if it were widespread, such 'free riding' could put the schemes at risk by undoing the positive network externalities that the schemes create. The 'no surcharge' rule does not distort relative prices and create cross subsidies. In fact, the 'no surcharge' rule enforces the important positive externality created by credit card networks.

International evidence suggests that, in practice, merchants will generally not charge more to their customers for credit card purchases even if they are permitted to do so, at least in those areas of selling (higher unit value items) where the 'buy now, pay later' feature is most relevant. Thus, abolishing by regulation the 'no surcharge' rule is unlikely to have the effect that the RBA is apparently seeking i.e. consumers who make credit card purchases pay more than consumers who pay by other means.

In any case, ABA submits that the RBA has not made a convincing case that the 'no surcharge' rule is distortionary or anti-competitive. Moreover, abolishing the 'no surcharge' rule could conceivably lead to a significant problem, viz free riding by those merchants who would be prepared to risk alienating their card credit card paying customers by charging them extra. If this practice became widespread, it would endanger the viability of the credit card networks, to the detriment of consumers and merchants.

Since a valid rationale attaches to the 'no surcharge' rule, the burden of proof falls on the RBA to demonstrate that this rule has negative social effects and that its removal via government regulation would lead to significant improvements to social welfare. Until and unless the RBA can do so, the case for regulatory intervention has not been made.

ABA notes that in the RBA's 12 April media release announcing designation of the open credit card schemes, the RBA indicated that any intervention in respect of this rule would apply also to the closed schemes — yet these schemes have not yet been designated. ABA stresses again that any regulation of the setting of interchange fees in four party credit card schemes should clearly also apply to the closed schemes — again implying that they too be designated if regulation of such fee setting is contemplated for *any* four party credit card schemes.

[49] Australian taxi drivers surcharge their customers for credit card payments. (Strictly speaking, the surcharge is a "service fee".) In this case, the surcharge (10 per cent) is far more than the merchant service fee, indicating that consumers, far from facing correct relative prices, are having surplus extracted from them by sellers (taxis) with monopoly power.

Attachment

The Avoidable Cost Model: Identification of Costs and Implementation

Distinct Features or Functionalities of Credit Cards

A credit card typically has three distinct functionalities: payment, extended credit and cash advances. Each of the three credit card functionalities is described below from that perspective.

Payment functionality allows a cardholder to make a purchase and defer payment until his or her bank issues a statement and requests payment. The period of time between purchase date and payment due date is typically 35 to 40 days. The ability to buy now and pay later is a primary distinguishing functionality of a credit card product compared to other payment products (such as cash and EFTPOS). Without it, the other functionalities such as extended credit would not exist. The payment functionality allows merchants to accept credit cards without issuing their own proprietary cards and is effectively the outsourcing of credit card payment functionality for merchants, which they can opt in or out of as they see fit. For small merchants a proprietary credit card would be ludicrously expensive and historically if they desired to offer deferred payment type arrangements they often provided store credit maintained on customer ledger cards. For large merchants credit cards represent an option to outsource their existing proprietary store card or co-brand a credit card.

Although it is importantly augmented by the option of access to revolving credit, the payment functionality of a credit card is otherwise similar to the payment functionality of a charge card that is issued by three party card associations such as American Express or Diners. These are referred to as three party schemes because the same entity (the card association) usually performs the activities related to card issuing and merchant acquiring.[50]

Extended (revolving) credit allows cardholders to defer payment beyond the payment due date (subject to minimum monthly payments). This is not a functionality in which the merchant participates. Although extended credit requires that a purchase transaction occur, the decision of the cardholder to extend payment beyond the original payment due date is often made after the purchase transaction takes place. It is an arrangement between the cardholder and the card issuer. Those costs of providing extended credit which could be avoided by not offering the extended credit functionality, even if the 'buy now, pay later' payment functionality were still offered, would not be included in interchange costs. It is important to note that a number of credit related costs still would be included in that case — e.g. costs associated with evaluating creditworthiness, debt collection costs and some credit losses.

