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Interchange Regulation: Lessons Learned From RBA Intervention in Australia

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MasterCard Worldwide

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Interchange Regulation: Lessons Learned From RBA Intervention in Australia

In the last few years, government authorities around the world have started to pay attention to the regulation of credit card interchange fees. Prior to such regulatory attention, credit card schemes were largely self-regulated, albeit subject to close antitrust scrutiny and intense competitive pressure. Leading the drive to regulate the interchange fee has been the Reserve Bank of Australia (RBA).

The RBA intervention in interchange was initiated by the report of the Wallis Financial System Inquiry in 1997, which recommended that the credit and debit card interchange systems be reviewed by the Australian Competition and Consumer Commission (ACCC). In 1999, the RBA and the ACCC, announced a joint study into, amongst other things, interchange fees and membership criteria for credit card schemes.

In 2000, the RBA and ACCC published "Debit and Credit Cards Schemes in Australia—A Study of Interchange Fees and Access." The report asserted that (i) interchange fees were not in line with costs, (ii) competitive pressures were insufficient to bring interchange fees to reflect costs, (iii) no surcharge rules were undesirable, and, (iv) access to membership to the credit card schemes was too restricted. Following the publication of the report, ACCC recommended that the RBA use its power to regulate the credit card systems in Australia. In 2001, the RBA brought the payments systems operated by MasterCard, Visa and Bankcard, all four-party payments systems, under its regulation. The RBA chose not to regulate American Express and Diners Club because there are no explicit interchange fees in these three-party payments systems. In 2002 the RBA announced its regulation; which focused primarily on the adoption of a new approach to interchange calculation, the elimination of the "no surcharge rule," and changes to Australian banking laws to facilitate greater access to four-party schemes.[1]

Legal challenges to the RBA regulations by MasterCard and Visa were unsuccessful and the regulatory measures came into effect in 2004. Almost three years have passed since the RBA regulatory measures were implemented, and there is now sufficient data to assess the impact of some of these measures. As will be detailed, not only have these regulatory measures been ineffective in achieving the intended results as stated by the RBA, market data also suggests that a number of very negative unintended consequences have emerged. These outcomes can only be described as regulatory failures; and Australia is now saddled with a more expensive payments system that delivers fewer benefits to cardholders, distorts market competition, suppresses technological innovations, and allows large merchants that enjoy near monopoly market power to take advantage of the situation to gouge customers.

Australia is now saddled with a more expensive payments system that delivers fewer benefits to cardholders

RBA Regulation and Intended Results

The RBA regulatory measures and intended consequences can be summarized as follows:

Regulatory Measure #1

Reduction of interchange from 0.95% to 0.55%. The rationale used by the RBA is that the interchange fee has to be "cost-based," and this puts the RBA as the penultimate judge of what should or should not be considered as a "cost" for doing business. Reducing the interchange fee from 0.95% to 0.55% is based on the RBA's decision of what should not be included as "costs" of doing business.

Intended Consequences

1. Merchant fees would be reduced which would then be passed onto consumers, resulting in lower prices for all.

2. Debit cards usage would expand while credit usage would decline, which in the RBA's opinion would be a more "efficient" outcome given debit cards are cheaper.

3. With a reduction of the four-party schemes' interchange, the cost of accepting three-party schemes would follow suit without regulatory intervention.

Regulatory Measure #2

Elimination of the "no surcharge" rule. The RBA believes that this will allow merchant pricing, with surcharging, to reflect more accurately the "true cost" of accepting credit cards, thus ending what the RBA sees as "cross-subsidization" of credit card users by users of other payment instruments.

Intended Consequences

4. Merchants would judiciously surcharge for accepting credit cards; and in so doing, make credit usage less attractive than debit card usage; which would in turn encourage higher debit card usage.

Regulatory Measure #3

Easing of "restricted access" to four-party schemes, which Australian banking law

previously restricted to authorized deposit-taking financial institutions.

Intended Consequences

5. Facilitate new entrants to memberships of the four-party schemes, thus increasing market competition.

Intended Consequences Versus Actual Outcomes

As mentioned above, a significant body of evidence has been compiled with which the intended consequences of the RBA regulation can now be assessed against actual outcomes. These assessments are summarized as follows.

Intended Consequence 1

Merchant fees would be reduced which would then be passed onto consumers, resulting in lower prices for all.

