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9 June 2006

The Hon. Bruce Baird MP
Chairman
House of Representatives Standing Committee on
Economics, Finance and Public Administration
Parliament House
CANBERRA ACT 2600

Dear Mr. Baird,

Visa International appreciated the opportunity to appear before the House of Representative Standing Committee on Economics, Finance and Public Administration hearings with regard to the Reserve Bank and Payment System Board Annual Report 2005 on Monday, 15th May 2006.

During the course of the two days, there were a number of issues raised by various participants that Visa felt warranted further clarification and follow up. In particular, we wanted to correct four common misunderstandings that were referenced throughout the hearing by a number of parties, being;

- Credit card customers are subsidized by other customers
- Interchange is illegal
- Interchange fees should be set at zero
- Honour All Cards is akin to tariff protection for small players

The attached submission addresses each of the above myths and comprehensively provides evidence that these are without foundation or logic.

We also thought it would be helpful for the Committee if we provided a more readily accessible digest of the research and data that Visa relied upon to support our submission. We have also taken the opportunity to reference new research and commentary from the hearings to support our arguments.

I trust that this additional material will assist the Committee in its deliberations, particularly around the importance of the Honour All Cards rule going forward.

Yours sincerely,

Bruce Mansfield

Bruce Mansfield
Executive Vice President, Australia & New Zealand
Visa International

VISA INTERNATIONAL SUPPLEMENTARY SUBMISSION TO THE HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

PAYMENT SYSTEM REGULATION IN AUSTRALIA

JUNE 2006

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1. INTRODUCTION

Visa International is pleased to have the opportunity to present this supplementary submission to The House of Representatives Standing Committee on Economics, Finance and Public Administration.

The purpose of this supplementary submission is to:

- correct some common misunderstandings about payment card systems (see section 2 below); and
- provide a concise summary of the empirical evidence that Visa International has commissioned and accumulated in support of its claims regarding the effects of recent RBA payment system regulation (see section 3 below).

2. ADDRESSING COMMON MISUNDERSTANDINGS ABOUT PAYMENT CARD SYSTEMS

MISUNDERSTANDING #1: CUSTOMERS THAT PAY BY CREDIT CARD ARE SUBSIDISED BY CUSTOMERS WHO USE OTHER MEANS OF PAYMENT

On a strict economic definition of a cross-subsidy, in order to claim that card users are subsidised by customers who use an alternative means of payment, card users must pay less than the incremental cost of card payments. Incremental costs are defined as the difference between:

- total costs when merchants serve card users AND customers who pay by alternative means of payment (e.g. cash); and
- total costs when merchants serve only customers who pay using non-credit card payment methods. [1]

Michael Katz, who was commissioned by the RBA as economic expert, admitted that on this definition, there is no cross-subsidy to card users by customers who choose not to pay by card.[2]

Visa International has consistently argued that while merchants incur costs when they agree to accept VISA Cards in the form of a merchant service fee, VISA Card acceptance also confers numerous benefits to merchants. These include:

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1 Here we use the definition that has been adopted by the RBA's commissioned expert, Michael Katz in footnote 136 of his report (Commissioned report by Professor Michael Katz, August 2001).

2 Paragraph 137 of Commissioned report by Professor Michael Katz, August 2001.

- increasing the number and value of sales by facilitating purchases by temporarily cash-constrained consumers and reducing the transaction costs these customers face in making purchases and by raising the average value of each purchase via a 'bigger trolley' effect that has been well-documented.[3] This allows merchants to make cost savings by taking advantage of economies of scale and scope, leading to lower overhead costs. In competitive retail markets, the resulting cost savings would be passed on to the consumer. If they are not, then the problem lies with retail competition and not credit cards.

- facilitating e-commerce and telephone order sales, allowing merchants to sell into geographic areas other than those in which they have physical stores.[4] This tends to reinforce the cost savings described in the first bullet point above.

- 'risk shifting' to card schemes due to the guaranteed payment provisions of the card acceptance agreement. Card schemes effectively take on the role of 'outsourced manager of risk and fraud' for participating merchants and perform this role more efficiently because costs are spread over the whole network and many participating merchants.

- 'convenience benefits' to merchants from accepting card payments from customers.[5] For instance, card networks provide payment processing services that substantially reduce merchants' overhead costs by reducing bad debt, personnel costs, bookkeeping costs, and costs associated with handling and processing customer payments.[6]

- allowing smaller merchants to compete more effectively with larger merchants.[7] While larger merchants may have resources to set up their own risk and fraud management systems, small merchants would be disadvantaged without the services offered by card schemes. Thus, participation in a payment card scheme like the Visa International Network helps promote retail competition, which benefits all consumers.