[50] As noted in the body of this submission, however, American Express at least apparently operates a four party scheme in the Australian market with independent issuers and interchange fees.

Cash advance functionality allows the cardholder to withdraw cash from an ATM or over-the-counter at a bank and charge the amount to his or her credit card. The transaction is then treated in a similar fashion to a purchase transaction (the ability to defer repayment and the ability to extend repayment beyond the payment due date). This is not a functionality in which the merchant participates. The cost of providing cash advance functionality, which could be avoided by not offering this functionality even if the payment functionality were offered, would not be included in interchange costs.

Relating Cost Elements to Functionalities

The application of the avoidable cost methodology focuses on which of the issuers' costs are related to the payment functionality. Costs related to the extended credit and the cash advance functionality that would be avoided if those functionalities were not offered are excluded from interchange costs. The costs related to the payment functionality are the starting point for the calculation of the interchange fee.

The costs related to the payment functionality can be calculated in two ways. The first is related to the stand alone costs: the costs for an organization to establish and operate a payment card with the buy now and pay later functionality. The costs incurred for adding extended credit and cash advance functionality are excluded as they would be avoided if the those functionalities were not provided.

The second method to calculate interchange costs is to determine incremental costs of providing the payment functionality if deferred payment functionality was added to other card products that had pre-existing functionality such as extended credit, cash advances, or transaction account access / EFTPOS. For practical reasons, it is not possible to offer a card with extended credit functionality only and a cash advance card for which the cardholder could obtain cash now and pay later would not have sufficient transaction volumes to make it commercially viable — it would not be offered and ATM transactions would be made with a transaction account access card or EFTPOS card. Therefore, the only viable card product on which buy now-pay later functionality could be offered (and is offered) is a transaction account / EFTPOS card. Thus the incremental costs are the costs associated with extending the functionality of a transaction account access / EFTPOS card to include the buy now, pay later functionality.[51]

Both costs would be calculated because efficient pricing theory says that, externality considerations aside, interchange fees for the payment card functionality should be no higher than stand alone costs and no lower than incremental costs.

Stand Alone Costs

The stand alone costs associated with providing a 'buy now, pay later' card are described in Table A.1 below. The table provides a summary line item listing of all card issuer cost categories (sorted by sub-function with which they are associated). The table also indicates if some portion of the issuers's costs would be avoided if the additional functionalities of extended credit and cash advances were not offered.

[51] In some markets banks offer a line of credit tied to a transaction account. It is not offered to all transaction account holders and is not an intrinsic feature of the transaction account / EFTPOS payment product.

Table A.1

PAYMENT FUNCTIONALITY STAND ALONE COSTS

Cost Category	Functionality		
	Stand Alone Payment Functionality Costs	**Extended Credit Costs Avoided**	**Cash Advance Costs Avoided**
Payment Guarantee			
Net Bad Debt Write-Offs	Yes	Yes	Yes
Net Fraud Write-Offs	Yes		
Fraud Investigation	Yes		
Collections processing	Yes	Yes	Yes
Authorisation Processing	Yes		
Referral Processing	Yes		
Chargeback Processing	Yes		
Net Chargeback Write-Offs	Yes		
Finance Cost			
Cost of Funding the Free Period	Yes		
Cost of Funding Other Outstanding Balances	No	Yes	Yes
Cost of Equity Capital	Yes	Yes	Yes
Operating Costs			
Account Recruitment	Yes		
Risk Assessment	Yes		
Transaction Processing	Yes		
Card Production and Delivery[1]	Yes		
Statement Production	Yes	Yes	Yes
Payment Processing[1]	Yes	Yes	Yes
Customer Service	Yes	Yes	Yes
Marketing and Retention Programs	Yes		
Product Development	Yes		
Association Assessments	Yes		
Centre Management	Yes		
Corporate Overheads	Yes	Yes	Yes
GST and Statutory Costs	Yes		

[1] Includes related branch costs.