Actual Outcome

Merchant service fees dropped as per RBA's regulatory measures, but the actual outcome has been completely different from what the RBA intended. Over the 2003 to 2004 period,

The actual outcome has been completely different from what the RBA intended

when the merchant service fees declined substantially, research data shows that some 70% of merchants were not even aware of it, and in fact believed that there had been no change in their merchant service fees.[2] Thus, the RBA's entire hypothesis that merchants would pass their reduced merchant service fees to consumers in the form of lower prices could not be substantiated by empirical evidence. Furthermore, the annual reports of Australia's retailers, clearly showed that any decrease in their costs (therefore including reductions in merchant service fees) are immediately used to improve their bottom lines.

Intended Consequence 2

Debit card usage expands while credit usage declines. In the RBA's view, debit cards are a more "efficient" payments card than credit cards.

Actual Outcome

The evidence suggests that the opposite has occurred. According to the Reserve Bank's own data in 2002, the year prior to the regulations, debit card payments including cash withdrawals comprised 57.2% of total card payments with credit cards comprising the remainder with 42.8%. In 2006, debit card payments had fallen to 55.3% of total card payments.

Intended Consequence 3

With a reduction of the four-party schemes' interchange, the cost of accepting three-party schemes would follow suit without regulatory intervention.

Actual Outcome

Merchant fees charged by three-party schemes decreased only marginally, from 2.7% in 1999 to 2.33% in 2005, compared with a decline from 1.8% to 0.98% for the four-party schemes over the same time period. Meantime, three-party schemes have been taking advantage of the higher annual fees charged by issuers of four-party schemes (see Regulatory Failure #5)

and raised their annual fees. MasterCard's own research has seen increases as high as 120%.[3]

Intended Consequence 4

Merchants would judiciously surcharge for accepting credit cards; and in so doing, make credit usage less attractive than debit card usage; which would in turn encourage higher debit card usage.

Actual Outcome

Where merchants have introduced surcharging, it has been arbitrary and non-systematic. Many merchants have introduced differential surcharging by brand, while many others do not offer clear disclosure of how they surcharge,[4] making a mockery of the RBA's aim of making the four-party schemes more "transparent" and "efficient."

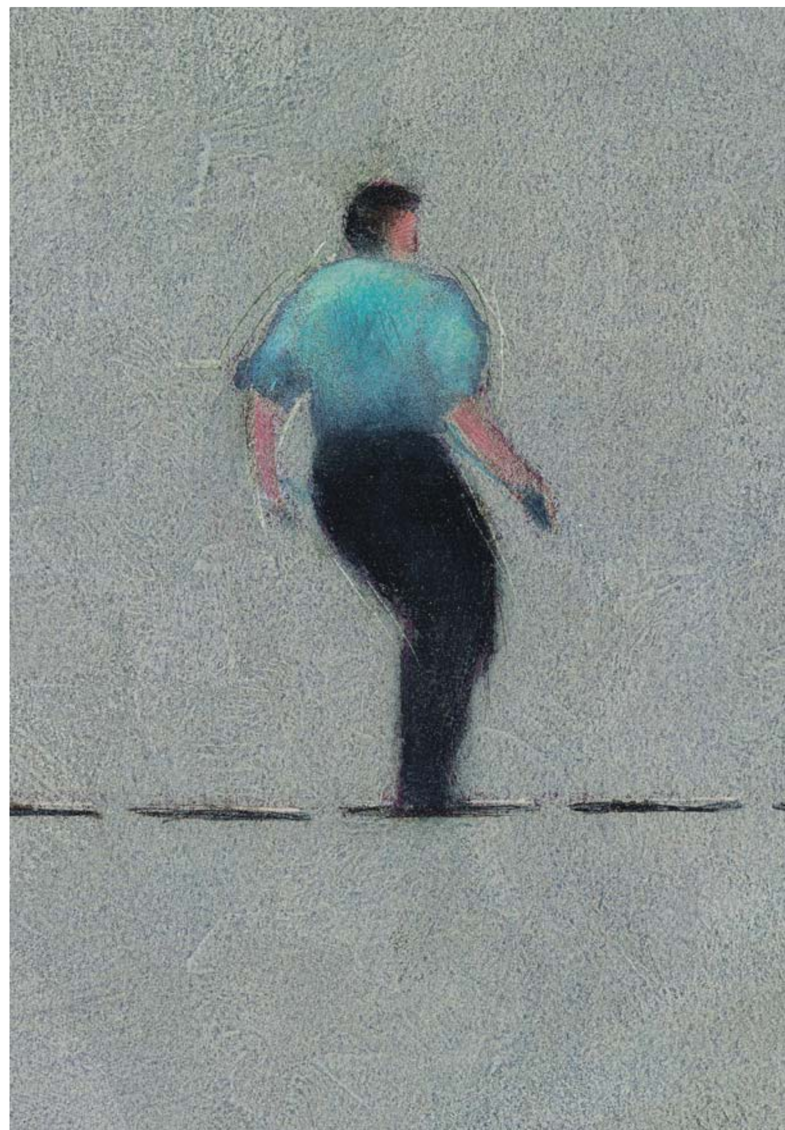
Furthermore, surcharging has been prevalent in markets where merchants do not face strong competition, such as Qantas and Telstra. Most retail segments, which typically face the highest levels of competition, see very little or no surcharging.