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3 For evidence of this see pp. 61-62 and pp. 73-78 of NECG 2002, 'Response to the Reserve Bank of Australia's Consultation Document and Report of Professor Michael Katz'.

4 Coles has found that 70 per cent of its online customers have not shopped at a Coles supermarket and that the penetration of its online service is highest in those areas that do not have a Coles supermarket. More examples are provided in NECG 2002, 'Response to the Reserve Bank of Australia's Consultation Document and Report of Professor Michael Katz', p. 64.

Some highly-specialist retailers' businesses simply would not be viable without the scale that e-commerce provides them (See pp. 68-71 of NECG 2002, 'Response to the Reserve Bank of Australia's Consultation Document and Report of Professor Michael Katz' for more examples of the relationship between credit cards and e- commerce).

Evidence that credit cards lead to increased merchant sales is also available from a recent US survey which found that i) 83 per cent of merchants reported that their sales increased when they accept payment cards and; ii) 58 per cent of merchants reported that their profits increased by accepting payment cards (Chakravorti, S. 2003, 'Theory of Payment card Networks: A Survey of the Literature', Review of Network Economics Vol.2, Issue 2, June).

5 For evidence see UMR Research 2002, Retailers Research Study, March, page 18.

6 Guerin-Calvert, M. and J. Ordover, 2005 "Merchant Benefits and Public Policy towards Interchange: An Economic Assessment", Review of Network Economics Vol.4, Issue 4, December.

7 This is confirmed in Visa surveys. See UMR Research 2002, Retailers Research Study, March.

These merchant benefits take the form of cost savings which in total are likely to exceed total card acceptance costs. Thus, even under the no surcharge rule, card users would not pay less than their incremental cost because, taking into account the benefits as well as the costs of acceptance, merchants either incur no net cost of acceptance or most likely enjoy a net benefit.

Finally, the ultimate test of whether a cross-subsidy exists is in the market response to such pricing behaviour. Merchants have always had the freedom to either offer cash discounts or even not to accept cards at all before the RBA regulations were introduced. There was, and still is, nothing preventing a merchant from preferring and incentivising customers to use payment methods that they regard as lower cost. If a genuine cross-subsidy from non-card users to card users did exist, then it could be undermined or even eliminated by merchants via such responses.

MISUNDERSTANDING #2: INTERCHANGE IS ILLEGAL

There has been no finding by regulators or courts in Australia, the United States and Europe on the illegality of interchange fees. Indeed, to the best of Visa International's knowledge, no regulator or court in the world has ruled that interchange fees are illegal.

Regulators in the UK and Australia have expressed concern about the way interchange operates and the level of the interchange fee. They have subsequently either required or negotiated changes to the process of setting interchange fees. However, none of these regulators have found interchange fees to be illegal under any aspect of competition law.

Interchange fees are legal in Australia

The Australian Competition and Consumer Commission (ACCC) took action in September 2000 alleging a breach of s45 of the TPA against National Australia Bank for its participation in the multilateral setting of interchange fees but later dropped the action.

Subsequent regulation of the Australian payment system by the Reserve Bank of Australia (RBA), which is now under consideration by the Committee, accepted interchange fees as legitimate before regulating them. Legal actions that followed the RBA's decision only went to the question of whether the RBA had properly exercised its powers in regulating interchange fees. The courts found in favour of the RBA on the basis that it had properly exercised its powers but there has been no finding of illegality with respect to interchange fees.

Interchange fees are legal in the United States

While there has been substantial litigation on other aspects of open card scheme practices in the US, no judgement to date has found interchange fees to be illegal. Indeed, in the landmark Nabanco case[8], the court found that the interchange fee was not illegal because the pro-competitive benefits of collective setting of interchange fees outweighed any anti-competitive effects.

8 National Bancard Corporation v. Visa U.S.A., Inc., 596 F. Supp. 1231 (S.D. Fla. 1984), aff'd, 779 F.2d 592 (11th Cir. 1986), cert. denied, 479 U.S. 923 (1986).

In May this year, US merchants filed a class action against the open card schemes in relation to their interchange fee setting practices. However, this legal action does not go to trial until 2008.

Interchange fees are legal in Europe

The European Commission made a major decision in relation to interchange fees in 2001. It came to an agreement with Visa International to gradually reduce cross-border interchange fees on credit cards and signature/PIN debit cards by December 2007. However, the EC accepts the multilateral setting of interchange fees as legitimate notwithstanding concerns about fee levels.[9]

In the United Kingdom, the Office of Fair Trading (OFT), in its recent decision on MasterCard, concluded that there were benefits in terms of improving production and distribution and promoting technical and economic progress from the existence of the interchange fee.[10] As a result, the interchange fee met one of the cumulative conditions for exemption from the prohibition on collective price restriction in the UK, although the OFT recommended adjustments to the fee to meet all cumulative exemptions. The OFT's concerns related to the level at which the fee was set, rather than the legality of the fee.

