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The Impact of the RBA's Regulation of Open Credit Card Schemes

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Introduction

From early 2003, the Reserve Bank of Australia introduced new regulations for credit card schemes in Australia. Significantly, the regulations apply to Visa, MasterCard and Bankcard, but not to American Express or Diners Club.

Overall, the evidence of their impact suggests that the new regulations have had either a negligible or, more likely, a slightly negative effect on consumer welfare.

In introducing the changes, the Reserve Bank claimed the regulations would promote 'greater transparency, efficiency and competition in the Australian payments system, to the benefit of the Australian community as a whole'. However, Visa and others questioned the validity of the Reserve Bank's expectations, saying that the regulations would not produce the improvements in efficiency hoped for and, in any case, that there was no need for the type of intervention contemplated by the Bank. Visa thought that self-regulation in the credit card industry was already working well in meeting the needs of customers and merchants and in protecting the integrity of credit card schemes.

In late 2004, Visa commissioned the Network Economics Consulting Group (NECG) to test whether the 'real world' outcomes validated the predictions made by the Reserve Bank and Visa about the effects of the new regulations.

While it will take some time still to properly assess the long-term costs and benefits of the regulations, NECG used a variety of recent data and information to reach some early conclusions.

In summary, the NECG found that:

- Merchants are paying lower bank fees. Most report that this has either not resulted in a change to their operations or that they are increasing profits rather than passing the lower costs through to consumers;
- Visa, MasterCard and Bankcard cardholder benefits and rewards have declined while fees and charges have, in many cases, increased;
- The regulations have provided American Express and Diners Club with a clear competitive advantage;
- Banks have found ways to limit the regulations' impact on their portfolios;
- Only a small proportion of merchants surcharge customers who use credit cards;
- Consumers do not feel they have benefited from the regulations; and
- Despite the lower fees for merchants, the net impact of all the changes appears to have increased consumer prices slightly.

Visa believes, therefore, that the Reserve Bank regulations have not had their intended effect, and that consumers – including the majority of credit card customers – are not benefiting from the new regulations. Visa will continue to monitor the impact of the changes over the coming years and will argue for sensible changes to remedy some of their unintended negative consequences with a view to achieving a level playing field, consistency and transparency.

Fundamentals of the Credit Card Systems

Open Credit Card Schemes

Visa and MasterCard operate 'open' credit card schemes that involve four parties:

- **Cardholders** – customers who use a scheme that offers wide acceptance of their credit cards, has cardholder benefits/rewards, and guarantees payment;
- **Card issuing institutions/banks ('issuers')** – compete with each other to attract cardholders, set customer card fees and interest rates, and offer cardholder benefits/rewards programs;
- **Merchants** – that accept a customer's card are guaranteed payment by acquirers. Merchants pay service fees (MSFs) to acquirers and under the new regulations they can also apply a surcharge to customers who pay by credit card; and
- **Merchant acquiring institutions/banks ('acquirers')** – compete with each other to offer banking services to merchants. They set and collect MSFs, and guarantee payment to merchants.

Closed credit card schemes

In contrast, the 'three-party' closed credit card schemes operated by American Express and Diners Club have traditionally involved customers, merchants and a single organisation that plays both the issuer and acquirer roles.

However, there are also arrangements between closed schemes and banks that issue cards on their behalf. Despite there being four parties to these arrangements, the Reserve Bank has so far decided that they should not be subject to the regulatory regime that is imposed upon other payment card systems.

Interchange fees

In the open credit card system, interchange is the fee paid by merchant-acquiring banks to card-issuing banks, each time a card is used for payment.

The interchange fee provides a means for merchants to contribute to the costs of issuing cards and processing charges to a cardholder's account. These fees mean that issuing banks can afford to limit the costs of cards to customers and add features and benefits to their card scheme packages, such as rewards programs. Both merchants and cardholders benefit from the use of cards.

Specifically, increased card usage benefits merchants who accept credit

cards, by increasing sales, reducing risk¹ and guaranteeing prompt payment².

