

Deloitte Access Economics

Competitive neutrality in Australian payments markets

March 2014

Contents

Executive Summary	i
1 Background	1
1.1 The importance of competitive neutrality	2
2 The economics of payments systems	3
2.1 Key elements.....	3
3 Regulation to date – intentions and impacts.....	9
3.1 Who gets regulated.....	14
3.2 Interchange regulations	16
3.3 Impact on cardholder incentives	18
4 The evolving payments landscape	20
4.1 Four party companion cards	20
4.2 Impact on Australia’s credit card market.....	22
Conclusions: Reform options	29
Interchange fees.....	29
References.....	31
Limitation of our work.....	33

Charts

Chart 3.1 : Ratio of non-designated to designated scheme MSFs	18
Chart 4.1 : Market share of American Express and Diners Club transaction value	22
Chart 4.2 : American Express/Diners Club Card Payments*	24
Chart 4.3 : Average value of American Express/ Diners transaction relative to Visa/MasterCard transaction*	25
Chart 4.4 : American Express MSFs relative to Visa/MasterCard	26
Chart 4.5 : Direct cost to merchants caused by increases in American Express/Diners Club market share	27

Tables

Table 3.1 : Summary of impact of RBA regulations.....	11
Table 3.2 : Four-party credit card rewards programs	19

Liability limited by a scheme approved under Professional Standards Legislation.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Table 4.1 : Reward per \$100 spent on Visa/MasterCard and companion card, December 201121

Figures

Figure 2.1 : Four-party card scheme model and the role of interchange fees	5
Figure 2.2 : Four-party card scheme model and the role of interchange fees	7
Figure 4.1 : Structure of American Express companion card model.....	21

Executive Summary

Australia has now had just over a decade of experience with the changes to the regulation of its retail payments system implemented progressively by the Reserve Bank of Australia (RBA) since 2003. The key element of these changes was the regulation of interchange fees charged on four-party scheme credit and debit cards (operated by MasterCard and Visa).

The RBA's decisions were motivated by a number of concerns it had at the time. Foremost among these considerations was the differential in incentives cardholders faced in using scheme cards over alternative payment instruments, in particular EFTPOS and cash. Also, the setting of interchange fees was viewed by the RBA to be too inflexible, with interchange fees remaining constant over time despite changing market conditions. By regulating interchange fees and allowing merchant surcharging, a further element of the RBA's changes, the RBA believed that the different payment channels would be able to compete more effectively.

The RBA did not, however, regulate the internal transfers embedded in the three-party credit card schemes operated by American Express and Diners Club (known as 'proprietary schemes'). In part this was because the lack of an explicit fee meant that any regulatory solution would likely be more complex than the interchange regulation it imposed on the four-party schemes. Further, at the time the regulatory changes were designed, three-party card schemes held a relatively small share of the payments card market – a combined average of 14.7% of the value (and 10% of the volume) of transactions in the six months prior to the changes.

Instead of imposing equivalent regulations on the three-party proprietary schemes to the interchange regulations imposed on MasterCard and Visa, it was hoped at the time that allowing surcharging, in combination with a requirement for the three-party schemes to report their merchant service fees, would place sufficient downward pressure on three-party proprietary schemes' merchant services fees. This would then flow through to these schemes offering lower rewards to their cardholders. Thus, it was thought that the competitive landscape would not be substantially affected.

As it has turned out, this expectation has not materialised; the competitive landscape was significantly changed by the regulations.

The payments system is a particularly dynamic market with the rapid advances in the development and take-up of new technologies quickly altering the landscape. Yet the RBA regulations remain focused on card platforms.

Even here, the landscape has changed substantively in recent years. Merchant service fees charged in the four-party card schemes fell sharply in line with the reduction in interchange fees and continued to fall until plateauing from 2007 onwards. Merchant service fees for the three-party proprietary schemes have also declined. However, the relative gap between the different types of schemes has widened, allowing the three-party proprietary schemes to offer noticeably more attractive rewards packages. Surcharging has become more prevalent over the period since the reforms, although a large majority of card transactions still do not attract a surcharge.

Of particular significance has been the entry into the market of offerings that amount to new four-party card schemes that are being offered by traditional three-party proprietary schemes and four-party schemes that were not present in Australia at the time of the RBA interchange reforms. These new offerings are taking advantage of the unregulated status of these schemes. The most prominent of these has been American Express “GNS” four-party companion cards. Both Diners Club and China UnionPay (CUP) are now also either offering four-party companion cards or have publically flagged their intent to do so.

These cards operate on a four-party model where the payments company plays the role of the acquirer on transactions but cards are issued by the cardholder’s bank. For example, American Express pays the partner bank an ‘issuer rate’ which plays the role of interchange fees in the traditional four-party model. The issuer rate is then used to fund the issuer’s card business and reward schemes for cardholders.

These arrangements are termed ‘four-party companion cards’. Although they operate according to a four-party model, these cards have escaped the interchange regulations that govern the traditional four-party card schemes that were incumbent operators when the RBA regulations commenced. This has meant that they are uncapped when setting their issuer (or interchange) rates and are therefore able to potentially support significantly more advantageous business cases to issuing banks that then, in part, fund substantially higher rewards programs than would be possible under the circumstances present for those schemes captured by the regulation of interchange fees.

By circumventing the interchange regulations, these instruments are jeopardising the stated objectives of the 2003 changes. The result has been a significant increase in market share for the traditional three-party card companies that now run four-party companion card schemes. While these schemes held a combined market share of less than 15% by value at the time of the reforms, this figure has now risen to around 20%. The increases in market shares of the three-party schemes over this period have coincided with the issuance of four-party companion cards by major banks, implying that these cards are driving the shift in market structure.

In addition, while at the time of the 2003 changes the three and four-party schemes occupied different segments of the payments market, this is no longer be the case. The traditional three-party proprietary scheme cards were targeted at corporates and relatively high-income individuals who were able to make sufficient purchases to overcome the higher annual fees. The four-party companion cards target a much broader range of customers.

This result is illustrated by the types of purchases made using the four-party companion cards. For example, according to a survey by the RBA, supermarket purchases accounted for less than 10% of American Express and Diners Club payments in 2007, but by 2010 this figure had jumped to above 40%.

Hence, the companies that manage the unregulated three-party proprietary schemes are increasingly competing for transactions through their four-party companion card offerings that were previously dominated by other forms of payment. Ordinarily such competition would be welcome. However, when it is in part the result of uneven regulatory treatment, it is likely to result in an inefficient distortion of market structure.

The rising market share of unregulated four-party schemes since the first half of 2003 when the regulations were introduced has directly cost merchants an estimated \$125 million in higher fees in the 2013 financial year and a cumulative \$770 million in 2013 dollars since the reforms were introduced in 2003.

Given developments in the payments market since the initial changes in 2003 and the Federal Government's establishment of the Financial System Inquiry, including the payments system in its Terms of Reference, it is timely to re-assess this regulatory environment. The rise in the use of cards belonging to unregulated, four-party companion card schemes, and the further potential market entry of traditional but unregulated four-party schemes, which was not contemplated at the time of the reforms, are currently jeopardising the objectives of the reforms.

There are several options that may be considered to address competitive neutrality concerns including:

- remove the regulations on interchange fees to allow the traditional four-party schemes to compete on a level playing field with the four-party companion card schemes and other new entrant four-party schemes; or
- regulate the four-party companion cards in a comparable manner to incumbent four-party schemes and other new entrant four-party schemes.

Payment instruments compete in a complex environment and designing an optimal regulatory regime is not straightforward. However, if the payments system is to operate in an effective manner that achieves the stated intentions of the 2003 reforms, then restoring competitive neutrality among competing instruments will be an important step.

Deloitte Access Economics

1 Background

From 2003, the RBA introduced a series of credit card scheme regulations with the stated aim of promoting efficiency and competition in Australia's payments system. Prior to the introduction of the regulations, the RBA was concerned that interchange fees were not subject to adequate market forces. Although the economic theory of payments systems was still in its infancy, and indeed is still not well understood, the RBA judged that interchange fees were higher than desirable and this was creating inefficiencies in the credit card market.

In an effort to address these concerns, the RBA enacted reforms which included:

- capping interchange fees set by designated incumbent four-party credit card schemes, namely Visa, MasterCard and Bankcard; and
- removing the 'no surcharge' rule for domestic transactions on credit cards for all major credit card companies in Australia, which also included traditional three-party proprietary schemes such as American Express and Diners Club.

At the time, the RBA anticipated that the cap on interchange fees would flow through to lower merchant service fees (MSFs) for designated schemes. There was some concern that, by designating only Visa, MasterCard and Bankcard, non-designated schemes might be able to leverage their position to grow their market shares. However, the RBA hoped that competitive pressures together with greater transparency and the allowance of surcharging would be enough to lower MSFs for non-designated schemes and substantially reduce any competitive advantage gained by non-designated schemes flowing from the regulations.

These regulations have now been in place for a decade. There is now sufficient evidence to review the predictions set out by the RBA and others prior to the enactment of the changes, and compare these predictions with observed outcomes. Accordingly, the purpose of this report is to analyse the impact of the RBA regulations on the credit card industry, with a particular focus on competitive neutrality.

The report is set out as follows. Chapter 2 provides an overview of the theoretical context underpinning two-sided markets, such as credit card markets. It explains the structure and business model of traditional credit card schemes. It also briefly outlines the competitive implications of having inconsistently applied regulations.