MISUNDERSTANDING #3: THE INTERCHANGE FEE SHOULD BE SET AT ZERO

The proposal to set the interchange fee at zero has been raised by merchants in testimony to the Committee.[11] The economic effects of setting the fee to zero would be the same as abolishing it altogether (see discussion below).

Visa International argues that the notion that interchange fees should be set at zero is based on a lack of appreciation of the role of interchange as a balancing device for open card schemes. To understand this balancing role, it is firstly important to understand the significance of network effects in open card schemes.

Interchange fee as a pro-competitive balancing device

Card schemes have to attract cardholders in order to persuade merchants that card acceptance will confer benefits. At the same time, card schemes have to attract merchants in order to persuade prospective cardholders that there is value in holding the scheme's cards.

The decision of how much to charge cardholders versus merchants to participate in the scheme is critical to achieving the right balance of both types of users. However, the process of achieving the right balance of charges between cardholders and merchants is complicated by the existence of network externalities in card schemes.

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9 See for instance the discussion of interchange fees in European Commission April 2006, 'Interim report I: Payment cards'.

10 Office of Fair Trading 2005, "Investigation of the multilateral interchange fees provided for in the UK domestic rules of MasterCard UK Members Forum Limited (formerly known as MasterCard/Europay UK Limited)", Decision of the Office of Fair Trading No. CA98/05/05, 6 September.

11 See in particular the testimony of Russell Zimmerman, Chairman of the Australian Merchant Payments Forum to the Committee on 15 May 2006.

Positive network externalities arise in card schemes because the addition of a new cardholder to the scheme increases the value that existing cardholders derive from participating in the network by making card acceptance more attractive to merchants (so that more merchants join the network). Similarly, the addition of a new merchant to the scheme increases the value that existing merchants derive from participating in the network by making VISA cardholding more attractive/convenient for cardholders (so that more cardholders join the network). As a result of an interdependency in cardholder and merchant demands, each side of the network benefits as the number of participants on the other side of the network increases.

Conversely, network externalities can also operate in reverse so that if the card network suffers a loss of cardholders, this is likely to reduce the value to other cardholders of remaining in the network as a loss of cardholders will also likely lead to a loss in the number of merchants willing to accept the card in question.

The objective of any card scheme in setting charges between the two sides of a payment card network (i.e. the cardholder side and the merchant side) is to take maximum advantage of positive network externalities. To accomplish this an asymmetric charge is needed to resolve an investment incentive problem on the issuer side. The investment incentive problem can be demonstrated by the following example:

> Suppose Issuer A incurs additional costs to attract a significant number of new cardholders. If A succeeds, this growth in cardholders will attract more merchants to the card scheme. An increase in the number of merchants encourages more card transactions by existing cardholders and also attracts additional cardholders.
>
> However, without an interchange fee, Issuer A, which incurred the costs that set this cycle in motion, would gain only a part of the additional revenue that would be earned by the network. Other issuers would be able to 'free-ride' on Issuer A's expenditure (i.e. they will benefit from the appeal of higher levels of merchant acceptance to prospective cardholders without incurring any costs themselves). Because they do not incur such costs, they are able to attract Issuer A's customers by offering their cards at a lower price (or with greater benefits) than Issuer A. Therefore without an interchange fee, Issuer A, being aware of this free-rider problem, would correspondingly reduce or eliminate investment in network growth.

This is why interchange fees are charged by issuers to acquirers (in other words, interchange fees redistribute funds from acquirers to issuers). An interchange fee which transfers revenues to the issuer side with each cardholder transaction addresses the underinvestment problem that would otherwise be encountered on the issuing side of an open card scheme. The interchange fee rewards issuers when they make efforts to attract cardholders which are commensurate with the interests of the card network overall (including the interests of merchants due to interdependent demands).

Asymmetric charges such as non-zero interchange fees are common in other types of two-sided networks

Open loop payment card schemes are not unique in using an asymmetric charging arrangement (i.e. non-zero interchange fee) to balance interdependent demands between the two sides of a network (as opposed to a simple 'user pays' approach in a one sided market).

Closed payment card schemes also use a MIF-like device to maximize the size of their networks. While closed schemes have the ability to set the overall level of fees unilaterally, they will still set the structure of fees to take into account the need to strike a balance between the demand by cardholders and the demand by merchants.[12]

There are also many examples of asymmetric charges in two-sided networks outside the payment system. For example, shopping malls often provide free parking to consumers, but recoup the relevant costs by charging rent to merchants. Telephone directories are free to subscribers and paid for by advertisers. Consumers might not visit a shopping mall if parking were not free; similarly consumers might not purchase a telephone directory if it was not only free, but also delivered free of charge. Merchants and advertisers benefit from increased numbers of potential buyers, and therefore it is efficient for them to shoulder more of the corresponding costs.