Interchange fees are not pre-determined; the market sets them. If the fees are too high, acquirers will have difficulty persuading merchants to participate in the system. If the fees are too low, issuers cannot afford to create a system that includes enough benefits/rewards to attract new cardholders. Acceptance by each side of the market increases the benefits to the other – the more consumers using cards, the more merchants' costs can be spread while the more merchants that accept the cards, the more convenient use is for cardholders.

While the closed card schemes do not set an explicit interchange fee, there is no difference in substance to the operation of interchange in the open card schemes. For the closed card schemes, the balance between the charges and benefits that apply to cardholders and merchants determine the implicit interchange fee. Thus, for example, if a closed card scheme raises its MSFs in order to fund more attractive packages for cardholders, this would be equivalent to an increase in the interchange fee in an open scheme.

¹ Card scheme rules generally protect merchants from fraud where proper card acceptance procedures are followed.

² Visa and its members generally process payments within 24 hours.

The Regulations Introduced by the RBA

The RBA claimed that the regulatory changes it introduced would promote greater economic efficiency through a combination of constraining the fees that operators could set, allowing merchants to charge customers more for using credit cards and making it easier for new players to enter as issuers and acquirers.

The Regulations:

- Require credit card companies to set interchange fees at levels that reflect 'attributable' costs;
- Remove the scheme rule that had prohibited merchants from surcharging customers who use a credit card; and
- Allow so-called 'specialist' credit card institutions to become open card scheme members.

While the new Reserve Bank regulations do not affect the closed card schemes, in negotiations leading up to the changes, American Express and Diners Club agreed that they would remove their 'no surcharge' rules.

In market economies, direct intervention by the authorities is usually only contemplated if there are strong signs of market failure, and/or when any regulation is likely to deliver continuing and tangible benefits to a nation's 'social welfare'. Intervention is not costless and 'government failure' can present as much of a risk as market failure. Visa has argued that there was insufficient evidence of market failure to justify

regulatory intervention. Moreover, in a very complex system such as the payments system it was unclear whether intervening in one aspect of the system would have positive or negative effects for the system as a whole.

The following summarises the main evidence to date on the impact of the regulations. It concludes by judging that the regulations appear to have not delivered the promised benefits – and certainly not to the extent that would warrant direct intervention. In fact, on balance, the regulations may have had a small negative impact on consumer welfare. The evidence relates to the impact of the regulations on MSFs, the level of surcharging by merchants, consumer prices and the nature of competition. In addition, the survey evidence sheds light on aspects of merchant behaviour and, in turn, whether the regulations are likely to affect the market in the way that the RBA had anticipated.

Merchants' Attitudes to Credit Cards

A recent survey conducted by the independent research house, Cannex, explored how merchants felt credit cards affected their businesses. The picture to emerge was a strongly positive one. Three-quarters of merchants felt that accepting credit cards contributed positively to growth in their business through making it more convenient for customers to purchase from the merchant and do so in a secure payments method (see Table 1).

Table 1: Role of Credit Cards

Statement	Strongly Agree (%)	Agree (%)	Disagree (%)	Strongly Disagree (%)	Net Positive Effect (%)
Convenience of credit cards makes it easier for customers to shop with me	4	62	6	1	59
Credit cards provide a lower risk payment method	8	58	10	2	54
Accepting credit cards has a positive impact on business growth	11	55	15	1	50
Customers increase total spend because of access to credit	16	43	27	2	30
Customers would spend the same amount regardless of whether I accept credit cards	8	33	40	11	(10)
Accepting credit cards is an unnecessary expense	11	30	55	9	(33)
Accepting credit cards does not have a positive impact on business growth	8	17	57	16	(48)

Source: Cannex 2004, *Card Reforms in Australia, Monitoring of Market Effects, November, p.33*