Chapter 3 discusses the intentions of regulations to date, with particular reference to the 2003 RBA reforms, and reviews evidence of their impacts, with reference to the outcomes expected prior to the introduction of the reforms. The chapter covers the impact of the reforms on: the flexibility of interchange fees; MSFs charged by regulated and unregulated schemes; and the impact on cardholder benefits.

Chapter 4 explores how the payments landscape has evolved following the 2003 reforms. In particular, it considers the emergence of unregulated four party companion cards administered by traditional three party schemes. It then analyses how these have affected the structure of payments markets in Australia, and their impact on competitive neutrality.

Finally, the Conclusions chapter summarises preliminary conclusions about the overall impacts of the regulations and considers some options for addressing market distortions driven by the uneven application of the regulations.

1.1 The importance of competitive neutrality

Competition fosters improvements in productivity and leads to higher standards of living. In competitive markets, the equilibrium price and quantity of goods traded will result in the efficient use of resources. The goal of improving efficiency in the economy is helped by encouraging as much competition in a market as possible.

One barrier to competition can be regulation. According to the COAG National Competition Policy Review,

“Many sectors of the economy... operate under regulatory regimes which restrict certain forms of competitive behaviour. ...For example, price regulation intended to assist favoured classes of producers or consumers restricts competition.”

If the burden of a regulation falls more heavily on some suppliers than others, it may have a negative impact on competition in a market. By raising costs relatively more for certain suppliers than others, it could inhibit their ability to offer attractive prices to customers.

The Hilmer Competition Inquiry (1994) explains that:

“Differences in regulatory and other requirements imposed on firms competing in the one market may distort competition and hence undermine market efficiency. Differences of these kinds may also be seen as inequitable, particularly where they are not clearly supported on public interest grounds.”

Given the competitive implications discussed above, it is important that regulations have the same or similar impact on all players. When designing regulations, relevant bodies should be cognisant of any differential effects they might have. Ideally, there would be a single regulatory framework. In practice, however, it may take the form of equivalent regulations to ensure a level playing field.

2 The economics of payments systems

Payments systems are unusual among partially regulated industries in the way they combine two sides of the market (the customer and the merchant). Such two-sided markets are characterised by network externalities, where the value of participating depends on the uptake by the other side of the market.

The theoretical underpinnings of two-sided markets have only been developed recently, with much of the economic research being conducted since the 2003 reforms. Indeed, in Lowe (2005), the then Assistant Governor (Financial System) at the RBA, Dr Philip Lowe, stated that:

“It is undoubtedly true that the theory of two-sided markets and interchange fees is still evolving and realistic models are still being developed... Measuring these various externalities is extremely difficult and, to my knowledge, no one has yet come up with empirical estimates that one can have confidence in and that can be used for policy work. The issue is then largely one of judgement.”

2.1 Key elements

As noted above, payments systems can be described as two-sided markets, and are characterised by strong network effects. The attractiveness of any given payment platform is influenced by the number of parties who subscribe to it.

In a two-sided market structure, the costs of maintaining a platform can be recovered from either side of the market. One example of this is newspapers. This market also has two sides – consumers or subscribers on the one hand, and advertisers on the other. Prices can be levied on either side of the market, or both. For example, at the extremes, newspapers may operate on a subscription basis, or they may offer free papers to consumers and instead recoup costs from advertisers.

The main revenue source will vary according to each newspaper’s business model. It is difficult to determine whether there is an ‘optimal’ structure for recovering the platform’s costs, and what exactly the ideal split might be.

The same principle applies to payment systems.

Consumers are the individuals and/or organisations who seek to purchase goods and services. They do this by using a medium of exchange (provided by a platform) to pay a merchant. In return, consumers receive goods and services.

Merchants are the individuals and/or organisations who seek to sell goods and services. They do this by receiving payments from consumers in return for providing them with goods.

In order to accept payments, merchants must subscribe to one or more payments platforms including cash, cheques, credit or debit cards, and a wider range of instruments that are evolving online or using mobile technologies. This may incur some costs. For instance, they might have to pay a fee to the platform provider or an intermediary, or set up internal processes to facilitate secure and efficient payment processing.

Despite these costs, merchants may choose to offer several payment platforms. This is to attract a wider range of consumers. Where a merchant makes multiple payment platforms available, it is generally consumers who decide which method to use. They consider three factors when making this decision:

- convenience – the likelihood that the method will be accepted by merchants, and the ease of using it;
- cost – what the price of using this platform is; and
- rewards/benefits – any additional advantages which could arise, such as point schemes or security.

As outlined above, **platforms** are the means through which consumers and merchants can exchange value. They facilitate transactions by providing a common base on which consumers and merchants can 'meet'.

There are many different types of retail payments platforms. Some examples include scheme debit/credit cards, eftpos, BPAY, cheques, cash and direct debit/direct credit. More are emerging, with recent examples including Bitcoin.

In Australia, all platforms (apart from cash) are commercially owned and operated. Their revenues are generally derived from charging either consumers or merchants for accessing their systems. In most platforms – such as eftpos and credit card schemes – this is done indirectly; the platform charges the consumer's and/or merchant's financial institution a fee for facilitating transactions and accessing the platform.

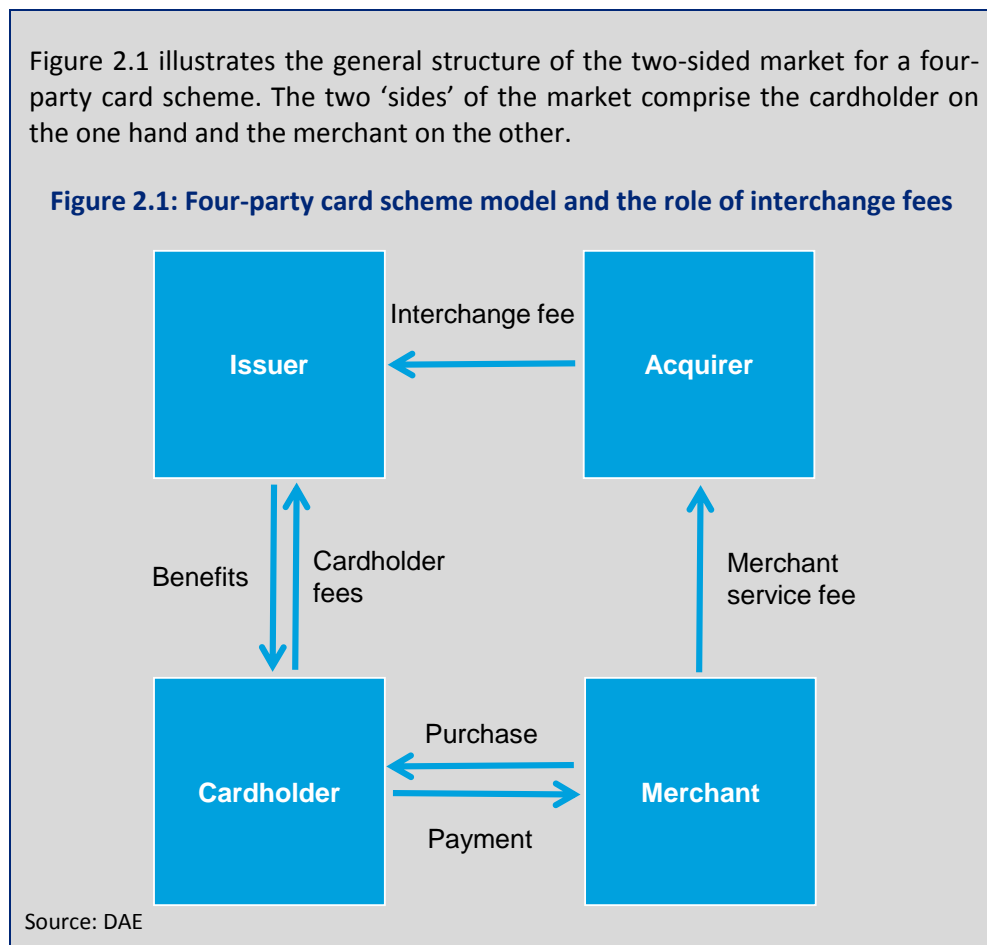
Given that the benefits on each side of the market differ, the goal of platforms is often to set and leverage prices and incentives in a manner aimed to maximise total use of the platform by both sides of the two-sided market, namely merchants and customers.

Platforms compete with each other for customers and offer different value propositions. They deliver these using different business models and internal structures, and are often subject to different regulations. There can even be variations within a platform – for instance, three-party and four-party credit card scheme models operate, and are regulated, differently.

This report focuses on regulatory settings around credit cards. As such, the two historical credit-card business models are described briefly below.

2.1.1 Four-party schemes

The first of the two basic platform models used in two-sided payment markets is the four-party card schemes. The structure of the four-party card scheme is illustrated in Figure 2.1 below.



The transaction is facilitated by exchanges between the merchant's bank (the acquirer) and the cardholder's bank (the issuer), with a payment, known as an **interchange fee**, passing from the acquirer to the issuer. The card scheme does not play a direct role in the transaction, but instead provides the platform on which the transaction takes place.