What if the interchange fee were set at zero?

If card schemes such as Visa International were compelled to set the interchange fee at zero, they would be prevented from addressing the investment incentive problem on the issuer side. Cardholders would need to pay the full cost of card innovation even though it is clear that many of these innovations in cards provide substantial benefits to merchants, particularly innovations in the area of security and anti-fraud measures.

Since the cost of cardholding would need to rise to compensate for the reduced contribution by merchants to scheme costs, cardholding would become less attractive and the issuers of open scheme cards would find it more difficult to attract cardholders to open card scheme. This would lead to an initial reduction in cardholder participation which would in turn induce a reduction in the number of merchants accepting cards from open schemes (due to interdependent demands), leading to further reduction in cardholder participation because of reduced merchant acceptance. Thus a zero interchange fee would prevent the scheme from taking advantage of positive network externality effects which would otherwise benefit both cardholders and merchants.

This would have serious repercussions for the competitiveness of open loop card schemes with closed card schemes that rely on an implicit MIF-like device.

If the current Visa International interchange fee were reduced to 0 while the implicit MIF embodied in the merchant service fee that American Express charges its merchants was unregulated, the potential pool of funds for investing in the cultivation of cardholder membership would be cut by millions of dollars each year. For these issuers the prospect of issuing American Express cards would become relatively more attractive than issuing VISA cards, leading them to promote issuing of American Express payment cards at the expense of Visa International.

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12 Diners Club did this when it started up in 1950 by initially giving away cards to consumers and charging merchants 7 per cent of their bill (Evans, D. and R. Schmalensee 2005, 'The economics of interchange fees and their regulation: Overview').

Consequently the number of VISA card transactions and eventually Visa International cardholding and acceptance would substantially decline relative to the number of American Express payment card transactions and American Express cardholding and acceptance. As a result, American Express' market share would grow at the expense of Visa International's market share.

This switching to American Express would occur even though prior to such regulatory intervention the merchant service fee that merchants face for VISA Card acceptance was lower than the equivalent fee they face for American Express payment card acceptance.

RBA regulations set the wrong balance

The RBA interchange fee regulations are aimed at establishing what it regards as 'appropriate' price signals to cardholders, not to shift a disproportionate burden of maintaining the payment system onto cardholders or issuing banks. However, the discussion above suggests that the RBA has got the balance wrong because:

- The RBA's focus on the resource costs involved in providing credit card services was fundamentally flawed, ignoring the countervailing benefits that accrue to merchants from participating in payment card schemes. It fails to take into account the fact that efficiency need not be at all closely aligned with the cost of the resources employed in delivering the payments services of credit cards.

- The findings of the relevant economic literature suggest that a cost-based methodology would not be consistent with increasing the economic welfare of all parties other than by chance.[13]

- In any case, there are already significant competitive forces both within open card schemes and between open card schemes and other payment systems which create incentives for open card schemes to set an interchange fee that is as close as possible to what would be considered 'socially optimal' (i.e. making all parties, and not just cardholders better off).[14]

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13 Baxter, W F, 1983 "Bank Interchange of Transactional Paper: Legal and Economic Perspectives" , 26(3) Journal of Law and Economics; Schmalensee, R, 2001 "Payment Systems and Interchange Fees", National Bureau of Economic Research, Inc, Working Paper 8256, April; Rochet, J-C and Tirole, J, 2000"Cooperation among Competitors: The Economics of Payment Card Associations", 16 May; Schwartz, M and Vincent, D R, 2000 "Save Price, Cash or Credit: Vertical Control by Payment Networks", Draft, November.

According to Schmalensee, Richard. 2002, "Payment Systems and Interchange Fees," Journal of Industrial Economics, 50 (2), page 118 for many industry structures (in terms of the competitiveness of the issuing, acquiring and retailing sectors), the 'socially' optimal interchange fee is the same as the profit- and/or output maximising interchange fee.

14 Rochet and Tirole (2005) identify three factors that would ensure this outcome, namely:

i) Network externalities imply that weakening one side of the business reduces the demand from the other side. For instance, if issuers set an interchange fee that was too high, this would induce many merchants to drop out of the open card scheme. If too many merchants drop out, this would not be in the interests of other scheme participants. This is because cardholders would reduce their use of the card or 'drop out' themselves, as many merchants would not accept the card. Thus any tendency towards setting excessively high interchange fees would tend to be self-correcting.

MISUNDERSTANDING #4: THE HONOUR ALL CARDS RULE PROTECTS SMALL PLAYERS LIKE TARIFFS PROTECT INFANT INDUSTRIES

Committee member Dr Craig Emerson has compared the Honour All Cards Rule (HACR) to industry tariffs for protecting infant industries.[15] In Visa International's view, such a comparison is invalid as the HACR differs from an industry tariff in both purpose and effect.