Classification of Cost Categories as Included in or Excluded from Stand Alone Costs

All of the issuer costs, with the exception of funding the outstanding balances beyond the payment due date, are costs that the Issuer would incur in providing a buy now, pay later payment card. For several cost categories, a higher level of costs would be incurred if extended payment and ATM functionality was included with the card. These instances are described below.

Credit losses and collections

When a cardholder defaults on payment, the outstanding balance may include both purchases and cash advances made in prior periods (and that have been revolved) and purchases and cash advances made during the current period. Therefore the costs associated with credit losses and collections relate partially to the payment functionality of the credit card and partially to the other functionalities. As such, some portion but not all credit losses and collection costs are included in stand alone costs. The portion that would be included is credit losses and collection costs associated with purchases made in the period just prior to the cardholder defaulting on payment.

Cost of equity capital

A credit card business requires equity capital. In cases where the credit card business is part of a large commercial enterprise (such as a bank or in the case of a store card, a retailer), the equity capital requirements are implicit in the enterprise's overall capital structure.

Each aspect of the credit card business (i.e. each functionality) requires capital. Therefore the portion associated with offering the payment product functionality is included in interchange costs.

Sunk costs

From the mid 1970s to the early 1990s, banks invested considerable amounts of money on rolling out the credit card networks which ran at a loss, both in accounting and in economic terms. In economic terms, this investment can be seen as an asset on which a reasonable return should be able to be earned. (As discussed in Chapter 3, the apparent accounting profits currently being earned on credit cards networks are larger than the economic profits, because the former, but not the latter, exclude the capital costs of this sunk investment.)

It is of course difficult to quantify precisely these sunk costs and hence the amount by which the costs of interchange should be augmented over identifiable accounting costs. At the very least, however, recognition of this category of costs in principle would imply that both the incremental and stand alone accounting cost estimates are a lower bound on the corresponding economic costs. From a practical perspective, sunk costs are typically reflected in the return on equity capital that is earned to recognize the risk of the business and the life cycle return on capital requirements.

Operating costs

Virtually all of the issuers' operating costs would be incurred if only the payment functionality was offered. There are several instances in which those costs might increase if extended credit and ATM functionality was offered: statement preparation, payment processing and customer service. For example, postage for a statement that contained only a revolving balance would not be part of the stand alone costs of offering the payment functionality. The costs that are incurred for revolving balances only or ATM cash advance transactions only are not included in stand alone costs.

For each of the cost categories in Table A.1, the following cost elements would be included:

- **Staff costs** of personnel directly associated with supporting credit card activities. These costs would include salary, overtime and fringe benefits but would exclude overhead allocations;

- **Facilities costs** for credit card department personnel and equipment including rent/lease/depreciation, utilities and maintenance;

- **Bank branch costs** for delivering credit cards to cardholders and receiving payments from cardholders for remittance processing;

- **Systems and data processing costs** for operating and maintaining hardware and software required for credit card applications. These costs include charges for CPU/computer resource usage, disk storage, communications, software maintenance, equipment maintenance, and so forth. Also included are leasing/depreciation/amortisation expenses associated with capitalised hardware and software used to support credit card activity;

- **Supplies and consumables expenses** such as forms, postage, and so forth that are incurred for credit card products;

- **Third party costs** such as those incurred for outside contractors (entities unrelated to the Issuer) that provide various services in support of credit card activities; and

- **Other costs in direct support** of the credit card business that may not fall into the above categories.

Incremental Costs

The incremental costs for the buy now, pay later payment functionality are those costs that would be incurred if that functionality was added to an existing card product. For practical purposes that would be the inclusion of the functionality to a transaction account access / EFTPOS card. A comparison of the costs that would be included as stand alone costs and incremental costs is provided in Table A.2 below.