The interchange fee is not a 'price' in the usual sense. As noted above, the value that consumers/merchants derive from a payments platform is determined by the number of merchants/consumers who will use/accept it. This is made clearer when considering the different network externalities each side of the market faces:

- **Cardholders:** receive the benefits of convenience from holding cards which a large number of merchants accept, with these benefits increasing with the number of merchants who accept the card; while

- **Merchants:** receive benefits, including among other things greater sales, from accepting cards, with these benefits increasing with the number of consumers who hold those cards.

That the benefits from participating in the market differ on each side demonstrates the balancing role that interchange fees play. They are a means of internalising the network externality within the scheme and are set by the card scheme to maximise transaction volumes on a particular platform. An increase in the interchange fee will increase the MSF and reduce the take-up from merchants, but encouraging cardholder take-up. A reduction in the interchange fee will have the opposite effect. Broadly, the direction of any interchange fee movement is thus determined by which side of the market needs greater 'encouragement' to participate in the scheme.

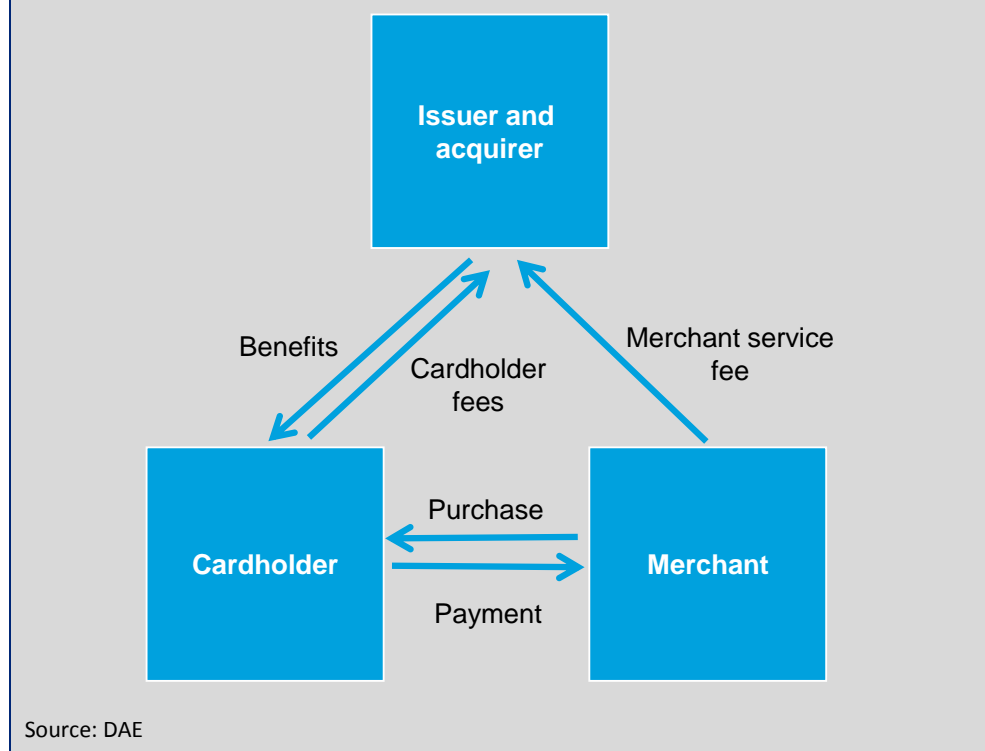
As such, an interchange fee plays the role of balancing the two sides of the market, encouraging use from the side that would otherwise probably under-use the service provided.

2.1.2 Three-party schemes

The second of the two basic platform models in two-sided payment markets is the traditional three-party card scheme illustrated in Figure 2.2.

Traditional three-party proprietary schemes operate according to a broadly similar structure to four-party schemes. However, instead of separate acquiring and issuing entities within the platform, the card scheme itself directly fulfils both of these roles. An implicit interchange fee then plays the same balancing role as outlined for the four-party schemes. Figure 2.2 illustrates the traditional three-party model.

Figure 2.2: Four-party card scheme model and the role of interchange fees



The traditional three- and four-party models have generally adopted different pricing structures. Three-party schemes have tended to charge significantly higher merchant services fees than four-party schemes. Together with annual fees charged to cardholders, these fees fund generous reward schemes and encourage increased participation by cardholders. In contrast, the acquiring and issuing banks for four-party schemes have tended to charge lower fees to merchants and cardholders, and offer commensurately less generous rewards.

The different fee structures largely reflect the origins of the two types of scheme. Diners Club, developed in the early 1950s, was the first card to be widely accepted among

merchants. What began as a card used at restaurants by wealthy diners expanded rapidly and was soon accepted at many holiday destinations and entertainment locations. American Express soon followed and together, Diners Club and American Express were marketed to wealthier individuals as exclusive cards with a focus on the travel and entertainment sectors.

In contrast, Visa and MasterCard – originally known as BankAmericard and Interbank – were issued by banks able to leverage existing customer relationships and target a much broader range of households.

These divergent profit maximising pricing structures and market positions for traditional three- and four-party credit card companies have been maintained over time. Reflecting their niche target market, the market share of traditional three-party schemes was significantly below that of four-party schemes while the average transaction value was higher. In 2002, prior to the introduction of the regulations, the average credit card transaction size for three-party scheme cards was \$179, more than 50% above that of four-party schemes at \$117.

3 Regulation to date – intentions and impacts

When the RBA implemented its reforms in 2003, it did so with little international precedent and only a relatively nascent economic theory on which to base its decisions. The decade since the reforms has seen developments in the theory and experience of payments systems, and the debate around, and justification of, the reforms has become more nuanced. This section sets out the thinking that underlay the decision to regulate interchange fees and surcharging at the time of the reforms.

The rationale for the 2003 regulations emerged from the RBA and ACCC Joint Study into payments systems released in 2000. Overall, the RBA believed that the combination of interchange fees with rules preventing surcharging and governing card acceptance choices contributed to a system that was not in society's interests. It also considered that the market itself lacked sufficient competition, with interchange fees appearing inflexible over time, and therefore seen to be not subject to the usual forces of competition. Part of this inflexibility was seen as a result of the fact that fees were set bilaterally between institutions, or multilaterally within card associations, which made them resistant to change.

In 2003, the RBA designated the then incumbent four-party card schemes as 'payment systems' under the *Payment Systems (Regulation) Act 2003* and imposed several related standards on the schemes. In brief, these consisted of:

- Regulation of interchange fees: the weighted average interchange fee for regulated four-party credit cards was capped at 50 basis points of transaction value. For four-party scheme debit cards, the interchange fee was capped at 12 cents per transaction.
- Surcharging: rules preventing merchants from surcharging were removed from both the three- and four-party schemes, allowing merchants to pass on the merchant service fee should they choose to do so; and
- Card acceptance: rules preventing merchants from refusing to accept cards belonging to a scheme were removed, giving merchants the ability to refuse payments from products with high merchant service fees.

Traditional three-party credit card schemes were neither designated nor formally regulated as part of these reforms.

The RBA argued that these reforms would increase competition between payment instruments by placing them on a more level playing field from the perspective of cardholder incentives. It was also expected to empower merchants, particularly through granting them the ability to surcharge, while merchant service fees were expected to fall as a result of the lower average interchange fees.

More specifically, the expected outcomes of the reforms were:

- Surcharging: a significant number of merchants were expected to surcharge for those cards which imposed a significant fee on merchants. Surcharging would have the effect of neutralising the interchange fee as it 'closed the loop' among the parties in the card

schemes because cardholders would face the costs their card use imposed on merchants;

- Merchant service fees: were expected to decline due to competition among acquirers who passed on the reduced interchange fee;
- Market shares of competing instruments: the reforms would have the effect of reducing the difference in rewards faced by consumers using competing payment instruments. In particular, the gap between rewards received for payments using credit cards, scheme debit and eftpos would narrow, with an expected reduction in market share for card schemes.

Although the regulation of interchange fees only affected the four-party schemes, similar impacts were expected for the three-party schemes for which surcharging was also allowed and pricing transparency was promoted. Further, at the time, the traditional three-party schemes were not considered close substitutes for the four-party systems. In particular, while the traditional three-party cards were typically used for more high-end or luxury purchases, four-party cards were typically used for everyday purchases.

However a report by NECG Pty Ltd commissioned by Visa in 2001 foreshadowed the likely consequences of regulating only four-party credit card schemes. In particular, the report, entitled 'Delivering a Level Playing Field for Credit Card Payment Schemes', predicted among other things that:

- Lower interchange fees would lead to decreased merchant service fees and cardholder rewards, leading to decreased four-party scheme card usage relative to other instruments;
- Corresponding changes in fees and rewards would not be seen in the traditional three-party schemes, causing cardholders to migrate to those instruments. Competition would not cause a reduction in the rewards or merchant service fee gap between the three- and four-party schemes; and
- The result would be an inefficiently high use of traditional three-party instruments over those offered by the regulated four-party schemes.

The intentions and impacts of these regulations are summarised in Table 3.1 below.

