21 September 2015

Senate Standing Committee on Economics
By email: economics.sen@aph.gov.au

Dear Dr Dermody,

RE: Inquiry into matters relating to credit card interest rates

A number of submissions to the *Inquiry into matters relating to credit card interest rates* explore the issue of interchange fees. Some claim that the Reserve Bank of Australia's (RBA) proposed efforts to further lower interchange will result in harm to consumers.[1] CHOICE wishes to provide additional detail for the Committee's consideration through this supplementary submission.

For over a decade, CHOICE has raised concerns that interchange fee-setting arrangements are opaque and lead to a large group of consumers cross-subsidising benefits for a small group.[2] As noted in our original submission, CHOICE supports the Financial System Inquiry Final Report's recommendation and the RBA's suggested reform to lower interchange fees.

What is interchange?

An interchange fee is the charge one bank (the card issuer) charges another (the merchant's bank) whenever a consumer chooses to pay by card.[3] Interchange fees are set by card schemes - like Visa, MasterCard and American Express - but collected by banks.

There is pressure for interchange fees to increase as card schemes compete for banks to issue their brand of card. The higher the interchange rate, the more attractive it is for a bank to issue a certain scheme's card. Higher interchange fees flow on to higher costs to merchants, which are eventually reflected in higher than necessary consumer prices, paid not only by cardholders but by all consumers.

---

[1] See submissions from Australian Taxpayers' Alliance and the International Alliance for Electronic Payments, Christopher Zinn, MasterCard and Visa.
[2] See Australian Consumers' Association (2002), Response to the Reserve Bank of Australia's Draft Standards and Access Regime for Credit Card Schemes, Australian Consumers' Association, Sydney.
[3] See Reserve Bank of Australia (2015), *Review of Cards Payment Regulation, Issues Paper*, Reserve Bank of Australia, Sydney, p.6.

WWW.CHOICE.COM.AU **E** CAMPAIGNS@CHOICE.COM.AU
57 CARRINGTON ROAD MARRICKVILLE NSW 2204 **P** 02 9577 3333 **F** 02 9577 3377

Australian payments system reform in 2003: reducing interchange to reduce system costs

After a number of government inquiries, the RBA implemented reforms to Australia's payments system in 2003.[4] The reforms aimed to address the high level of interchange fees which resulted in higher than necessary costs for the overall system, largely borne by merchants and consumers.

Prior to the reforms, consumers were being encouraged to use high-cost credit over low-cost cash or EFTPOS payments. As noted by the RBA: "… the payment method that was most expensive to the community was actually growing faster than the ones that were cheaper to the community…"[5]

As part of the 2003 reforms the RBA set an average rate for some card scheme interchange fees and allowed merchants to charge a reasonable surcharge to reflect the realities of accepting cards with high costs. The RBA's changes were heavily contested by the banking industry and card schemes. This is perhaps unsurprising given that the reforms resulted in the banks receiving an estimated $430 million a year less in interchange fees because of the changes.[6]

Australia was one of the first jurisdictions to directly regulate high interchange fees. Since 2003, interchange fee caps have been applied in 38 jurisdictions and there is growing pressure for further reductions.[7]

As a direct result of the reforms, average interchange fees for MasterCard and Visa (the two regulated card schemes) were reduced to around 0.5%, down from around 0.95%. This has had a predictable flow-on effect to merchant service fees which have reduced, on average, from 1.44% for MasterCard or Visa transactions in March 2003 to 0.84% now.[8]

---

4 These include House of Representatives Standing Committee on Finance and Regulation (1991), *Pocketful of Change,* APH, Canberra; Reserve Bank of Australia (2001), *Reform of Credit Card Schemes in Australia: Consultation Document*, Reserve Bank of Australia, Sydney.
5 Reserve Bank of Australia, *Official Hansard*, 4 June 2004, p. 24.
6 Ibid, p. 27.
7 Hayashi, F, Maniff, J (2014), *Interchange fees and network rules: a shift from antitrust litigation to regulatory measures in various countries*, Federal Reserve Bank of Kansas City, Kansas City, p.1.
8 Reserve Bank of Australia (2015), *C5: Average Merchant Fees for Debit, Credit and Charge Cards,* http://www.rba.gov.au/payments-system/resources/statistics/index.html

WWW.CHOICE.COM.AU **E** CAMPAIGNS@CHOICE.COM.AU
57 CARRINGTON ROAD MARRICKVILLE NSW 2204 **P** 02 9577 3333 **F** 02 9577 3377

Addressing criticisms of the 2003 RBA reforms: scheme funded research supports scheme interests