Intended Consequence 5

Facilitate new entrants to memberships of the four-party schemes, thus increasing market competition.

Actual Outcome

There have been no new entrants of significant size into the Australian market as a result of the RBA regulation. Quite to the contrary, as discussed later, the credit union industry is exiting credit card issuing, while the Bankcard brand has also recently been shut down.



Unintended Consequences: Regulatory Failures

The RBA intervention also has many unintended, but potentially highly damaging and anti-competition consequences that can only be described as regulatory failures. These regulatory failures, as described below, had actually been anticipated by MasterCard.[5] These are summarized as follows.

Regulatory Failure #1: Creating Artificial and Unfair Competitive Advantages for Three-Party Schemes

By imposing direct regulatory intervention selectively on the four-party schemes without addressing the three-party schemes, the RBA has created competitive advantages for the three-party schemes. A rapidly expanding body of evidence suggests clearly that the three-party schemes have been increasing their market share at the expense of the four-party schemes. Three of the four largest issuers have moved a part of their issuing to three-party schemes; their collective share of issuing three-party-scheme cards has grown since the RBA regulations.[6] Given the RBA's stated purpose of making fee structure more transparent, and given that the fee structure of three-party schemes is completely opaque, whereas information on the interchange fees of four-party schemes is regularly reported and accessible to the public, the artificial and unfair competitive advantages created by the RBA in favor of three-party schemes are particularly troubling. In its submission to the RBA in 2002, MasterCard pointed out that large issuer-acquirers would be motivated to recover lost interchange fees by either partnering with the unregulated three-party schemes, or dealing directly with merchants and focusing on "on-us" transactions thus effectively creating their own three-party schemes.[7] While Australian issuers have not formed their own three-party schemes, MasterCard's warning was directionally correct as several large issuer-acquirers in Australia have become issuers of the more expensive closed three-party-scheme cards such as American Express and Diners Club since the RBA regulations.

Regulatory Failure #2: Hurting Small Players in the Four-Party Schemes

MasterCard warned in 2002 that RBA's new interchange regulation would make it commercially unviable for small issuers, leading to market consolidation, hence less competition in the payments market.[8] The recent demise of the Bankcard scheme (a previously profitable

portfolio) and the acquisition of the small CUSCAL and Bank of Queensland credit card portfolios by Citibank, suggest that, as predicted by MasterCard, smaller operators have found it increasingly difficult to remain profitable under the new RBA regulations.[9] By ignoring the competitive process that already existed in Australia, the RBA regulation has created unnecessary and undesirable market distortions which in turn undermine market competition.

Regulatory Failure #3: Creating Artificial and Unfair Competitive Advantages Between Larger and Smaller Four-Party Schemes

By setting an arbitrary level of interchange fee to be followed by four-party schemes, the RBA regulation has created a potentially disastrous loophole that advantages one regulated four-party scheme over another merely due to differences in their respective portfolio makeup. This is because the artificially set interchange fee level is an average of several interchange fees for different cards: premium, business, and standard cards, for example. A scheme with a lower share of premium cards than its competitor, can significantly raise the interchange fee for the premium cards to encourage and reward issuers that aggressively push their issuance, while lowering the interchange fee only marginally (hence without unduly discouraging issuing) in the standard cards to compensate for the higher interchange fee for the premium cards, and in so doing achieve the required average. MasterCard has already encountered competitive pressure in Australia as a direct result of the RBA's poorly conceived regulation. Thus, the RBA regulation has created a situation where the previously more normal competitive process has been subverted to benefit one player in the payments market; contradicting directly the RBA's stated regulatory objective of making the market more competitive and in the process proving that it is impossible to predict the consequences of the regulatory intervention, and why such regulation should be the absolute last recourse. Of course in Australia, the RBA and ACCC embarked on a highly interventionist regulatory and price-setting exercise without first giving the industry an opportunity to address any of the perceived "inefficiencies" of the existing setup.