Table 3.1: Summary of impact of RBA regulations

Issue	RBA view	Alternative views¹	Outcomes
Flexibility in interchange fees	Interchange fees had lacked flexibility and transparency, in part because they were “set collectively by members that are otherwise competitors in providing credit card payment services to cardholders and merchants” (RBA, 2002b: 5).	Agreed that interchange fees had not changed much over time, however not clear that this implied market outcomes were inefficient.	Interchange fees are subject to more frequent adjustment and there are fee differentials across cards reflecting the various forces in different market segments (although flexibility is inherently limited through the imposition of a regulated and capped basket).
Regulated scheme MSFs	“Since interchange fees set a floor for merchant service fees, the reduction in interchange fees would be expected to result, <i>pari passu</i> , in lower merchant service fees.” (RBA, 2002b: 5).	Agreed	As expected

¹ Based on DAE summaries of submissions prepared by, or on behalf of, Visa

Unregulated scheme MSFs	Competition would force 3-party schemes to lower their MSFs “if (3-party) fees did not adjust, some (merchants) might stop accepting the latter cards altogether, a viable option because merchants may not fear losing many sales in view of the relatively small network size of American Express and Diners Club.” (RBA, 2001:119)	“Competition will not lead one card system to match another system where the latter system is forced to set a structure of fees that leads to an overall lower level of benefits to its cardholders and merchants.” (NECG, 2001: 2).	American Express and Diners Club MSFs have come down, although the ratio between MSFs for three party schemes relative to four party schemes is higher than prior to the regulations, and as the three party scheme’s market share has grown there is more pressure on merchants not to surcharge. 3-party scheme MSFs are between 2.2 and 2.6 times higher than 4-party schemes, up from 1.8 times higher in 2003. The reduction in MSFs has also been smaller for 3-party schemes, falling by 26% since March 2003 compared to 42% for 4-party schemes.
Four-party rewards	The RBA expected that lower interchange fees would reduce benefits and/or increase fees for 4-party cardholders.	Agreed that four-party schemes would reduce rewards.	The value of reward programs for 4-party schemes has declined by around one-third (Chan et al, 2012).
Three-party rewards	Competitive pressure to reduce 3-party MSFs would lead 3-party card schemes to reduce the attractiveness of their credit card packages.	Traditional 3-party schemes would not match changes in the 4-party schemes and “consumers will make greater use of the cards offered by the closed schemes, which will be able to offer more generous reward programmes for card usage” (NECG, 2001:2).	The value of rewards offered for four-party companion cards are typically around 1.5 to 2 times greater than Visa/MasterCard.

Surcharging	<p>The no surcharging rule was suppressing price signals to consumers about the resource costs associated with different payment methods and “denies merchants the freedom to set prices for customers that promote the competitiveness of their business”.</p> <p>It was also thought that surcharging may assist merchants in their negotiations with acquirers, placing downward pressure on MSFs. (RBA, 2002:63)</p>	<p>Visa contended that surcharging would not closely reflect the underlying transaction cost. “A minority of merchants who have substantial market power (will take) advantage of the situation and impose on cardholders as much surcharge as the market will bear” (NECG, 2006:21), while merchants without market power would not surcharge.</p>	<p>Only around 30% of <i>merchants</i> surcharged at least one brand of credit card in 2010 (RBA 2011: 2). An even lower proportion of <i>transactions</i> are subject to surcharging, reflecting the fact that some merchants who process a large number of transactions, for example supermarkets, tend not to surcharge. The RBA has also varied the Standards to address concerns about the incidence of excessive and blended surcharging.</p>
Competition between credit and debit cards	<p>The RBA was concerned that credit card use was higher than optimal. It predicted that credit card growth would slow as a result of the reforms.</p>	<p>Visa claimed that the regulations would encourage the growth of high-cost 3-party card schemes rather than the growth of other payment instruments.</p>	<p>Credit card growth has slowed, though this is likely to be a combination of the regulations, and household preferences following the GFC.</p>
Competition between 3- and 4-party schemes	<p>The RBA expected that competitive forces and increased transparency would force traditional 3-party schemes to lower their MSFs. It was also expected that merchants would be able to exercise market power to place discipline on MSFs.</p>	<p>Although 3-party card schemes might reduce MSFs slightly, they would maintain high MSFs and high rewards, leading to gains in market share. Merchants would not be in a position to force lower MSFs.</p>	<p>3-party schemes have grown their market share.</p>

3.1 Who gets regulated

As outlined previously, under the 2003 RBA reforms, only four-party card schemes are formally governed by the interchange regulations.

3.1.1 Intention

Prior to the 2003 changes, the RBA had considered whether the traditional three-party schemes should also be regulated. These schemes applied implicit interchange fees that provided the same incentives as interchange in the four-party schemes, with cardholders receiving benefits and rewards funded in part from merchant service fees.

The RBA ultimately declined to regulate the traditional three-party schemes directly, instead settling for an agreement for those schemes to publish data on their merchant service fee levels and remove certain rules which restricted the ability of merchants to steer consumers towards particular payment options. Rules prohibiting surcharging were also removed as with the four-party schemes.

The RBA may have considered that there is no simple way of regulating incentives paid by unregulated four-party schemes to issuing banks. Any caps on interchange fee payments for unregulated schemes could be offset with other forms of marketing and product support payments. While this could be addressed by regulating all payments to issuing banks, the RBA views this as difficult. It expressed the opinion that any increased regulation of support payments will need to be applied to the four-card schemes to maintain competitive neutrality, a move which was viewed as excessive.²

The stated argument for not regulating traditional three-party schemes directly was that, unlike designated schemes, interchange fees were not set collectively by the financial institutions that were members of the schemes. Further, because designated schemes dominated the market with around 85% of the value of credit and charge card transactions, the RBA judged that the regulations would not prevent schemes from being able to compete effectively.

The RBA has more recently indicated two further reasons why the undesignated schemes should not be regulated. First, it has expressed doubt as to whether there was sufficient competition for acquiring services under unregulated four-party schemes. The main difference between traditional four-party schemes and four-party companion card schemes is that, for four-party companion card schemes, the scheme is the sole acquirer of its own transactions. The RBA is concerned that a cap on interchange fees for unregulated four-party schemes would not flow through to lower merchant service fees due to the lack of competition for acquiring services. In contrast, competition on the acquiring side of the market for traditional four-party schemes means that the lower interchange fees are passed through to merchant service fees.

² Note, as outlined later in this report, this argument is inconsistent if applied to a like-for-like comparison of traditional and new-entrant four-party schemes.

Although the regulations applying to traditional three-party systems were somewhat weaker, it was not known at the time whether they would be sufficient to maintain a level playing field with the four-party schemes. The thinking was that if merchant service fees fell roughly in line with those in the four-party card schemes then so too should the reward points that were available to be offered to cardholders and more direct regulation of these transfers would not be necessary.

Further, the traditional three-party schemes occupied a somewhat separate segment of the payments market, targeting high-income consumers who could earn sufficient rewards to cover the relatively higher annual fees. In contrast, the four-party cards were typically used for more day-to-day purchases. The high-fee-high-reward feature of the traditional three-party model also meant that they held a significantly lower market share than the four-party schemes.

Further, it was hoped that the regulations would be sufficient to affect traditional three-party schemes indirectly and maintain an even playing field through:

- allowing merchants to pass on merchant service fees to credit card users through surcharging; and
- increasing transparency by regularly publishing merchant service fees on the RBA website.

3.1.2 Difficulties in regulating three-party schemes

In Lowe (2006), the RBA acknowledged the difficulty in regulating interchange fees within the traditional three- and four-party schemes in a consistent way:

“Given the different structure of the schemes, any argument that American Express should be regulated in the same way as MasterCard or Visa is tantamount to the argument that interchange fees should not be regulated. The only way in which uniform regulation could have been applied would have been for the Bank to do no more than require the removal of the no-surcharge rule. While such an approach had the appeal of regulatory neutrality, we judged that, by itself, it would be unlikely to establish more appropriate price signals to cardholders within a reasonable time...”

Instead, its approach was to rely on the transparency effects of published merchant service fees and removal of the no-surcharging and anti-steering rules to achieve the required pressure on reward points in these schemes:

“Ultimately, it is this process of downward pressure on merchant service fees – not the regulation of payments to partner banks – that will determine the reward points that American Express cards can offer, whether issued by American Express itself or by its partner banks.”

That is, the RBA considered there to be no simple method of stopping cardholders from receiving price signals leading them to prefer three-party cards over alternative payment instruments. Hence, instead of attempting to regulate these price signals directly as it did for four-party schemes, it relied on granting merchants more power through publishing merchant service fees and allowing them to pass on these fees to cardholders if they chose to do so.

In summary, the RBA determined that it was difficult to regulate interchange fees for traditional three-party schemes because:

- regulating the interchange fee might not flow through to merchant service fees due to lack of competition for acquiring services; and
- there is no simple way to regulate incentives.

3.1.3 Impact

In the decade since the initial reforms, developments in the instruments offered by companies running traditional three-party card schemes have meant that the lack of direct regulation of transfers in these schemes has become a material issue. Traditional three-party schemes have developed ways to take advantage of their unregulated position, primarily by entering the four-party scheme market through the development of four-party offerings such as ‘companion cards’, all of which are unencumbered by fee caps and are now undermining the RBA’s ultimate objectives of an efficient and competitive payment system.

As is outlined in section 4.2, the market share of the unregulated card schemes has increased, as they have entered the four-party card scheme market through the creation of an unregulated four-party model based on the issuance of companion cards through partner banks. More details on these instruments and their impacts on the payments landscape are provided in section 4.