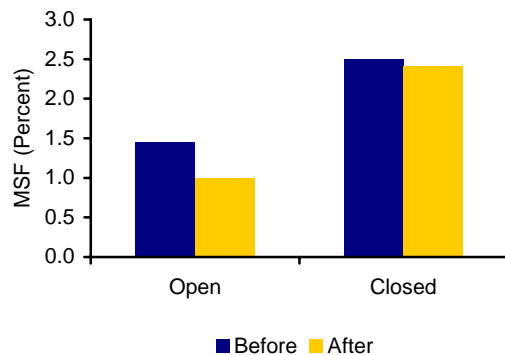
Importantly for the examination of the impact of the regulations, the Cannex survey and other recent research highlights the notion that consumers – not merchants – drive growth in the credit card industry. Merchants tend to respond more to customer attitudes than direct price signals. Consequently, those regulations that rely on merchants to drive behaviour by affecting the costs to merchants of accepting certain cards may be less effective than if consumers were directly targeted. This, in fact, shows through in some of the following evidence.

Lower fees charged to merchants

Since the interchange fee changes were introduced, the Reserve Bank estimates that, on average, interchange fees have reduced from 0.95 percent of transaction value to 0.55 percent.

Open card scheme MSFs have also declined by an equivalent amount (from 1.41 percent to 0.99 percent). In contrast, closed card scheme MSFs have fallen by considerably less and remain much higher than those for the open card schemes.

Chart 1: Merchant Service Fees



Source: RBA with NECG calculations

The Regulations Provide a Clear Competitive Boost to American Express and Diners Club

The difference in the MSF reductions for the two schemes suggests the regulations have seriously affected competition between open and closed card schemes. Yet, for the two systems to remain competitive, closed scheme MSFs would have to decline by at least as much as open card scheme MSFs given that the closed card schemes' MSFs were so much higher initially. It should be remembered that in the credit card market the ability to charge higher MSFs leads to an ability to offer cardholders greater rewards. Higher costs on one side of the two sided network results in a competitive advantage on the other.

The boost to the competitive position of American Express and Diners Club was widely forecast. One reason for the competitive advantage is that, contrary to the RBA's predictions, merchants have not forced close card schemes to match the open card scheme MSF reductions. As a result, the closed card schemes have been able to maintain cardholder benefits and embark on fresh marketing campaigns, including in partnership with some of the major banks. Indeed, if closed schemes expand their market share because of their improved competitive position, they may not have to reduce cardholder benefits to maintain profit levels even if their MSFs continue to reduce marginally.

Also, there is no evidence of merchants ceasing to accept American Express or Diners Club cards despite their higher costs.

Cardholders – Open Card Scheme Benefits and Rewards Have declined

In contrast, since, the regulations were introduced, the reduction in interchange fees has led to fewer benefits going to open scheme cardholders. The extent of the decline varies between issuers.

Cannex research points to relatively modest changes in some credit card fees and charges. Cannex also confirmed that

a number of reward programs have been significantly reduced or capped.

RBA statistics show that bank fee income from credit cards increased by 38 percent in 2003 – \$164 million more than the previous year and by 30 percent in 2004, up \$180 million on 2003. While some of the increase could relate to extra income from credit card transactions, other fees (such as late payment fees) and tightened collection procedures, may have also contributed.

In summary, it appears that interchange fee reductions have led to a clear shift in the ability of open card schemes to offer benefit/reward packages to cardholders that are attractive compared to the closed card scheme packages while at the same time cardholder fees applying to open card schemes have increased.

Banks – Limiting the Regulations' Impact on their Portfolios

The major banks have used various ways to limit the regulations' impact on their own portfolios. Some adjustments by the banks are consistent with the RBA's aims – for example, to have fewer cardholder reward benefits and increased card fees.

However, three major banks have formed special partnerships with unregulated closed card schemes. These have higher MSFs than open scheme MSFs, and have the capacity to offer appealing cardholder rewards and to increase their credit card market share. To date the marketing of these jointly issued cards has been directed toward existing high value open card scheme customers.