> The normal competitive process has been subverted to benefit the largest player in the payments market

Regulatory Failure #4: Retarding Technological Development and Innovations

MasterCard warned in its submission to the RBA that squeezing the interchange fee could potentially retard technological development and innovations in the payments industry, and negatively affect Australia's e-commerce growth.[10] While it is difficult to assess at present whether e-commerce growth has been affected by the RBA regulation, what is clear is that the development of technological innovations in the payments industry have been retarded. As other markets, in Asia and elsewhere, have been rapidly adopting new technologies such as chip and EMV over the past several years, no such developments have occurred in Australia.

Regulatory Failure #5: The Entire Payments System Has Become More Expensive

Contrary to the RBA's intention of making the payments system more efficient and increasing competitive intensity, the exact opposite has happened in Australia. In addition, the payments system has actually become more expensive for the average cardholder. While there is no evidence of retail price reduction by merchants (so confidently predicted by the RBA), there is widespread acknowledgement that issuers have actually increased fees to cardholders to compensate for lower interchange fees since the RBA regulation. Examples include:[11]

- Commonwealth Bank: Annual fee on its standard card increased from AUD46 to AUD59. Interest rates charged on cards (Commonwealth Awards and Commonwealth Awards Gold) have also increased by more than increases in the official cash rate.
- Westpac: Annual fee on its Gold cards increased from AUD65 to AUD90, and annual fee on its 55-day interest-free Visa cards from AUD24 to AUD30.
- ANZ: Annual fee on its ANZ First Free Days Visa cards increased from AUD28 to AUD30, Qantas Visa cards from AUD67 to AUD95; and fees for late payment and for exceeding credit limits increased by AUD10 each.

For most issuers, the rewards programs have been downsized, and in some instances very substantially. In addition, cardholders are subjected to random surcharging at the point-of-sale for various credit card transactions.

From the cardholder's point of view, the net results of the RBA regulation have been increased costs, reduced benefits, and no savings.

Reflection on RBA's Regulatory Failures

As summarized in this report, a growing body of market data and evidence suggests that the RBA's regulatory intervention in setting the interchange fee in Australia has resulted in multiple regulatory failures. The intervention has failed to achieve its intended objectives (regardless of whether these objectives are justified); and has created an extensive range of unintended and negative consequences. Upon reflection, the failures of the RBA regulation stem from a serious misunderstanding of the nature of the credit card industry, aggravated by regulatory zeal to engage in social engineering—deciding for all Australians what is really good for them in terms of payment options. The key mistaken interpretations are:

The intervention has failed to achieve its intended objectives and has created an extensive range of unintended and negative consequences

- A failure to understand that the four-party credit card system is subject to intense competition— externally with other payment options, including two-party and three-party payments systems and cash; and internally between issuers and acquirers. Such intense

competitive pressure has led to the rapid evolution of the four-party credit card system in the past decades, both in terms of technology and in meeting customers' needs with highly focused and increasingly beneficial services, in the complete absence of regulatory intervention, apart from sporadic antitrust scrutiny.

- The line of credit feature of the credit card system is neither a marketing gimmick nor a luxury as often implied by the RBA, but a profound financial innovation. It enhances purchaser liquidity, and, as such, it delivers a net benefit to the economy, including merchants that accept credit cards.

Appendix: Alternative Approaches to Interchange Fee Regulation

During the process of the RBA intervention in interchange fee regulation, a number of approaches to the setting of the interchange fee were proposed. These are summarized briefly as follows.