An industry tariff is a tax imposed on imported goods for the purpose of protecting domestic industries from foreign competition. Protection is achieved by increasing the price of imported products (inclusive of the tariff) relative to domestic substitute products. This disadvantages consumers if prices for domestic products are higher than for comparable imported products if the tariff was zero.

The 'infant industry argument' alluded to by Dr Emerson is that temporary tariffs may be justified as a means of allowing newly founded domestic industries to achieve efficiencies by reaching a reasonable size or by learning to master production techniques. Once greater scale and efficiency are realised, domestic prices should be lower, so that consumers would no longer be disadvantaged and tariffs would no longer be necessary for protection purposes. However, the problem with the infant industry argument is that it is often the case that protection insulates the domestic industry from competition and innovation and incentives to achieve efficiencies. As efficiencies are never realised, the infant never grows up. Even if larger scale is achieved, the lack of competitive pressure means that domestic prices are not reduced and consumers continue to suffer.

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ii) Competition within a particular open card scheme means that any reduction in the members' marginal cost of doing business would be ultimately partly or fully competed away in favour of cardholders or merchants as a result of the interchange fee. This is because the revenues provided by the interchange fee are a competitive tool that is placed in the hands of all issuers. This effect would be expected to restrain issuers from setting interchange fees at an excessive level (beyond the level that would be necessary to balance the differing incentives of cardholders and merchants to join and remain in the network).

iii) Finally, competition between payment card networks implies that merchants can switch to an alternative card scheme or payment instrument if an open card scheme charges excessive interchange fees that translate into excessive merchant service fees and if cardholders can equally switch to alternative payment instruments. Therefore, even if the markets for issuing and acquiring were not effectively competitive, competition between payment systems would tend to reduce the margins of both issuers and acquirers.

(Rochet and Tirole, "An Economic Analysis of the Determination of Interchange Fees in Payment Card Systems", 2005. Pages 16-17).

15 See his comments in the transcripts of the Committee hearings of 15 May 2006.

The general consensus amongst economists was that protection of domestic industries hindered the realisation of efficiency and discouraged innovation in the Australian economy over a long time frame. Furthermore costs were raised generally in the Australian economy as sectors dependent on protected industries faced higher prices for their inputs. For these reasons tariffs and other forms of protection were gradually reduced and largely removed in the microeconomic reform process of the 1980s and 1990s.[16]

In stark contrast to the effect of industry tariffs, the HACR does not raise prices for a particular product and it also does not disadvantage consumers or merchants. The HACR serves the very distinct purpose of maximising the use of the Visa International network but not by raising prices for particular products to consumers or disadvantaging merchants. As explained further below, Visa International cardholders benefit from the HACR as it guarantees wide acceptance of their particular card (irrespective of whether the type of card and irrespective of the financial institution that issued the card). The ubiquity of the Visa International network means that cardholders face lower transactions costs and hence there is more demand for VISA cards. However, as this means more transactions, it also benefits merchants. There are some cards that have features that consumers value but that are more costly for merchants to process than cards without those features and this may be the source of the allusion to protection by the HACR. However, to the extent that the HACR encourages the use of such cards, this cannot be labelled as protection where consumers value the additional features and face lower transaction costs because of HACR and merchants benefit from the expansion of transactions.

Unlike industry tariffs, the HACR does not hinder competition. The HACR promotes competition by enabling smaller issuers to compete in the issuing market. The HACR essentially equalises the bargaining power between smaller issuers and participating merchants with market power (as the merchant is obliged to accept cards with a particular acceptance mark). This is discussed further below.

The HACR also does not hinder innovation – in fact the opposite is true. The HACR removes the need for Visa Members to set up separate acceptance networks for each new card product, allowing issuers to experiment with a range of customised cards. The rule therefore enables issuers to overcome barriers to new product innovation by allowing them to innovate and disseminate new products that are valued by consumers on a lower scale than would otherwise be required. Absent the HACR many of these products would not be made available to consumers as it is unlikely they would ever achieve the scale required to warrant their own acceptance mark. The pro-innovation effect of the HACR is discussed further below.

Thus, the pro-competitive and pro-innovation effect of the HACR is entirely different to the effect of industry tariffs, which reduce both competition and innovation in the Australian economy. Importantly, the pro-competitive and pro-innovation effect of the HACR benefits both merchants and cardholders.