The RBA's 2003 reforms and more recent proposal to further reduce interchange fees have been heavily criticised. Much of the criticism is from work sponsored by or which appears to be linked to the card schemes or banking industry. Studies paid for by or associated with card schemes or banks claim that Australian consumers have been harmed by payment system reforms, with criticisms that often contradict the conclusions of the RBA's 2008 assessment of the reforms.[9]

CHOICE is concerned that a body of research sponsored by those that benefit from high interchange is misleading or presenting highly selective information about the impact of reforms on consumers. A list of research which discloses links or funding from industry is attached in appendix A. In addition, CHOICE is also concerned that groups claiming to represent the consumer interest in the interchange debate are directly funded by card schemes. For example, the only known funder of the International Alliance for Electronic Payments (IAEP) is MasterCard.[10]

There is a suggestion that any further reduction in interchange will disadvantage Australian consumers, as a reduction in interchange fees allegedly harmed consumers in 2003. The typical arguments are that:

- Merchants haven't passed on savings to consumers, despite a significant cut in merchants' annual merchant service fee costs. Typically, reports don't claim prices are not lower than they would have been without the reforms, just that there's no evidence to prove it.
- Credit cards reward programs have reduced in value and will continue to decline if interchange is reduced.
- Credit cards have become more expensive because of a reduction in interchange and subsequent reduction in bank profits. If interchange is reduced, annual fees will rise and some card providers may be unable to offer low rate cards.

This submission addresses each of these criticisms and provides additional data for the Committee's consideration on the likely impact of reducing interchange fees.

---

[9] Reserve Bank of Australia, (September 2008), *Reform of Australia's Payments System: Conclusions of the 2007/08 Review,* http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-conclusions.pdf
[10] See Mumbrella, (18 June 2015), *MasterCard emerges as key backer of international body behind anti-RBA campaign*, http://mumbrella.com.au/mastercard-emerges-as-key-backer-of-international-body-behind-anti-rba-campaign-300602

Criticism one: interchange shouldn't be reduced because there is no evidence that merchants will pass on savings to consumers

One of the key reasons to reduce interchange is to create a more affordable payments system, which should ultimately be reflected in lower prices for consumers across the economy. There are some claims that merchants will not pass on savings from lower interchange costs, or that there is no evidence that previous savings have been passed on to consumers. It is argued that interchange should remain at current levels to allow banks to use profits to offer consumers more services.

Reducing interchange will lead to a small cost reduction for every merchant in Australia. The RBA's current proposal is to reduce average interchange rates to 0.3%, from 0.5%[11], consistent with the European Unions' recent intervention.[12]

With underlying inflation at a little over 2% per annum, a 0.2% reduction will be difficult to directly observe in retail prices. Economic theory tells us that changes in business costs are reflected in the prices that businesses charge. Arguably, it's impossible to produce hard evidence showing the direct impact on retail prices resulting from small card acceptance cost decreases or at least to do so would require complex statistical modelling across every industry in Australia.

It is likely that some merchants operating in sectors that face little competitive pressure will not pass on the full amount of savings if their card acceptance costs are reduced. But this is a reason to address competitive pressure in those markets, not to keep interchange at high levels. This issue comes down to an assessment of who do we trust to pass on savings to consumers: the highly concentrated banking industry currently making record profits or all other businesses consumers have contact with, some facing more competitive pressure than others.

---

[11] Reserve Bank of Australia (2015), *Review of Card Payments Regulation, Issues Paper,* http://www.rba.gov.au/payments-system/reforms/review-of-card-payments-regulation/pdf/review-of-card-payments-regulation-issues-paper.pdf

[12] Official Journal of the European Union, *Regulation (EU) 2015/751 of the European Parliament and of the Council of 29 April 2015 on interchange fees for card-based payment transactions,* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2015_123_R_0001&rid=1

choice

Criticism two: reducing interchange will reduce the value of rewards programs

Credit card rewards programs did decrease in value after 2003. This was one of the intentions of the RBA reforms in order to reduce the incentives for consumers to use high-cost payment systems over low-cost cash or EFTPOS.

A similar result should be expected if interchange rates are reduced again. We are already seeing this trend in the EU as rewards schemes are being revalued or removed as a result of the 2015 reforms.[13] This change will likely disadvantage a small group of well-off consumers while benefiting all others.

It is important to note that rewards schemes have never offered good value to most consumers. In 2003 consumers with a MasterCard and Visa rewards cards needed to spend an average of $12,400 to get a $100 voucher.[14] This increased to $14,400 in 2004 and $16,000 in 2006.[15] Today, the average spend required for a rewards credit card to receive a $100 voucher is $17,926.[16]

Rewards schemes are designed to encourage spending on credit cards and tend only to benefit higher-income consumers who are able to spend significant amounts on cards but also are able to pay off their full balance each month to avoid interest and fees.