Table A.2

STAND ALONE VS INCREMENTAL COSTS

Cost Category	Cost Categories Included	
	Stand Alone Costs	Incremental Costs
Payment Guarantee		
Net Bad Debt Write-Offs	Yes	Yes
Net Fraud Write-Offs	Yes	Yes
Fraud Investigation	Yes	Yes
Collections processing	Yes	Yes
Authorisation Processing	Yes	Yes
Referral Processing	Yes	Yes
Chargeback Processing	Yes	Yes
Net Chargeback Write-Offs	Yes	Yes
Finance Cost		
Cost of Funding the Free Period	Yes	Yes
Cost of Equity Capital	Yes	Yes
Operating Costs		
Account Recruitment	Yes	Yes
Risk Assessment	Yes	Yes
Card Production and Delivery	Yes	No
Transaction Processing	Yes	Yes
Statement Production	Yes	Yes
Payment Processing	Yes	Yes
Customer Service	Yes	Yes
Marketing and Retention Programs	Yes	Yes
Product Development	Yes	Yes
Association Assessments	Yes	Yes
Centre Management	Yes	Yes
Corporate Overheads	Yes	No
GST and Statutory Costs	Yes	Yes

As can be seen from Table A.2, most costs related to the payment functionality of a credit card are incremental to the cost of providing a transaction account access card.

Derivation of the Interchange Fee from Stand Alone and Incremental Costs

The stand alone and incremental costs calculations form the foundation for setting the issuers' prices for recovery the costs. This involves a series of calculations as described below.

Interchange costs that are not related to domestic purchase transactions are excluded. These costs are typically uniquely identifiable (e.g. international chargebacks) or are the same for domestic and international purchase transactions (e.g. transaction processing) and can be assigned to domestic purchase transactions based on transaction volumes.

Interchange costs for all participants will be compared to a benchmark and the interchange fee will be based on benchmark costs (see below). Individual participant data that are significantly above or below the range of responses will be excluded from subsequent calculations By using benchmark costs, high cost issuers will be motivated to reduce costs or find other sources of revenue to recover costs. Issuers with lower than benchmark costs will be motivated to keep their costs low and make investments that will enhance their credit card business.

The issuers have two sources of revenue to recover their costs. One is the interchange fee that is charged to the acquirers. In the case of on-us transactions, the costs are directly reimbursed to the issuer from the merchant via the merchant fee because the issuer is also the acquirer. For those transactions, the issuer is effectively paying an implicit interchange fee to itself. In the case of not-on-us transactions the interchange fee is an explicit fee charged by the issuer to the acquirer, who has the direct relationship with the merchant.

The second source of revenue is the cardholder in the form of cardholder fees (annual fees, late fees etc). To the degree that the issuer receives revenue from the cardholder to recover costs, it does not need to recover those costs from the acquirer by means of an interchange fee. Therefore, it would be appropriate for cardholder revenues to be deducted from calculated issuer costs to determine the net interchange costs that are to be included in the regulated interchange fee calculation. These cardholder revenues are those that are connected with the payment functionality of the credit cards, and so exclude interest margins, *inter alia.*

This would be done for the calculation of both stand alone costs and incremental costs.

It should be emphasised that this procedure is not the same as in the Residual Cost Recovery methodology. In that methodology, the interchange fee was derived by subtracting total cardholder revenues from total issuer costs. Under the avoidable cost methodology, interchange fees are derived by subtracting those cardholder revenues associated with payment functionality from payment functionality costs.

Resulting interchange fee calculation

After the calculation described above, there will be two net interchange costs: one based on stand alone costs and one based on incremental costs. Because these are likely to be similar the possible range of the interchange fee is likely to be small. The efficient interchange fee will lie between the two points.[52] The decision as to the specific interchange costs will be based on an assessment of market conditions. For example, if the economy is weak and merchants are not performing well, the point selected is likely to be at the lower end of the range.

Assuming the credit card payment network members systems can accommodate it, the interchange costs are divided between (a) domestic purchase value related costs and (b) transaction volume related costs. The interchange fee is calculated as a percentage of dollar turnover plus a fixed amount per transaction. If the systems cannot process a split fee, the costs are converted to a single ad valorem rate.

[52] Because of the externality, it is not likely to be close to be the lower bound of the range.