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16 For a good overview of Australia's experience with trade liberalization, see Banks, G. 2003, 'Gaining from trade liberalization: Some reflections on Australia's experience', available at http://www.pc.gov.au/speeches/cs20030605/cs20030605.pdf

The Honour All Cards Rule is essential to the viability of open card schemes

An essential requirement for the success of a payment system is to be able to guarantee wide acceptance of its means of payment. Wide acceptance is also important to open card schemes like Visa International because the integrity of the system – the value of the “brand” associated with the network – is best served by ensuring that all cards on issue are treated equally. The HACR achieves this objective by requiring that any merchant that participates in a particular system, e.g. the Visa International network, must accept any VISA card carrying a particular acceptance mark (e.g. the Visa Flag acceptance mark), irrespective of which bank issued it. In particular, this ensures that Australians can be confident of being able to use their cards anywhere, even if the card is not issued by a major Australian bank, but by a small credit union or local deposit-taking institution.

Without the HACR, the value of a VISA branded card to cardholders would be reduced, since none of them can be completely sure that, even when they make purchases from a participating Visa International merchant, they will be able to make purchases using their particular VISA card. Holders of less common types of VISA cards of a particular brand or VISA cards issued by smaller issuers would likely get a lot less value out of joining the Visa International Network. The confidence cardholders have in the VISA brand would be diluted by the highly qualified nature of its ‘guaranteed acceptance’. Thus the wide acceptance promoted by the HACR is essential to the viability of open card schemes like Visa International.

The Honour All Cards Rule has pro-competitive and pro-innovation effects

The HACR provides a platform for small financial institutions and credit unions to participate in the provision of card services side-by-side with larger institutions. Without the HACR, small financial institutions might have to bargain with participating merchants to encourage them to accept the payment cards they issue. Some of these merchants have substantial market power. Alternatively, they would have to bargain with their competitors to gain access to their acceptance networks. The likely result of such bargaining would reflect the inequality of bargaining power between the negotiating parties rather than any efficiency considerations.

Under both these scenarios, entry and innovation into issuing would be deterred. However, under the HACR, these smaller issuers will enjoy guaranteed acceptance of their cards as long as they fall within the scheme-branding that participating merchants are contractually obliged to accept. Therefore the HACR has an entry promoting effect on the issuing market which in the long term contributes to innovation and competition in the issuing market, including through the encouragement of greater choice of card services given the larger pool of issuing participants.

In addition, the HACR also promotes innovation by allowing open card schemes like Visa International to experiment with a range of customised products to suit cardholders with different needs. This is because under the HACR, issuers do not need to develop separate merchant acceptance networks for separate card brands. The HACR allows issuers to promote these niche products on existing network platforms used to market the more popular card brands rather than having to invest in separate promotion networks. This allows them to take advantage of network economies of scale and scope.

3. RESEARCH AND DATA IN SUPPORT OF VISA INTERNATIONAL'S ARGUMENTS ON THE EFFECTS OF THE RBA REGULATION

The purpose of this section is to concisely summarise the empirical evidence of the impact of RBA payment system regulation to date.

3.1. CLOSED CARD SCHEMES HAVE NOT MATCHED THE FEE REDUCTIONS OF OPEN CARD SCHEMES

Closed card schemes have not matched the Merchant Service Fee (MSF) reductions of open card schemes notwithstanding the RBA's claim that it is sufficient to regulate open card schemes' interchange fees to promote lower MSFs in closed card schemes. In a 2005 report by NECG commissioned by Visa International, it was noted that open card scheme MSFs fell from 1.41 to 0.99 per cent over October 2003 to May 2005, a 42 basis points reduction. In that same period, closed scheme MSFs fell by only 13 basis points.[17]

More recent RBA data confirms these trends. From November 2003 to December 2005, closed card scheme MSFs fell by 25 basis points, compared to 45 basis points for open card schemes.[18] According to MasterCard calculations over a longer period, the gap between American Express MSFs and open card scheme MSFs has grown from 0.90 per cent in 1999 to 1.35 per cent in December 2005.[19]

The disparity between open card scheme and closed card scheme MSF setting has also been noticed by merchants. According to a Cannex survey in August/September 2004, 39 per cent of merchants said their MSFs fell, while 10 per cent said they increased for open card schemes. In contrast for closed card schemes, around half of the number of merchants said their fees increased, and half cited a decrease.[20]

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17 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', p. 28. The calculations were based on RBA data.

18 Lowe, P. 2006, 'The evolution and regulation of the payments system', available at http://www.rba.gov.au/Speeches/2006/sp_ag_140306.html

19 MasterCard submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

20 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', p. 30.