3.2 Interchange regulations

3.2.1 Intention

The Joint Study asserted that the system of interchange fees in place at the time was encouraging an inefficient use of competing payment instruments. In particular, it argued that, while card scheme payments were more costly to process relative to competing non-scheme payment mechanisms such as eftpos, incentives designed to induce consumers to use scheme cards steered them away from low cost payment instruments, resulting in a higher cost payments system than socially optimal.

This led the RBA to conclude in its 2002 Regulation Impact Statement (RBA, 2002) on the reform of the credit card schemes that:

“Normal market mechanisms are not working effectively in the retail payments system in Australia and, overall, the community is paying a higher cost for retail payments than is necessary.”

3.2.2 Difficulties in regulating interchange fees

While the structure of these schemes is simple enough, academic analysis of two-sided markets provides remarkably few concrete conclusions. Indeed, in a survey of the literature, Evans and Schmalensee (2005) conclude that:

“While some studies suggest that privately determined interchange fees are inefficiently high, others point to fees being inefficiently low. Moreover, there is a consensus among economists that, as a matter of theory, it is not possible to

arrive, except by happenstance, at the socially optimal interchange fee through any regulatory system that considers only costs”.

And further, that:

“There is no apparent basis in today’s economics – at a theoretical or empirical level – for concluding that it is generally possible to improve social welfare by a noticeable reduction in privately set interchange fees.”

Further difficulties arise when trying to determine the optimal interchange fees across competing payment systems when multiple payment instruments are available. Yet this is obviously necessary if interchange fees are to be regulated as they have been in Australia. . Again, the RBA acknowledged this at the time of the reforms, stating in Lowe (2006):

“amongst a myriad of possibilities, it may be optimal for one payment system to be priced more attractively to cardholders than another, despite that payment system having higher total resource costs.”

Again, the direction of the interchange fee, which determines the attractiveness of a particular instrument to cardholders, is determined by the balancing effect on the two sides of the market. When establishing eftpos, most consumers already held bank cards and it was the merchants who needed to be incentivised to install the necessary equipment to allow transactions to take place. This incentive was affected by establishing an interchange fee flowing from consumers to the merchant. When credit cards were emerging, they could be processed using the same technology as used for eftpos. Hence, incentives were needed in the reverse direction, that is, an interchange fee flowing from merchants to cardholders.

Clearly, determining the optimal interchange fee, or system of fees, is difficult and depends on estimating the balancing effect of interchange fees rather than production costs as in other regulated markets. In practice, the information required to accurately estimate the relative magnitude of these balancing forces across competing instruments may be prohibitive. Hence, regulators cannot be sure whether a given fee cap produces an optimal outcome, or indeed whether it will even improve the unregulated outcome.

3.2.3 Impact

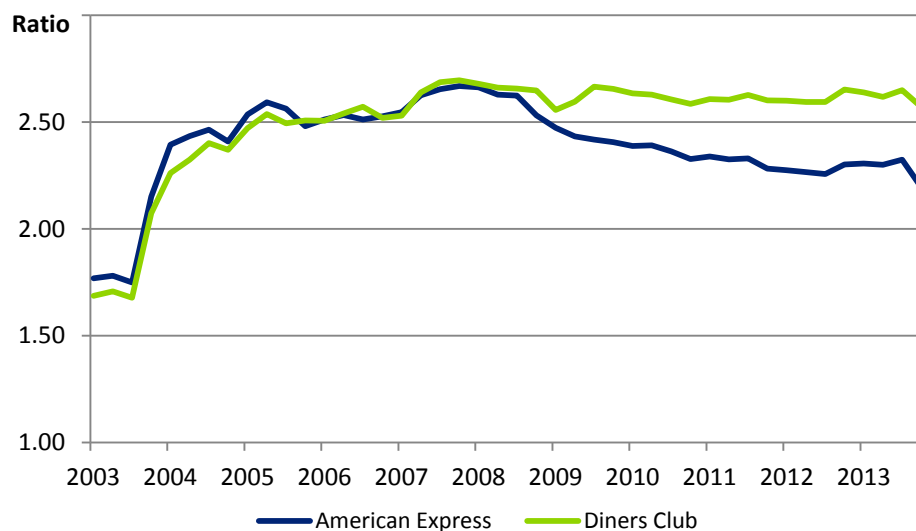
As anticipated, the regulated reductions in interchange fees in traditional four-party card schemes following the reforms in 2003 have largely been matched by falls in merchant service fees as acquirers have passed on their cost savings. Fees continued to fall until 2007 and have remained relatively flat since then. In the unregulated three-party schemes, the fall in merchant service fees has been less pronounced³. Those for American Express have fallen at a more-or-less constant pace since 2003, with an overall fall of around 0.6 basis points over the decade since March 2003. Diners Club fees have fallen significantly less over this period, down around 0.3 basis points and remaining broadly unchanged since 2007.

³ Noting this data includes the impact of the growth in unregulated new entrant four party and companion card schemes.

Chart 3.1 below shows the ratio of merchant service fees in the traditional three-party schemes to those in the regulated four-party schemes prior to the inception of the interchange caps in mid-2003 and following their implementation.

At the time of the reforms, merchant service fees in the three-party schemes had been around 1.8 times those in the four-party schemes. This ratio jumped as the regulations constrained the fees that could be charged in the regulated card schemes. By 2008 the merchant service fees in the unregulated three-party schemes were around 2.7 times higher than those in the four-party schemes. The ratio has remained at this level for Diners Club but has fallen to 2.3 for American Express, still significantly above the pre-reform level.

Chart 3.1: Ratio of non-designated to designated scheme MSFs



Source: RBA, DAE

The interchange regulations placed a cap on the weighted average interchange fees in the traditional four-party schemes but allowed flexibility in the mix of fees used to achieve this average. The decade following the reforms has seen an increase in the range of products offered by traditional three- and four-party card schemes, with the four-party scheme products now on offer covering a wider range of interchange fees while still meeting the regulated cap.

3.3 Impact on cardholder incentives

The RBA's reforms set out to reduce the relative incentives consumers faced for using scheme credit cards rather than alternative payment instruments. A key indicator of their success is therefore the card fees and rewards enjoyed by cardholders, and any changes in these incentives over time.

As expected, the incentives for consumers to pay with traditional four-party credit cards have fallen since the reforms. The reduction in interchange fee revenue has been recovered by issuers through both increases in annual fees and reductions in rewards. Table 3.2 shows

that the spending required to receive \$100 worth of rewards in a four-party card scheme increased by a little under 70% (in nominal terms) over the period 2003 to 2011.

Table 3.2: Four-party credit card rewards programs

	Average spending required for \$100 shopping voucher (\$)	Benefit to cardholder as a proportion of spending (%)
2003	12,400	0.81
2004	14,400	0.69
2005	15,100	0.66
2006	16,000	0.63
2007	16,300	0.61
2008	16,700	0.60
2009	17,000	0.59
2010	18,300	0.55
2011	18,400	0.54

Source: RBA

The 27 basis point fall in rewards as a share of spending is lower than the regulated reduction in interchange fees. This indicates that issuers are choosing to absorb some of the reduction and offer reward schemes that remain attractive to cardholders. They may be doing so in part as a means of attracting account holders, recovering the fees elsewhere in the bundle of banking services offered.

Similarly, the reduction in merchant service fees in the traditional three-party schemes is likely to have led to a reduction in rewards on the products offered by these schemes. Nonetheless, rewards offered by these products are in many cases higher than those for the four-party schemes. This is particularly true for premium companion cards which offer rewards at nearly double the rate of corresponding four-party credit cards.

Given the changes in incentives over time, coupled with the active promotion of companion cards by several major banks, it is not surprising that there has been a significant shift in market share towards the new entrant four-party companion card schemes administered by traditional three-party schemes.

4 The evolving payments landscape

Traditional three-party schemes have developed products to gain competitive advantage from their unregulated status. American Express was the first unregulated card scheme to introduce a new four-party card model known as ‘companion cards’ which are issued by financial institutions alongside cardholders’ primary cards and offer more generous rewards, being unconstrained by interchange fee regulation. This has driven a rapid take-up of these new entrant four-party companion cards among consumers, substantially increasing their market share and shifting the market balance away from merchants towards cardholders.

At the House of Representatives Standing Committee on Economics, Finance and Public Administration in 2006, the Dr Philip Lowe, the former Assistant Governor (Financial System) at the RBA, was asked how the RBA would determine the point at which competitive distortions outweighed the public benefit.

“There is no magic point here. The observation that I would make would be that if the market shares of the three-party schemes were to increase significantly and at the same time ... there was no reduction in the average merchant service fee of those schemes, then that would raise the issue of whether the competitive positions of the different schemes were starting to undermine the benefits of the reforms. But you would need to see both of those things, because there is nothing wrong with American Express increasing its market share. That may well be the outcome of a competitive marketplace. It would concern us more if we thought that that outcome was the result of the regulatory reforms, and one sign that that could be occurring is if the average merchant service fee that they charge did not fall any further.”

As outlined in section 3, while average merchant services fees have declined, the ratio of non-designated to designated scheme merchant service fees has increased since the reforms were enacted. This chapter addresses key elements of Dr Lowe’s statement:

- Do the regulations treat all card schemes equally?
- Has there been a significant shift in market share towards traditional three-party schemes?
- Can we conclude whether the outcome is due to the 2003 regulatory change, and is this conclusion consistent with movements in merchant service fees following the reforms?

The chapter starts by tracing the emergence of four-party companion cards, and then goes on to discuss their impact on efficiency and competition in the credit card market.