Even in 2003, the consumers most likely to get value from rewards points had high-incomes and consistent cash flows. RBA statistics demonstrate that consumers in the top quartile of income are ten times more likely to have a premium credit card (with rewards points) than consumers in the lowest income quartile.[17] CHOICE statistics support this, finding that only 19% of consumers earning under $50,000 per annum strongly agree that they are more likely to use a card with rewards points, compared to 32% of consumers who earn over $100,000.[18]

---

[13] For example see Hyde, Dan (10 April 2015), "Death of the credit card perk", *The Telegraph*, UK http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/11529393/Death-of-the-credit-card-perk.html
[14] Stillman, Robert, William Bishop, Kyla Malcolm and Nicole Hildebrandt, 28 April 2008, Regulatory Intervention in the payment card industry by the Reserve Bank of Australia, Analysis of the evidence. CRA International, London, p.16.
[15] Ibid.
[16] See CHOICE, (2015) Submission to Inquiry into matters relating to credit card interest rates p.13.
[17] Ibid p.5.
[18] CHOICE, survey into consumer use and understanding of credit cards, July 2015. N=1679. For further information see CHOICE, (2015) Submission to Inquiry into matters relating to credit card interest rates p.13.

choice

While only a small group of consumers benefit from rewards points, all consumers pay for them Any consumer who doesn't pay of their credit card each month is funding loyalty and rewards schemes and all consumers subsidise rewards to some extent through higher prices for goods and services charged by any merchant recovering high card acceptance costs.

Similar card rewards cross-subsidisation issues have been observed in other countries. In the United States, where interchange rates are significantly higher than in Australia, it was estimated that 54% of low and middle income families paid for the cost of interchange without receiving the benefits of any credit card. 59% of high income card holders received rewards financed by these fees, compared to 25% of low income card holders and 39% of middle income card holders.[19]

Rather than assessing how RBA reforms have created a somewhat more equitable payments system, critics use the reduction in "free" credit card benefits as evidence that the reforms have damaged all Australian consumers. The trick being played here is equating high-income cardholders with all consumers, ignoring the millions of people do not have or benefit from credit cards.

In short, rewards points have never been good value to most consumers. They are even worse value today compared to 2003 rates and may decrease in value should interchange be lowered again. This will be an overall positive step as few consumers benefit from rewards points but all consumers, even those using cash or other payment methods, pay for them.

Criticism three: reducing interchange will lead to annual fees increases and some card providers may be unable to offer low rate cards

There is some suggestion that lowering interchange will lead to higher annual fees, increased interest rates or the withdrawal of low-interest credit cards from the Australian market.

As noted by the RBA, credit cards are typically funded through three sources: fees, interchange revenues and interest payments.[20] These funding sources cover the basic cost of providing credit, card features related to credit like interest free periods and "special" features like rewards points.

---

[19] Shapiro, R. J. and Vellucci, J., *The Costs of "Charging It" in America: Assessing the economic impact of interchange fees for credit card and debit card transactions.*, February 2010. Consumers for Competitive Choice, p. 13.
[20] Reserve Bank of Australia, (2015), *Submission to the Senate Inquiry into Matters Relating to Credit Card Interest Rates*, p.3.

Increasingly, the cost of providing credit has become less important while the cost of rewards cards and card scheme fees have grown. The Australian Bankers' Association (ABA) has noted that funding costs for credit cards have become less important. Credit card funding comprised over half of card costs in 2008 but this has fallen to only a third of costs in 2014 while rewards programs and scheme fees (payments to MasterCard, Visa etc.) have comprised a greater proportion of bank costs in recent years.[21] The Commonwealth Bank notes in its submission that the cost of funds only contributes to 22% of credit card costs for the bank with pricing risk, operating costs and rewards programs the other key costs.[22] CHOICE expects that should interchange be lowered to 0.3%, high cost rewards programs will be affected as they comprise a growing cost that is not essential to the provision of credit.

It is difficult to accurately assess the claims that fees will rise and that low interest cards will not be able to be provided if interchange is lowered. Claims that card providers will no longer be able to offer low-rate cards haven't proved true in the European Union. Currently, there are credit cards available with much lower interest rates than in the Australian market, despite reforms to lower interchange similar to the RBA proposal.[23]

It is also important to note that banks are currently posting record profits and the spreads earned by credit card providers have increased since 2009.[24] If banks automatically passed on costs to consumers if interchange was lowered, this would indicate a much larger problem with the competitive pressure in the Australian banking industry.

Fees and interest payments are costs that a consumer can see and assess but interchange fees are opaque. Consumers have little ability to assess how much they pay in interchange fees through higher costs for goods unless a merchant charges a reasonable surcharge for accepting a card payment. Even then, it is not always clear that a surcharge is, or should be related to the higher cost of accepting high-end cards with high interchange fees.