Common notations:

F_i = Interchange Fee

c_I = Marginal Costs of Issuers

C_I = Average Fixed Costs of The Issuers

R_I = Average Revenue of The Issuers

c_A = Marginal Costs of Acquirers

C_A = Average Fixed Costs of Acquirers

R_A = Average Revenue of Acquirers

The MasterCard Approach

MasterCard proposed to the RBA that it set Australian interchange fees using its traditional credit card cost-based methodology, in which the weighted average of interchange fees in Australia not exceed the measured issuers' cost of providing a payment guarantee and processing transactions, plus the cost of funding the interest-free period; or

$$Fi = c_I + \text{(opportunity cost of capital for funding the interest-free period)}$$

And where c_I equals to the sum of the costs of providing a payment guarantee (including costs of fraud and credit write-off), and the costs of processing transactions from acquirers.

The ACCC Approach

The ACCC proposed that the interchange fees should be set by a comparison of the costs of issuing and acquiring with the revenues obtained by the issuers and acquirers; and that the interchange fee is the offset of any revenue shortfall of either the issuers or the acquirers.

Thus, if $R_I < c_I + C_I$, then $F_i = c_I + C_I - R_I$.

Alternatively, if $R_A < c_A + C_A$, then $F_i = c_A + C_A - R_A$.

If, however, both $R_I > c_I + C_I$ and $R_A > c_A + C_A$, then $F_i = 0$.

Implied in this approach is that the interchange fee should be a "balancing transfer" that restores the "balance" between the different parties. How marginal and fixed costs are to be defined is not specified, nor is the issue of how to aggregate the different marginal and fixed costs of the different issuers and acquirers (especially when they use different definitions) addressed.

The Australian Banking Association (ABA) Approach

The ABA proposed that the interchange fee be capped at the stand alone cost of providing payment functionality and should be no lower

than the incremental cost of that functionality. The costs to issuers in this approach include fraud costs, credit losses, cost of funding the interest free period, operating costs, marketing, promotion and retention costs (including costs of funding loyalty programs), and the costs of equity capital and sunk costs.

In this approach, while the interchange fee is to be capped at

$$Fi = c_I + C_I \text{ (opportunity cost of capital for funding the interest-free period)},$$

it allows all issuer costs associated with payment functionality to be passed through to acquirers and merchants.

The RBA Approach

The RBA rejected all the preceding approaches.

The RBA, in presenting its own approach to setting the interchange fee, argued that:

(i) Costs associated with credit losses on unpaid credit card debt related to the line of credit should be "recovered" through interest payments by revolvers, and not all credit cardholders.

(ii) The interest-free period is seen as a cost associated with providing a benefit purely to the cardholders and therefore should be recovered by fees charged to the cardholders.

(iii) The costs of funding loyalty programs should not be allowed to be included as a cost.

(iv) Cost of capital should not be included in interchange fee.

The RBA's approach defines the interchange fee as comprising of a narrow definition of marginal cost for the provision of payment functionality, net of costs associated with the line of credit, and only to the extent that such marginal costs are attributable to merchant benefits. Thus, RBA believed that it is in a better position than the market and its consumers in deciding what should and should not be considered as "costs" in doing business in Australia.

Apart from practical difficulties such as how to separate credit cardholders into "revolvers" and "transactors" in advance; the RBA in the end deviated from its own principles and, as far as it can be understood, accepted the costs associated with funding the interest-free period on a completely arbitrary basis.

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1. See Appendix for a summary of the different approaches to setting the interchange fee proposed, and how they compare with the RBA approach.

2. "Tracking Study on Credit Card Surcharging and the Interchange Fee," Roy Morgan Research, August 2005. Also see www.rba.gov.au/statistics/bulletin/C03hist.xls

3. See www.rba.gov.au/statistics/

4. "Tracking Study on Credit Card Surcharging and the Interchange Fee," Roy Morgan Research, August 2005.

5. MasterCard 2001 Submission to the RBA.

6. The expansion of the three-party schemes at the expense of the four-party schemes is supported by RBA's own data; please see www.rba.gov.au/statistics/bulletin/C02hist.xls.

7. P.32, "Response to the RBA's Consultation Document," MasterCard, 2002.

8. "Response to the RBA's Consultation Document," MasterCard, 2002.

9. "Estimation of Credit Card Industry Market Share," June 30, 2006. Ernst & Young.

10. P. 23, "Response to the RBA's Consultation Document," MasterCard, 2002.

11. "Interchange in Australia—Global Implications," Datamonitor, March 2005.

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