4.1 Four party companion cards

The four-party companion card model emerged following the introduction of the 2003 RBA regulations, as traditional three-party schemes sought to develop new products and capitalise on their unregulated, uncapped status. Under the four-party companion card model, new and existing Visa and MasterCard customers are issued with a four-party companion card (administered by a traditional three-party scheme) alongside the four-

party scheme card for which they originally applied.⁴ There is no additional annual fee for the companion card, and transactions and rewards for both cards are recorded in a single account.

The combined offering is popular among customers because they can take advantage of the more generous rewards programs offered by four-party companion cards and have access to a Visa or MasterCard for transactions where companion cards are not accepted. Table 4.1 shows the relative reward points offered by companion cards and the regulated scheme cards.

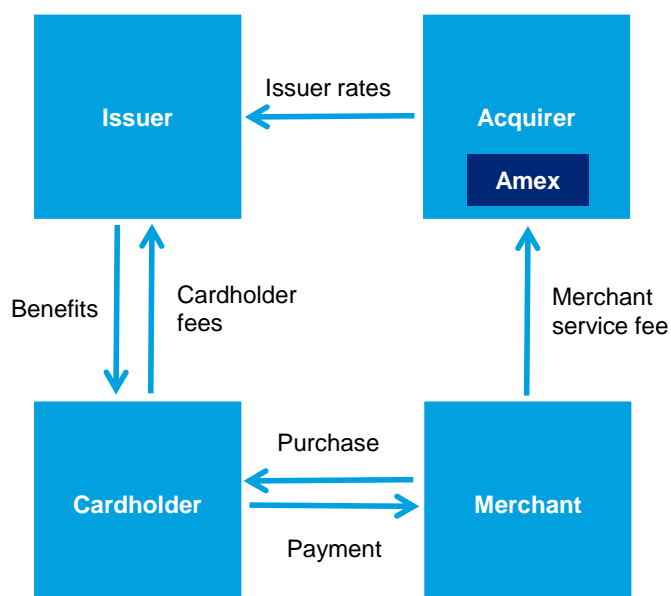
Table 4.1: Reward per \$100 spent on Visa/MasterCard and companion card, Dec 2011⁵

Card type	Visa/MasterCard	Companion card	Ratio
Standard	0.46	0.60	1.31
Gold	0.44	0.60	1.37
Platinum*	0.53	2.17	4.09
Super platinum	0.88	1.33	1.51

* Bank branded platinum cards

Source: RBA, DAE

Figure 4.1: Structure of American Express companion card model



Source: DAE

⁴ We refer to American Express companion card throughout these sections, but note that Diners Club and China UnionPay are now either offering four-party cards or have publically flagged their intent to do so.

⁵ Figures in this table are calculations based on RBA data from the publication “The personal credit card market in Australia: Pricing over the past decade”. That publication provides data on rewards for various product categories and average reward points if these products were combined with companion cards for 50% of the purchases. Deloitte Access Economics has used this information to calculate the implied rewards from the companion cards. The relative rewards on Platinum cards appear to be an outlier, but are based on the RBA data indicating that while \$18,800 of spending is required for a \$100 voucher on a scheme card, the corresponding figure for a companion card is only \$4,600.

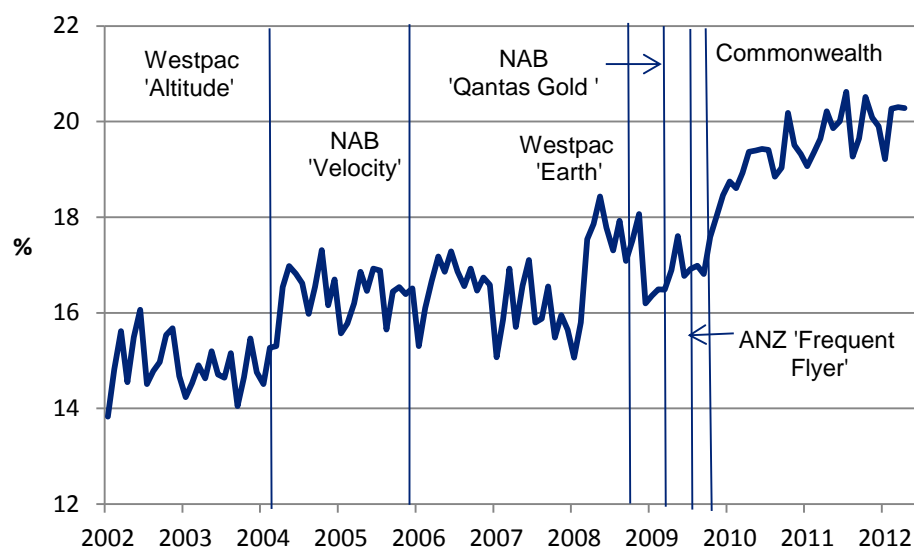
The structure of this new four-party companion card model mimics the traditional four-party credit card model (Figure 4.1). The issuer and acquirer are no longer the same entity, with the cardholder's financial institution continuing as the issuer and traditional third party scheme remaining the acquirer. The acquirer pays what are known as issuer rates to issuing banks, a fee that is directly analogous to an interchange fee under the four-party model. The revenue paid to issuers as issuer rates is then used to fund rewards programs and provide an economic incentive for customer banks to issue companion cards. Effectively, the companion card model operates as a four-party card scheme.

The key distinction, however, is that these new entrant four-party card schemes are not subject to the same RBA regulations as those four-party schemes in operation in 2003 when the regulations commenced. As a result, these new entrants, and any future entrant companies, are free to set their interchange fees on companion cards at a level unconstrained by regulation. This extends to new entrant four-party schemes who have no association with the traditional three-party schemes, such as China UnionPay, which has indicated its intention to launch an unregulated four-party offering in Australia (AFR, 2012; The Age, 2012). While companion cards may have entered the market regardless of the 2003 reforms, designated schemes cannot compete with the rewards offered by companion cards in the current environment because their pricing structure is restricted by the interchange fee cap.

4.2 Impact on Australia's credit card market

The four-party companion card has been widely adopted by consumers. In particular, all four major banks and a number of smaller banks now offering American Express companion cards as part of their rewards package. The cards are mainly targeted at the consumer card segment, although some corporate companion cards are also on offer.

Chart 4.1: Market share of American Express and Diners Club transaction value



Source: RBA, DAE

Westpac first introduced 'Altitude' American Express cards to existing 'Altitude' MasterCard customers in February 2004. Their issuance coincided with a sizeable jump in the market share of traditional three-party proprietary schemes⁶. The combined schemes' share of transaction values rose by 2.0 percentage points following the release of the companion cards, from 15% in January 2004 to 17% by May 2004, and maintained the higher share in subsequent years.

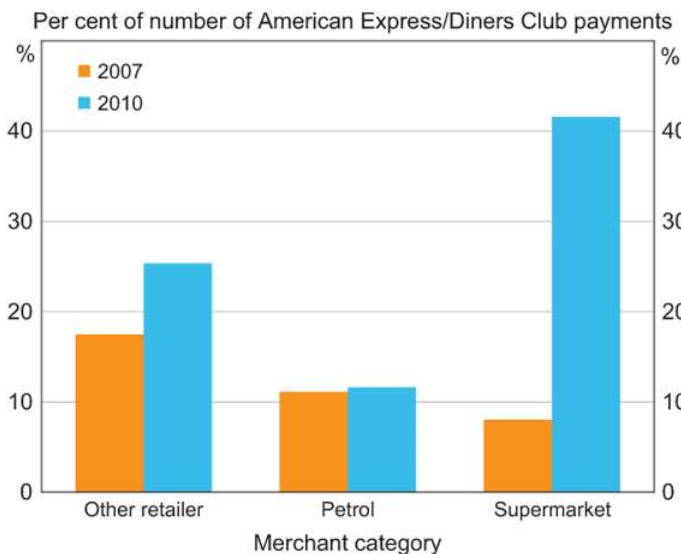
NAB, ANZ and Commonwealth Bank subsequently followed, with all four major banks now offering four-party companion cards. The reward programs differ across banks, with Commonwealth Bank offering up to 3 times as many reward points for spending on American Express cards compared to Visa or MasterCard credit cards (Commonwealth Bank of Australia, 2012).

RBA (2005) acknowledged the development:

"In the financial year prior to lower interchange fees coming into effect (2002/03) these schemes accounted for 14.6 per cent of the total transaction value. Over the past financial year, the comparable figure is 16.5 per cent. This increase was largely concentrated in the second quarter of 2004 and was coincident with the issuance of American Express credit cards by two of the major Australian banks."

In addition to the shift in market share, there is also evidence that the use of traditional three-party scheme cards has changed with the introduction of four-party companion cards. As discussed above, American Express and Diners Club were previously marketed at wealthier individuals, specialising in the corporate, travel and entertainment sectors. This contrasted with the traditional four-party schemes, which targeted a much broader range of customers.

⁶ Note, this data (Chart 4.1) includes both American Express and Diners Club.