3.2. REDUCED MERCHANT SERVICE FEES HAVE NOT BEEN PASSED THROUGH TO CONSUMERS

Visa International has argued that the removal of the no surcharge rule would not lead to general price reductions and that the claim that there would be a pass-through of what would in any case be very small cost savings from reduced MSFs was implausible and at best unproven.[21]

The data to date is consistent with Visa International's claims. According to a Cannex survey conducted in August/September 2004, most merchants (over 60 per cent) report that the reduced MSFs have either not resulted in a change to their operations or that, where they have enjoyed lower fees, they have increased their profits rather than passing the lower costs through to consumers.[22]

3.3. THERE HAS BEEN A DECLINE IN CARD BENEFITS AND REWARD POINTS AND AN INCREASE IN CARD FEES AND RELATED CHARGES TO CONSUMERS

Visa International has argued that any purported consumer benefits from the RBA's regulation will be wiped out because the magnitude of increases in card fees and related charges accompanied by the reduction in card benefits will far exceed any savings to other consumers from MSF reductions. The statistics support the claim of a high magnitude of card fee increases.

The average fee for standard rewards-based cards increased by 25 per cent from $61 to $76 in 2003 and again by 12 per cent to $85 in 2004. Average overdrawn fees increased to $29 in 2004, up from an average of $13 in 2002 before the implementation of the new regulation.[23]

More recent data from the RBA confirms these earlier trends, though there has been a slight slowdown in fee increases relative to the substantial increases observed earlier. In 2005 the average fee for rewards-based cards remained at $85, but the average fee for Gold cards increased to $134 (up from an average of $128 in 2004).[24]

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21 Note that in testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration Monday 15 May 2006, Assistant Governor Lowe admitted that the RBA could not prove that there had been a pass-through.

22 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', p. 30 and Chart 2 on p. 31.

23 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', p. 30 and Chart 2 on p. 34.

24 RBA Bulletin, June 2006, http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_may06/banking_fees_aus.html

Cardholder surveys support these findings. A MasterCard-commissioned survey of cardholders by Ernst & Young and Roy Morgan found that at least 75 per cent of credit cardholders observed an increase in the cost of owning and using their cards as a direct consequence of RBA regulation.[25] A more recent survey commissioned by Visa International found that 53 per cent of those surveyed said they had experienced increased annual fees, 52 per cent found that overall charges on cards had increased and 45 per cent found that their card interest rates had increased since RBA regulations were introduced.[26]

3.4. RBA REGULATIONS HAVE PROVIDED THE CLOSED CARD SCHEMES WITH A CLEAR COMPETITIVE ADVANTAGE

Visa International's claim that the RBA regulations would disadvantage open card schemes in their competition with closed card schemes is supported by the shifts in market share to closed card schemes that have occurred since the RBA regulations were introduced.

Over the period from January 2002 to March 2006, the combined market share of American Express and Diners Club measured as a percentage of the value of card transactions increased from 13.8 per cent to 16.7 per cent. Over the same period, the combined market share of Visa International, MasterCard and Bankcard (by the same measure) declined from 86.2 per cent to 83.3 per cent.

Over the period from January 2002 to March 2006, the combined market share of the closed card schemes measured in terms of number of transactions increased from 10.5 per cent to 12.6 per cent.[27] Over the same period, the combined market share of Visa International, MasterCard and Bankcard (by the same measure) declined from 89.5 per cent to 87.4 per cent.

Woolworths, in its testimony to the Standing Committee, notes that since the RBA regulations were introduced, American Express and Diners Club card use has grown to nearly 6 per cent of spending in their stores, from about 3 per cent prior to the regulations.[28]

3.5. SURCHARGING HAS LED AND WILL LEAD TO FURTHER COST INCREASES FOR CONSUMERS

Since the introduction of the RBA regulations, empirical research collected by Visa International has documented that there have been a small but growing number of merchants who regularly surcharge customers who use credit cards.

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25 MasterCard submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

26 UMR Research May 2006, 'Community perceptions of the RBA changes to the credit card system'.

27 This is documented in the most recent payment systems statistics from the RBA available at http://www.rba.gov.au/PaymentsSystem/PaymentsStatistics/payments_data.html

28 Testimony of Mrs. Dhun Karai, Group Head, Financial Services, Woolworths Ltd.

The incidence of surcharging has been found to vary from survey to survey but most estimates put the incidence of surcharging at close to 5 per cent. More importantly, recent surveys suggest the incidence of surcharging will grow in future:

- A 2004 UMR survey of consumers found that 30 per cent of respondents had paid an extra fee for using credit cards since January 2003.[29] An updated (2006) UMR research found that the figure had since increased to 46 per cent. In addition, consumers in metropolitan areas were more likely to be surcharged.[30]

- A 2004 Cannex survey found that 26 per cent of merchants surcharge at least some of the time. Only a very small minority (7 per cent) of merchants surcharge regularly.[31] The average surcharge is 1.8 per cent, almost double the level of the MSFs for the open credit card schemes. This huge discrepancy between MSFs and the average surcharge also refutes the RBA's claim that surcharging will lead to the 'correct' price signals being sent about the relative costs of payment instruments used.