Surcharging – A Small Proportion of Merchants Surcharge Regularly

Removing the No Surcharge Rule

The Reserve Bank wanted to encourage merchants to charge separately for the costs of delivering their services, including the associated costs of different 'payments instruments' (cash, cheques, direct credit, BPay EFTPOS, and credit and debit cards).

For this reason, the Bank's regulations removed the no surcharging rule, so that merchants could pass on credit card payment costs to cardholders.

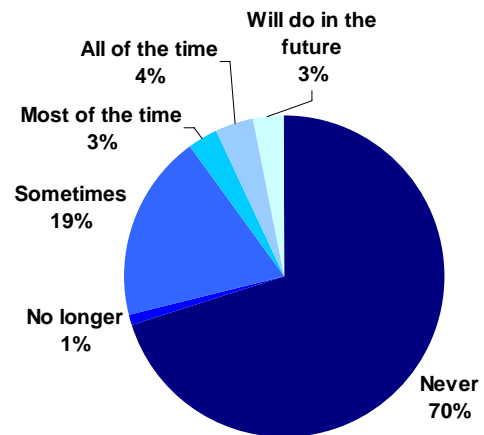
Four recent independent surveys shed some light on the extent and nature of surcharging that has flowed from the new RBA regulations.

How Widespread is Surcharging?

The different surveys report a low incidence of surcharging although there is divergence between the surveys. At the low end, a survey conducted by East & Partners of 2,277 merchants in November 2004 found that just 2.3 percent of merchants had chosen to surcharge.

In contrast, the Cannex data suggests that 26 percent of Australian merchants surcharge at least some of the time, although only seven percent surcharge regularly. Surveys conducted by UMR and by Griffith University's Services Industry Research Centre gave results in between these extremes.

Chart 2: Survey - Does Your Company Surcharge Customers for Using Credit Cards?



Source: Cannex 2004, *Card Reforms in Australia, Monitoring of Market Effects*, November, p.29

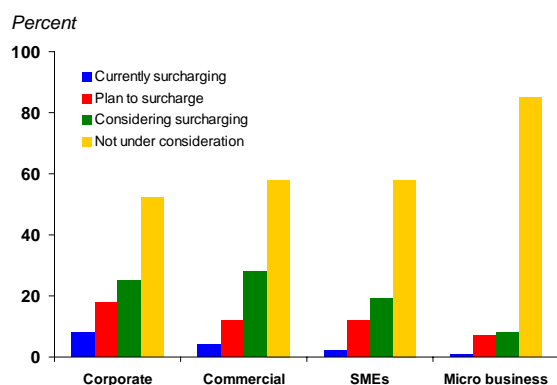
Taking the results from the four surveys as a whole, it is reasonable to conclude that between five and 10 percent of merchants have chosen to surcharge regularly. A larger group of merchants is considering doing so in future, but their lack of enthusiasm for this probably reflects the marketplace reality that customers react adversely to surcharging.

The low adoption of surcharging reflects a strongly adverse response by consumers. A UMR survey of consumers found that 58 percent were less likely to shop at a retailer that surcharged while only three percent were more likely to shop there.

Who is Surcharging?

Anecdotal evidence also indicates that when surcharging does occur, it tends to happen in areas of the economy where merchants have greater market power, for example by airlines and Telstra. This view is supported by evidence from both the East & Partners and Cannex surveys which highlights that smaller merchants are much less inclined to surcharge than larger merchants. Presumably, the larger merchants will tend to have greater market power.

Chart 3: Few Merchants Have Chosen to Surcharge



Source: East & Partners 2004, December

How Much is Being Surcharged?

The Cannex and Griffith University surveys indicate that most merchants who do surcharge set the rate between one percent and three percent of the transaction's value. This is roughly double the level of the MSFs for the open credit card schemes.

This level of surcharging supports predictions made by Visa and others that, when surcharging occurs, it tends to be where merchants are in a position to take at least part of the surplus.