In the interests of transparency, CHOICE supports lowering interchange so that costs are truly apparent to consumers through interest rates and fees. It is likely that some cards will raise annual

---

[21] ABA (2015), *ABA response into the Inquiry into credit card interest rates*, pp. 14-15.
[22] Commonwealth Bank, (2015), *Submission: Senate Economics References Committee Inquiry into matters relating to credit card interest rates*, p. 7.
[23] For example, cards with ongoing interest rates as low as 6.4% in the United Kingdom at http://moneycompare.which.co.uk/credit-cards/everyday-credit-cards
[24] See Treasury, (2015), *Submission to the Senate Economics References Committee Inquiry into Matters Relating to Credit Card Interest Rates*, p. 8.

fees or interest rates but we expect this to occur on high-end rewards cards, currently subsidised through the interchange system. Any suggestion that all consumers will be negatively affected by a reduction in interchange fees presents a highly selective interpretation of previous reforms and fails to consider the costs to all consumers should the current rates of interchange remain. It is spurious to suggest that reducing interchange is somehow going to create new costs for consumers; the costs already exist, they are simply submerged in business-to-business transactions over which consumers have little visibility or opportunity to respond. Ultimately, it would be a positive outcome if the costs of using high-end rewards cards were more transparent, and borne by those consumers who actively choose these products.

The debate about interchange is about the cost of our payment system

The interchange debate is about who pays for our payments system. Do we want a high-cost payment system with some of the funds going towards "special" features like rewards points that only high-spending customers can benefit from? Or do we want a lower-cost payment system that will reduce costs for all merchants and should lead to lower costs for consumers across the economy?

CHOICE supports lowering interchange rates to increase transparency in the payments system and to decrease overall costs. However, there is a need for further reform to make consumers more aware of features on their card and likely costs. There is also a need to increase competitive pressure on card providers to compete on the cost of interest rates and fees, not rewards points. Given this, CHOICE recommends that the proposals in our earlier submission are implemented alongside of further reductions in interchange fees.

Yours sincerely,

Erin Turner,
Campaigns Manager

WWW.CHOICE.COM.AU **E** CAMPAIGNS@CHOICE.COM.AU
57 CARRINGTON ROAD MARRICKVILLE NSW 2204 **P** 02 9577 3333 **F** 02 9577 3377

choice

Appendix one: research sponsored by or associated with card schemes or the banking industry

Research	**Funded by or associated with**
Chang, Howard, David Evans and Daniel D. Garcia Swartz, 26 September 2005, *The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia,* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=820044	Produced with financial support of Visa U.S.A.
Evans, David, Howard Chang & Margaret Weichert (2011), *Economic Analysis of Claims in Support of the "Durbin Amendment" to Regulate Debit Card Interchange Fees"*, http://ssrn.com/abstract=1843628	Visa Inc. provided funding for research and writing of the paper.
Evans, David, Howard Chang & Steven Joyce (2013), *The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2342593	Visa Inc. provided research funding.
Evans, David and Richard Schmalensee (2005), *MIT Sloan Working Paper 4548-05: The Economics of Interchange Fees and Their Regulation: An Overview*, http://ssrn.com/abstract=744705	Visa U.S.A supported the research on which the paper is based.
Evans, David, Robert Litan & Richard Schmalensee (2011), *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1769887	The authors received financial support from several large members of the Electronic Payments Coalition; these institutions also provided information and data and were given the opportunity to provide comments on the paper.

choice

	(Electronic Payments Coalition members include MasterCard Worldwide and Visa Inc. A full list is available at http://www.electronicpaymentscoalition.org/about-epc/)
Evans, David, Jean-Charles Rochet & Richard Schmalensee (2006), *The European Commission's Interim Report on Payment Cards: Some Comments and Suggestions*, http://ec.europa.eu/competition/sectors/financial_services/inquiries/replies_report_1/19.pdf	Funding from ServiRed (Spain's leading card payment scheme which offers co-branding with Visa and MasterCard). Authors also note that they consult for other members of the payments card industry.
Gans, Joshua and Stephen King (2002), *A Theoretical Analysis of Credit Card Regulation*, Melbourne Business School, University of Melbourne. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=352220	Research funded in part by the National Australia Bank.
Schmalensee, Richard (2002), *Payment Systems and Interchange Fees*, Journal of Industrial Economics, no.2 pp 103-122. http://www.ugr.es/~scarbo/MASTER83.pdf	National Economic Research Associates and Visa U.S.A provided financial support.
Stillman, Robert, William Bishop, Kyla Malcolm and Nicole Hildebrandt, 28 April 2008, *Regulatory Intervention in the payment card industry by the Reserve Bank of Australia, Analysis of the evidence.* CRA International, London	Funded by MasterCard Worldwide