Chart 4.2: American Express/Diners Club Card Payments*

* Top three merchant categories by number of payments on American Express/Diners Club cards in 2010
Source: Roy Morgan Research

However, according to a survey by the RBA, there have been clear shifts in the types of purchases that are now made using three party scheme cards. In particular, supermarket purchases comprised less than 10% of card payments in 2007 but their share had jumped above 40% by 2010 (Chart 4.2). Indeed, supermarket and petrol purchases now account for over 50% of American Express and Diners Club card payments.⁷

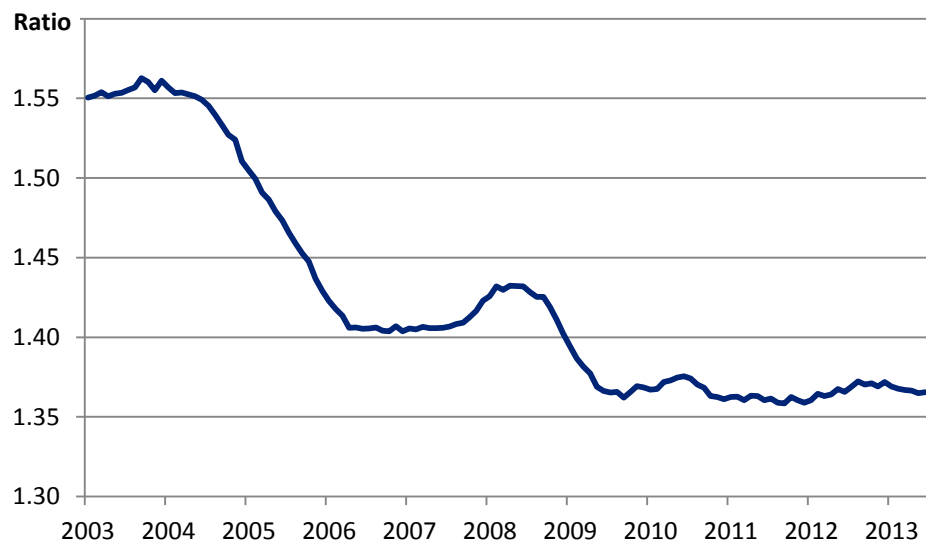
In accounting for this stark change in behaviour, the RBA Strategic Review of Innovation (2011) asserts that:

“characteristics of American Express cardholders may have changed as a result of significant growth in the issuance of ‘companion’ American Express cards by the four major banks. This may have shifted spending patterns away from the markets where American Express was traditionally strong, such as travel, towards more general spending categories such as supermarkets.”

The average size of transactions on three-party scheme cards has also declined significantly relative to traditional four-party card transactions. This is likely to be driven by the shift in the three party schemes’ business model away from the traditional three-party model aimed at high income individuals towards the broader target market of four-party companion card schemes. At its peak in 2003, the average transaction size of traditional three-party schemes was 56% higher than that of four-party scheme cards, but by 2012, this gap had narrowed to 37%.

⁷ The RBA notes that these data should be interpreted with some caution because of small sample sizes within merchant categories.

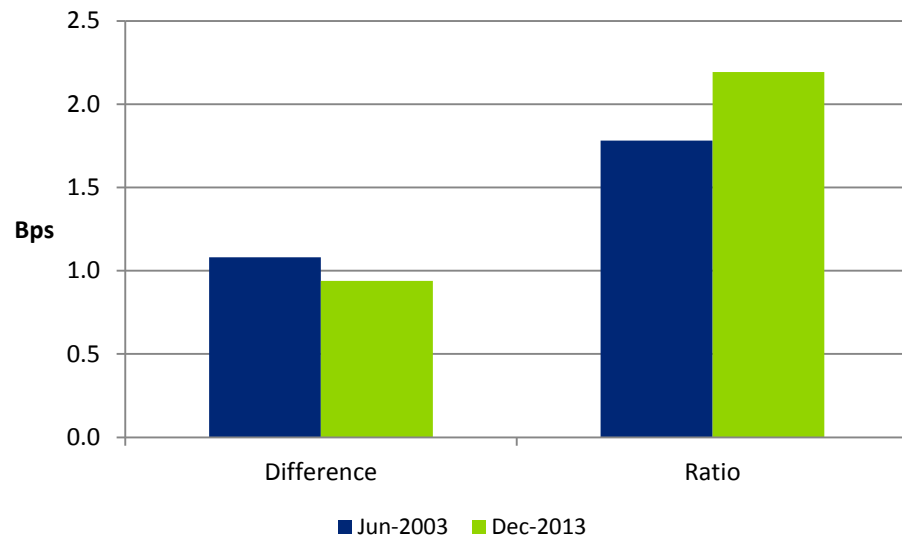
Chart 4.3: Average value of American Express/ Diners transaction relative to Visa/MasterCard transaction*



* Rolling annual average
Source: RBA, DAE

While regulated traditional four-party schemes have reduced rewards and raised costs to credit card users following the 2003 regulations, traditionally three-party schemes have been able to grow their higher cost model significantly. By adopting a four-party companion scheme model, traditional three-party schemes such as American Express have provided incentives to issuing banks to promote and distribute their four-party companion cards. These have been accepted by consumers, who can enjoy higher rewards at no additional cost, either in terms of fees or administration.

This widespread take-up of four-party companion cards has allowed three-party schemes such as American Express to grow their market share while maintaining relatively high merchant service fees to fund issuer incentives and rewards to consumers. While the merchant service fees charged have fallen by approximately the same amount as Visa and MasterCard, the ratio of these fees has widened (Chart 4.4). This is significant because the ratio of merchant service fees is a key determinant of the relative rewards offered by traditional three-party schemes which is, in turn, driving their ongoing growth.

Chart 4.4: American Express MSFs relative to Visa/MasterCard

Source: RBA, DAE

This ratio is likely to underestimate the relative increase in the proportion of merchant service fees that are directed towards rewards. Four-party companion card models are less costly to run than proprietary three-party scheme cards, with the acquiring business having to establish and maintain business relationships, and the overall cost of the scheme likely to have come down as an increasing number of cards are issued by banks. As a result, the share of the merchant service fee which is directed towards administering the scheme is likely to have fallen, boosting the amount that can be directed towards rewards. Hence, although the gap in merchant service fees between the traditional three- and four-party schemes is roughly at its pre-reform level, the widening ratio suggests that the difference in merchant service fees does not provide an accurate representation of the actual changes in rewards or the relative attractiveness of these products to cardholders.

As consumers switch to companion cards, there is also increasing pressure on merchants to accept them. While the higher merchant service fees are costly for businesses, they face potential losses if customers choose to purchase from a rival that does accept four-party companion cards. Indeed, the 2010 RBA survey of consumer payments found that 10% of American Express cardholders would go elsewhere if they were faced with a 2% surcharge for using their card. The share that would go elsewhere is likely to be similar, if not higher, for merchants who do not accept four-party companion cards at all. While 10% is small in absolute terms, it can nonetheless have a significant impact on profit margins.

These developments are distorting the credit card market in Australia, and artificially shifting the market back towards higher cost payment providers. Four-party companion cardholders are effectively being subsidised to switch to a higher cost scheme, which is opposed to the two stated aims of the RBA regulations, namely improving competition and efficiency.

It is difficult to draw inferences about the magnitude of the overall effects of the reforms on social welfare. The economic literature measuring efficiency in markets with large network externalities, like credit card markets, does not reach clear conclusions on this

issue. Nevertheless, the size of the shift in market share is likely in large part to reflect the reforms and provides some sense of the competitive advantage gained by the new entrant, unregulated four-party schemes.

DAE has estimated the cost of the rising market share of new entrant unregulated four-party schemes since 2003. This has been calculated on a quarterly basis, using RBA data, as:

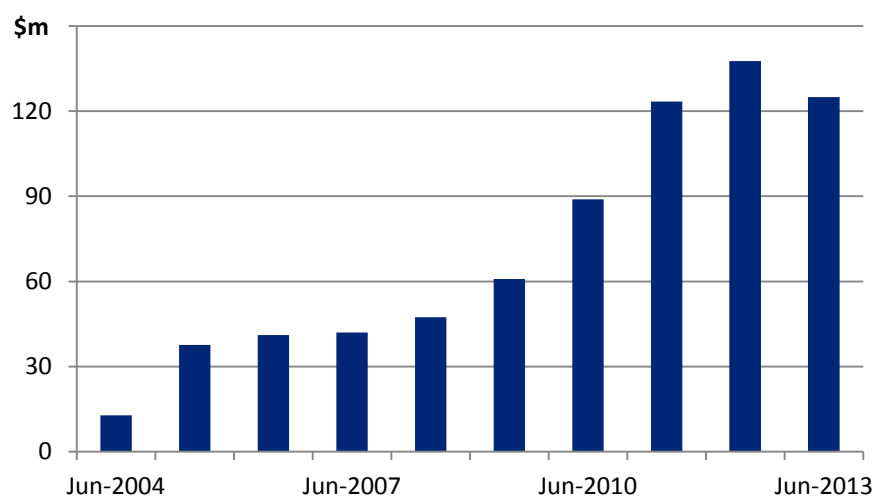
- *The rise in the proprietary four-party schemes' market share (by value, measured in percentages) over the period, multiplied by*
- *the difference in merchant service fees between the regulated four-party schemes and the un-regulated proprietary schemes (proxied by American Express), multiplied by*
- *total purchase value.*

Quarterly results were then summed to provide annual figures, and discounted to present value as necessary. The estimated results are shown in the box below and Chart 4.5.

