



15 March 2002

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By email: creditcards@rba.gov.au

Dear Dr Veale

COMMENTS ON CONSULTATION DOCUMENT

This letter provides the comments of the building society industry on the Consultation Document issued by the Reserve Bank outlining proposed reform of credit card schemes in Australia. I anticipate that one or more individual building societies may also make a submission.

Two building societies have their own credit card programs and an increasing number of other societies are agents for credit card issuers and therefore have an indirect interest in the reform proposals. The majority of the later societies are agents for American Express. The exact impact of the reform process on three party card schemes is yet to be determined.

In the RBA Consultation Document, two standards are proposed. One standard applies to the determination of interchange fees while the other considers the ability of merchants to recover the costs of accepting credit cards. An access regime in regard to credit card scheme participation is also proposed. It is noted that there is no established date that the proposed standards and access regime would become effective.

Public Interest and the Role of Smaller Issuers

Many smaller institutions issue credit cards and are able to compete very effectively in the markets they target. Credit cards allow such institutions to compete with the larger banks by offering a full array of products and building better longer term customer relationships. Smaller issuers may appear "less efficient" than the larger issuers because the economies of scale but smaller issuers are in fact technologically efficient given their size.

The reforms proposed by the RBA have been developed within the overall mandate of the Payment System Board to promote efficiency and competition in the Australian payments system, consistent with overall financial stability. The proposed standards have been developed under authority of the Payment Systems (Regulation) Act 1998 (PSRA) that allows the RBA to set standards for the safety and efficiency of the payments system. Standards can be established if the RBA determines they are in the public interest.

The public interest is defined in the PSRA as pertaining to financial safety for participants; efficiency; competitiveness; and not materially increase risk of the financial system.

Using the powers provided by PSRA, the RBA will impose a Standard for Designated Credit Card Schemes, the objective of which is to promote efficiency and competition. A Draft Standard on wholesale fee setting is included in the Consultation Document. Of greatest concern to smaller scheme issuers such as building societies is the method proposed for determining interchange fees. Clause 10 of the Draft Standard requires that:

"The interchange fee for each type of specified transaction must be calculated as a weighted average of the nominated Scheme participants' eligible costs for that specified transaction. The weights to be used are the shares of each nominated Scheme participant in the total value of the transactions undertaken on credit cards issued by all the nominated Scheme participants in the financial year to which the data relates."

Application of the weighted approach will result in costs of the four major banks determining the interchange fee for all card issuers and acquirers. This is a result of the domination of credit card issuing and acquiring by the four major banks (refer Figure 2.6 of the RBA and ACCC study "Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access").

The problem for institutions with small card programs is exacerbated if the cost of capital and sunk costs must be recovered through other revenue sources as proposed by the RBA and not through the interchange fee.

We are left with a position that four institutions will have the credit card market to themselves and it will be most unlikely that new entrants will be able to establish a business case for participating in credit card programs.

This hardly seems to fit with a Standard based on competition and supposedly in the public interest. The proposed RBA reforms should not adversely impact smaller issuers just because they are small.

As an aside, application of the same methodology to Visa debit card issuers would result in a different weighted average since the four major banks do not issue Visa debit cards.

Merchant Pricing for Credit Card Purchases

The RBA's proposed standard would not allow schemes or acquirer rules or actions to prohibit a merchant from recovering the cost of accepting a credit card from the credit card cardholder. This is a particularly contentious issue for international card schemes operating in Australia.

The RBA argues that price signals about the costs of different payment instrument's are distorted to customers. "Since they do not bear any of the costs imposed on merchants when they use their credit card, cardholders have no incentive to make an efficient choice between payment instruments."

A number of arguments have been advanced by supporters of the no surcharge rule. We are of the view that the interchange fee would be less contentious if merchants had the freedom to set their own prices for different payment types. We would argue that market forces based on clear pricing signals would be sufficient to drive reform.

While pricing of wholesale transactions must be transparent, much of the argument as to what can and should be included in the pricing and the inappropriate use of weighted averages would be less important. Accordingly, conditional support is provided to abolishing the no surcharge rule.

Wholesale Pricing Principles

While we submit that there should be less emphasis on wholesale pricing, wholesale pricing principles for all card based payment products should provide a consistent pricing framework. The framework should allow for differences in functionality offered, differences in cost structures of the card issuers and differences in cost levels between card products.

It was somewhat surprising that the interest-free period was not included in the interchange standard. The interest-free period, i.e. the funding cost from the transaction date until payment is made or interest begins to accrue, is a significant differentiating feature of credit cards compared to debit cards.

The result of excluding the interest-free period may be to significantly reduce the availability of a "buy now, pay later" payment product in Australia, except as offered by major retailers. The likely beneficiaries of the proposed interchange standard may be the large retailers that issue proprietary cards to a large customer base. Those retailers will have no restriction in regard to interchange fees and merchants' fees since they don't apply to merchants store cards. The merchants can wave surcharging and recover the costs of their store cards from all customers.

Concurrent and Consistent Reform Across Card Payment Products

While clearly building societies will be directly and indirectly affected by the reform of credit card schemes in Australia, the greatest impact will be felt with changes to Visa debit interchange arrangements and reform of EFTPOS (debit card) interchange arrangements. The overriding principle frequently reiterated by building society representatives is that credit card reform must be closely linked to appropriate and consistent reform of all card based products.

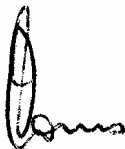
Financial institutions typically offer a variety of card payment products. These include four party credit cards, three party charge cards for example AMP and signature debit based cards such as Visa debit and EFTPOS. Some institutions are also significant acquirers and some such as building societies are not.

Reform of an individual card product is likely to have a different impact on a financial institution than that following the reform of all card products. Therefore, reforms anticipated or encouraged by the RBA (including credit cards, Visa debit and EFTPOS) should be determined and implemented concurrently to avoid unnecessary market and institutional disruption.

Building societies welcome comments from the RBA which indicated the Bank's acceptance of concurrent and consistent reform.

We look forward to working with the RBA in the future.

Yours sincerely



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