Accounting Manual

To ensure the methodology is consistently applied across all members, an accounting manual will be prepared that provides the detailed process for collecting appropriate costs. As needed, a third party will be engaged to work with the members to ensure consistent application of the accounting manual and to perform the subsequent data calculations.

The accounting manual will identify how costs that are different between credit card payment networks (Bankcard, MasterCard and Visa) will be captured and included in the interchange cost calculation. In this manner different interchange costs and fees can be calculated by payment network as appropriate.

To the degree possible, the source data for calculating the interchange costs will be the official books of record of the member, subject to verification and audit by a third party. All working papers will also be subject to third party review as required.

Implementation Issues

A number of implementation issues will need to be resolved, particularly if the calculated interchange fees are significantly different from those currently in existence. If so, ABA recommends that the new system be implemented with a phase-in period to give issuers time to adjust.

Choice of cost benchmark

This is an important issue. If it is set as the lowest of all issuer's costs this will seriously disadvantage those issuers who are too small to take advantage of scale economies. ABA suggests that an appropriate benchmark, which would give ample incentive for issuers to lower their costs (or keep them low), would be the weighted average costs of all surveyed participants — typically not including issuers with amongst the highest costs. This benchmark would provide an aggressive target for issuers whose costs were above the average while minimising the adverse impact on small issuers without the economies of scale of the large issuers.

Frequency of review

A complete review of interchange costs for each relevant credit card payment network should be conducted, say, about every three years. In addition, issuer specific reviews will take place as deemed relevant by the scheme members (e.g. the need to determine an interchange fee for new transaction types such as Internet payments).

Incentive regulation issues

It is now common practice in regulatory settings to provide regulated firms with the incentive to lower their costs below benchmark levels during the regulatory period, by allowing them to keep the associated increase in profits. In other words, if issuers manage to lower their costs below benchmark levels during the regulatory period, there is no corresponding decrease in interchange fees during that period. The time to review benchmark costs, and associated regulated interchange fees, is at the next scheduled regulatory review.

Interchange fees by transaction type

Interchange fees are determined by interchange costs and those costs often vary by transaction type (paper, electronic, cardholder not present and so forth). For example, the payment guarantee that the issuer provides the acquirer for a cardholder present transaction is limited for cardholder not present transactions with no signature (often referred to as mail order, telephone order or MOTO transactions).[53] Interchange fees will be calculated by transaction type in instances for which (1) transaction volumes (2) the cost of collecting the supporting data and (3) the expected difference in interchange costs warrant different interchange fees by transaction type. In this manner, an interchange fee applicable to MOTO transactions would be calculated. The process for collecting the appropriate costs would be included in the Accounting Manual and appropriate methods would be documented for conducting the required calculations.[54]

Scope for commercial flexibility

As discussed earlier, ABA considers that principles determined by the RBA to govern interchange fee setting should involve the minimum degree of prescription and leave maximum scope for commercial flexibility. Apart from differentiation of interchange fees by transaction type in respect of objectively based and significant differences in cost (discussed above) the scope for possible differentiation of fees among customer (merchant) segments should be left to the commercial parties.[55] This would not only be consistent with dynamic aspects of efficiency but be potentially positive for allocative efficiency, tending to reflect relative price sensitivity of different segments.

Treatment of future investments that will impact costs

Review and revision of interchange fees every three to five years will typically be adequate to provide cost recovery of major investments. When interchange fees are calculated, an assessment will be made of anticipated investments and changes in the issuers' costs compared to the data collection period. Any significant variation will be included in the calculation of interchange costs, clearly defined and documented for third party review.

[53] The cardholder can deny the charge and without a signed transaction slip the issuer typically charges the transaction back to the acquirer who in turn charges the transaction back to the merchant.

[54] There is a total cost to the issuer to support purchase transactions. If interchange costs are calculate based on transaction type, the aggregate cost for all transactions (transaction volumes times interchange costs by type summed for all transaction types) cannot exceed the issuers' total interchange costs.

[55] Any such differentiation would need to be exercised consistent with the avoidable cost based average fee for the class of transactions involved.