The rising market share of such schemes since the first half of 2003 when the regulations were introduced has directly cost merchants at least \$125 million in higher fees in the 2013 financial year and a cumulative \$0.77 billion in 2013 dollars since the reforms were introduced in 2003.⁸

These fees are used to fund the more generous rewards for companion card holders, thereby undermining the RBA's original objectives.

Chart 4.5: Direct cost to merchants caused by increases in American Express/Diners Club market share



Source: DAE, RBA

These costs to merchants are likely to continue to grow as the companion card model expands and new players replicate the model. As mentioned previously, Diners Club has

⁸ The market shares of American Express and Diners Club are not separately available. To the extent that some of the increase in the combined share is driven by Diners Club, which has the highest MSFs of the major credit card companies, the cost to merchants will be larger.

now joined American Express as the latest entrant into the four-party companion card scheme market and there is anecdotal evidence that other credit card companies, such as China UnionPay, will soon introduce a similar unregulated product to Australia.

Conclusions: Reform options

This report has illustrated the impacts that recent reforms have had on competitive neutrality and incentives in payments systems. Given the importance of maintaining competitive neutrality in the market, as discussed in section 1.1, this chapter canvasses some reform options that might help to restore balance in the market.

Interchange fees

To restore competitive neutrality in Australia's credit card market, the asymmetric regulations imposed on schemes ostensibly operating under the same model need to be addressed. There are two broad ways that this can be achieved: either existing regulations applying to regulated four-party schemes can be removed, or new entrant schemes that effectively operate under a four-party model whereby the issuer and acquirer are separate institutions can be brought under the same or a parallel set of regulations.

The second option appears to be more desirable from the RBA's point of view. Nonetheless, the uneven application of the regulations is causing a shift towards higher cost payment schemes that fall outside of the regulations, undermining the core objectives of the regulations.

There are several ways in which the regulatory frameworks could be extended to all schemes that operate under the four-party model. In particular, 'issuer rates' (and any current or future analogues) paid by the new entrant four-party schemes to issuing institutions, which are analogous to interchange fees under other four-party models, could be regulated in the same manner as interchange fees.

Prior to introducing the regulations, the RBA reasoned that the absence of competition for acquiring services in three-party schemes meant that regulating issuer rates would not lead to lower merchant service fees. The most recent surcharging regulations require that merchant surcharges be limited to the "reasonable cost of acceptance" of a card. These were intended to prevent merchants from excessive surcharging. However, there have been difficulties with implementing these rules, due to:

- difficulties calculating the reasonable cost of acceptance; and
- low incentives for schemes to enforce surcharging rules.

While the three-party scheme operator remains the only acquirer of transactions under the companion card model, the ability to set high issuer rates has been fundamental to growing the market share. High issuer rates provide the incentive to issuing institutions to market companion cards strongly. In turn, the expansion of one side of the network, namely cardholders, has weakened the market power of merchants and allowed three-party schemes to maintain high merchant service fees to fund issuer rates and cardholder rewards.

The RBA also noted that incentive payments by three-party scheme acquirers to issuing institutions, in addition to issuing payments, make regulation more difficult. While this issue does require further consideration, all card schemes currently provide incentive

payments to issuing institutions and this fact, in light of the weight of evidence of market distortion, should not preclude action to address the uneven interchange/issuer rate playing field.

Finally, interchange fee regulation may be confined to non-premium cards while premium products are exempted. This would have the advantage of allowing the premium cards offered by the traditional four-party schemes to compete on their own merits against current, and future, unregulated offerings. At the same time, the present cap on interchange fees would apply to the remaining products that compete more closely with other payment instruments such as eftpos.

In conclusion, regulation has harmed the competitive landscape. As Hilmer explained, competitive neutrality is vital. It is evident that regulation in the context of payments markets has failed in this regard. As Tirole (2011) states:

“A puzzle regarding the last two decades of antitrust enforcement in the payment industry is the sole focus on open systems. Such a focus tilts the industry’s business model in favour of three-party systems for no clear reason. Whatever regulation (or lack thereof) one advocates, neutrality with respect to business organization should be the rule, so as to let the most efficient forms emerge.

In reaction to downward pressure on [interchange fees], cardholders and issuers, who benefit from higher [interchange fees] so long as merchants keep accepting the card, have an incentive to migrate toward card payment schemes that put more of the burden on the merchant. A case in point is Australia where in the wake of the mandated decrease in the [interchange fee], 3 of the top 4 Australian banks signed up agreements to issue American Express or Diners Club cards. [Interchange fee] regulation therefore induces cardholder migrations toward three-party systems that offer them a better deal in the allocation between merchants and cardholders.”⁹

⁹ Jean Tirole, March 2011, “Payment Card Regulation and the use of Economic Analysis in Antitrust”.

References

- Bagnall, J, Chong, S and Smith, K 2011, 'Strategic Review of Innovation in the Payments System: Results of the Reserve Bank of Australia's 2010 Consumer Payments Use Study', *Reserve Bank of Australia*, June, <http://www.rba.gov.au/publications/consultations/201106-strategic-review-innovation/results/pdf/201106-strategic-review-innovation-results.pdf>, accessed 14 Nov 2012.
- Cai, P, 'UnionPay bankcard opening Chinese wallets here' *The Age*, pg 7 6 July 2012
- Chan, I, Chong, S, & Mitchell, S, 'The Personal Credit Card Market in Australia: Pricing over the Past Decade', RBA Bulletin March Quarter 2012
- Commonwealth Bank of Australia 2012, *Features: Platinum Awards*, <http://www.commbank.com.au/personal/credit-cards/platinum-awards/features.aspx>, accessed 14 Nov 2012.
- Cornell, A, 'NAB issues UnionPay' *Australian Financial Review*, pg 32 2 July 2012
- House Of Representatives Standing Committee On Economics, Finance And Public Administration 2006, 'Review of the Reserve Bank and Payments System Board annual reports 2005', 16 May, http://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/9268/toc_pdf/4700-2.pdf;fileType=application%2Fpdf, accessed 14 Nov 2012.
- Kavanagh, J 2009, 'Play with a double hand', *The Sydney Morning Herald*, October 28, <http://www.smh.com.au/money/saving/play-with-a-double-hand-20100524-w5uc.html>, accessed 14 Nov 2012.
- Lowe, P 2005, 'Innovation and Governance of Payment Systems', Address to *Banktech.05 Conference*, 16 September, <http://www.rba.gov.au/speeches/2005/sp-ag-160905.html>, accessed 14 Nov 2012.
- 2006, 'The Evolution and Regulation of the Payments System', Address to *Payments System Conference 2006 Melbourne Business School*, 14 March, <http://www.rba.gov.au/speeches/2006/sp-ag-140306.html>, accessed 14 Nov 2012.
- Network Economics Consulting Group 2001, 'Delivering a Level Playing Field for Credit Card Payment Schemes: A study of the effects of designating open but not closed payment schemes in Australia', August, <http://www.rba.gov.au/payments-system/reforms/cc-schemes/iii-submissions-vol2/t4-visa-0801.pdf>, accessed 14 Nov 2012.
- 2005, 'Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes: Is the market responding as the RBA predicted?', May, http://www.visa-asia.com/ap/au/mediacenter/hottopics/includes/uploads/050601_Visa_NECCG_RBA_Report_full.pdf, accessed 14 Nov 2012.

- Reserve Bank of Australia (RBA) 2001, 'Reform Of Credit Card Schemes In Australia I: A Consultation Document', December, <http://www.rba.gov.au/payments-system/reforms/cc-schemes/ia-consult-doc/index.html>, accessed 14 Nov 2012.
- 2002a, 'Reform of Credit Card Schemes in Australia', Media Release, 27 August, <http://www.rba.gov.au/media-releases/2002/mr-02-15.html>, accessed 14 Nov 2012.
 - 2002b, 'Reform Of Credit Card Schemes In Australia IV: Final Reforms and Regulation Impact Statement', August, <http://www.rba.gov.au/payments-system/reforms/cc-schemes/final-reforms/index.html>, accessed 14 Nov 2012.
 - 2005, 'Merchant Service Fees And Market Shares For Credit And Charge Cards', *Bulletin*, August, <http://www.rba.gov.au/publications/bulletin/2005/aug/pdf/bu-0805-2.pdf>, accessed 14 Nov 2012.
 - 2011, 'Review of Card Surcharging: A Consultation Document', June, <http://www.rba.gov.au/publications/consultations/201106-review-card-surcharging/pdf/201106-review-card-surcharging.pdf>, accessed 14 Nov 2012.
- Tirole, J 2011, 'Payment card regulation and the use of economic analysis in antitrust', *TSE Notes/Notes TSE*, n. 4, <http://neeo.univ-tlse1.fr/2850/1/tsenotes4.pdf>, accessed 14 Nov 2012.

Limitation of our work

General use restriction

This report is prepared solely for the use of Visa (AP) Australia. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose of informing Visa's response to the terms of reference of a financial sector inquiry. You should not refer to or use our name or the advice for any other purpose.

Contact us

Deloitte Access Economics
ACN: 149 633 116

225 George Street
Sydney NSW 2000

Tel: +61 2 9322 7000
Fax: +61 2 6175 7001

www.deloitteaccesseconomics.com.au

Deloitte Access Economics is Australia's pre-eminent economics advisory practice and a member of Deloitte's global economics group. The Directors and staff of Access Economics joined Deloitte in early 2011.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 200,000 professionals are committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2014 Deloitte Access Economics Pty Ltd