- An East & Partners survey of 2,277 merchants in November 2004 found only 2.3 per cent of merchants were surcharging.[32] But a more recent (November 2005) East and Partners survey found that the incidence of surcharging ranged from 1.6 (for 'micro' businesses) to 7.9 per cent (for 'corporates'). The percentage of merchants planning to surcharge ranged from 6.5 per cent to 19.4 per cent.[33]

3.6. CONSUMERS NOT HAVE PERCEIVED ANY BENEFIT FROM THE RBA REGULATIONS

Visa International-commissioned surveys have found that consumers have at best not perceived any benefits from the RBA regulations and at worst have felt they are worse off because of the regulations.

A 2004 consumer survey by UMR found that as of September 2004, 32 per cent of respondents supported the new regulations, while 48 per cent opposed them. Only 3 per cent of respondents felt that they were financially better off because of the new regulations, while 24 per cent felt that they were worse off.[34]

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29 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', page 39.

30 UMR Research May 2006, 'Community perceptions of the RBA changes to the credit card system'.

31 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', pages 47-48.

32 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', page 46.

33 East Partners April 2006, 'Australian merchant acquiring and cards markets'

34 NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes', pages 38-39.

The existence of surcharging is a particular point of dissatisfaction for consumers. A more recent survey commissioned by Visa International in May 2006 found that 85 per cent of those dissatisfied with the credit card system were against surcharging, compared with 75 per cent of those happy with it. Overall, 77 per cent of cardholders disapproved of surcharging.[35] In other words, surcharging seems to account for a significant part of the dissatisfaction felt by consumers with the current system.

3.7. OVERALL, THE EMPIRICAL EVIDENCE SUGGESTS THAT RBA REGULATIONS ARE LIKELY TO HAVE INCREASED CONSUMER PRICES SLIGHTLY

The evidence assembled above, when put together, contradicts the RBA's conclusion that overall consumers will benefit from the RBA regulations. In particular, quantification performed by a 2005 Visa International-commissioned NECG report suggests that despite the lower fees for merchants, the net impact of all the changes would be expected to have increased consumer prices slightly, based on the RBA's own assumptions.

The RBA expected a CPI decrease of 0.1 to 0.2 per cent from the regulations. However, bank fee income from issuing credit cards increased by 80 per cent between 2002 and 2004 primarily because of the response of issuers to the new regulations. Accounting for growth in the number of cards issued and volume of transactions, NECG estimated that this increase wiped off roughly half the MSF reduction for consumers. Even assuming a 1.8 per cent incidence of surcharging (which the recent estimates discussed above suggests is an underestimate), the remaining half of the MSF reduction assumed by the RBA would be likely to be exceeded by average price increases from surcharging. In particular, NECG found that under the generous assumption (given the findings to date) that 20 per cent of merchants passed on their MSF reductions to consumers, there would still be no net price reduction from the regulations.[36]

4. SUMMARY AND CONCLUSIONS

In this paper Visa International has attempted to do two things:

- clear up some conceptual misunderstandings with respect to the economics of payment card schemes; and
- document the evidence that is available on the effects to date of the RBA's payment system regulation.

With respect to the first objective, our discussion has shown that:

- the legality of interchange fees in the jurisdictions where there have been major inquiries into payment cards schemes is not in doubt;

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35 UMR Research May 2006, 'Community perceptions of the RBA changes to the credit card system'.

36 See pp. 37-38 of NECG 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes'.

- there was no cross-subsidy conferred on card users by other consumers before the no surcharge rule was abolished. This is because the total benefits that merchants receive from accepting cards in the form of cost savings are likely to exceed total acceptance costs;

- interchange fees are an important device for balancing interdependent demands of cardholders and merchants in open card schemes and essential to their ability to compete effectively with closed card schemes. The RBA approach to regulating interchange fees on the basis of cost ignores these foundations and is therefore misconceived;

- The Honour All Cards Rule is not at all comparable to industry tariffs because it is essential to the viability of payment card schemes and, rather than insulate card schemes from the need to improve efficiency and innovate in order to compete with rivals, it enhances the capacity of payment card schemes to harness economies of scope and scale and to innovate new products.

With respect to the second objective, we have documented evidence for the following claims regarding the effects of RBA regulations:

- Closed card schemes have not matched the MSF reductions of open card schemes;

- Merchant savings on reduced MSFs have not been passed through to consumers;

- The magnitude of increases in card fees and related charges resulting from the regulations is substantial;

- Closed card schemes have gained an advantage over open card schemes since the introduction of the RBA regulations:

- Surcharging has led and will lead to further cost increases for consumers;

- Consumers do not perceive any benefits from the RBA regulations; and

- Overall the empirical evidence suggests that the RBA regulations will increase consumer prices slightly.