Moreover, while the level of surcharging was higher for closed card schemes than for the open card schemes, the gap was much narrower than the difference in MSFs. Also, the Cannex data show that, contrary to the RBA's prediction, merchants do not differentiate between schemes because of the actual cost of accepting cards. Cannex found a virtually identical pattern of surcharging by merchants for both closed and open schemes.

Table 2: Survey - Does Your Company Surcharge Customers for the Use of Credit Cards?

	Open Schemes	American Express	Diners Club
Never	70	69	70
Sometimes	19	19	19
Most of the time	3	4	4
All of the time	4	3	3
Will do so in the future	3	4	3
No longer	1	1	1

Source: Cannex 2004, Card Reforms in Australia, Monitoring of Market Effects, November, p.29

Consumer Costs Appear to be Rising

Importantly, the focus of the new regulations was mostly on improving consumer welfare. The evidence suggests this has not occurred. A survey conducted by UMR indicates that consumers overall – not just cardholders – feel they have not benefited, and there is other evidence that supports their view.

The RBA has estimated that the lower MSFs had the potential to reduce consumer prices slightly, by between 0.1 and 0.2 percent, as long as merchants passed through their reduced costs to consumers. The evidence, however, paints a different picture.

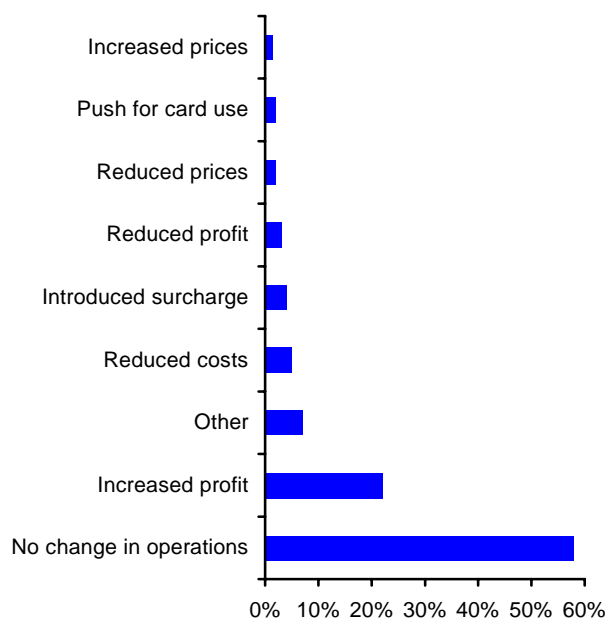
In particular, overall direct costs borne by consumers appear to have risen. The regulations have produced higher fees on cards, reduced cardholder rewards, some limited surcharging, and signs of a shift towards the costlier closed card schemes. In total, these effects are likely to outweigh the potential reduction in consumer prices that would occur even if merchants were to fully pass through the lower MSFs into lower prices.

The likelihood that the overall costs that consumers face may have risen, in contrast to the RBA's intention, is reinforced by the fact that merchants indicate that they have not passed on the lower MSFs to consumers. The Cannex survey asked merchants who accept credit cards whether the MSF changes had directly affected their operations, and to identify any changes.

While lower interchange fees have flowed through into generally lower MSFs, the Cannex data show very few merchants reducing prices in response. Rather, where the changes were identified as having an impact on operations, the most common response was that the lower MSFs had been used to increase profits.

So, it is difficult to see how the direct effects of the RBA's regulations will leave the average consumer better off.

Chart 4: Impact on Business as a Result of Fee Changes – Open Card Schemes



Source: Cannex 2004, *Card Reforms in Australia, Monitoring of Market Effects*, November, p.29

Overall – A Likely Negative Impact

Despite some predictions that the new regime would bring about radical change, the early signs are that any changes will only emerge gradually. So far, the main change is the competitive advantage that the regulations have provided to the closed card schemes.

Any other potential changes appear unlikely to generate the nature and scale of benefits projected by the RBA. In fact, the evidence suggests that the new regulations have had either a negligible or, more likely, a slightly negative impact overall on social welfare.

