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AUSTRALIAN SENATE INQUIRY INTO CREDIT CARD INTEREST RATES

SUBMISSION OF TIM ANDREWS OF THE AUSTRALIAN TAXPAYERS' ALLIANCE AND IAIN MURRAY OF THE INTERNATIONAL ALLIANCE FOR ELECTRONIC PAYMENTS

August 10, 2015

EXECUTIVE SUMMARY

Credit card interest rates and other features are only partly driven by factors such as the Reserve Bank of Australia's (RBA) cash rate. Other factors, such as interchange fees (the fee paid by a merchant to the bank of a customer when the customer uses a payment card to pay for goods or services) are extremely important. These fees are the subject of increasingly stringent regulation that is restricting the development of the credit card market and harming consumer welfare.

Innovation in the credit card market is being harmed by regulation. This is not just the development of new products, but also new consumer protection measures such as fraud prevention.

Interchange fees deliver significant benefits to merchants represented by an increase in sales, a guarantee of payment, and a shifting of the problem of credit risk to financial institutions. These benefits are reduced by regulation.

Revenue streams for card products have been changing over the years even in the absence of regulation. There is evidence that regulation has further affected the balance of these revenue streams, forcing financial institutions to raise fees and rates to make up for lost revenue from capped revenue streams. Meanwhile, the RBA's intention to shift payments from credit cards to debit cards and to EFTPOS has not been achieved. The RBA's efforts amount to social engineering and interference in a functioning market that have not only failed but are unjustifiable in a liberal market-based economy.

Cardholders benefit from costs associated with the provision of credit, including interchange fees. Interchange fees facilitate access to credit, and thereby access to capital.

In recent years, cardholders have been paying more for their cards, the cost of using cards has gone up for consumers but declined for merchants, and merchants have received windfall profits but have not passed on the savings to consumers.

The RBA's proposed further regulation of interchange fees will have several negative effects that can already be foreseen. It will likely continue the process of shifting costs from merchants to consumers, not just increasing interest rates and fees, but also reducing interest-free periods. It is also possible that the regulations will have a particularly heavy effect on the poorest consumers. Smaller banks will also have reduced capacity to offer low-cost cards.

This brief survey of the available evidence from around the world suggests that interchange fee caps not only place upward pressure on credit card interest rates, but also have a variety of additional effects that decrease overall welfare. We hope that the Senate will take all of these aspects into account.

In particular, we recommend that the Senate inquiry should report that

i) No action should be taken to impose an interest rate ceiling on credit card products
ii) Legislation be introduced to forbid the RBA from imposing any further counter-productive caps on interchange fees, and preferably to direct it to remove the existing caps
iii) The RBA should be mandated to consider the effect of any further regulation of credit cards on access to credit for the poor and on community-owned banks
iv) The RBA be instructed to end its social engineering project on approved forms of payment and allow the market to develop according to consumer demand.

INTRODUCTION

The International Alliance for Electronic Payments (IAEP) is a coalition of international free-market organisations who are concerned about the negative impact regulating interchange fees will have on the poor, consumers, small community lending institutions and the economy as a whole. Some members of the IAEP live and work in European countries and the United States, where they have seen firsthand how regulating interchange results in higher rates and fees for consumers. This type of regulation also means reduced access to credit for small businesses and fewer options for struggling individuals with lower incomes. We are delighted to be able to submit evidence to this inquiry.

The Terms of Reference for the Senate inquiry are:

The economic effect of matters including the difference between cash rates and credit card interest rates, with particular reference to:

a. The Reserve Bank of Australia‘s cash rate announcement and associated changes in credit card interest rates;

b. The costs to banks, credit providers, and payments systems, including those related to:

    i. Borrowings,

    ii. Credit risk and default rates, and credit risk pricing,

    iii. Various credit card loyalty programs, and

    iv. Consumer protection measures, including reforms introduced following the global financial crisis,

c. Transaction costs, including interchange fees, on the payments industry;

d. The costs to consumers, including those related to:

    i. How and when interest is applied,

    ii. Minimum monthly payment levels,

    iii. Various credit card loyalty programs of other users, and

    iv. Card fees, including ATM and POS fees;

e. What impact competition and price signals have on the credit card market;

f. How the enforcement of responsible lending laws and the national consumer credit regime affect consumer costs;

g. How consumer choice of credit card products can be improved, with reference to practices in other jurisdictions; and

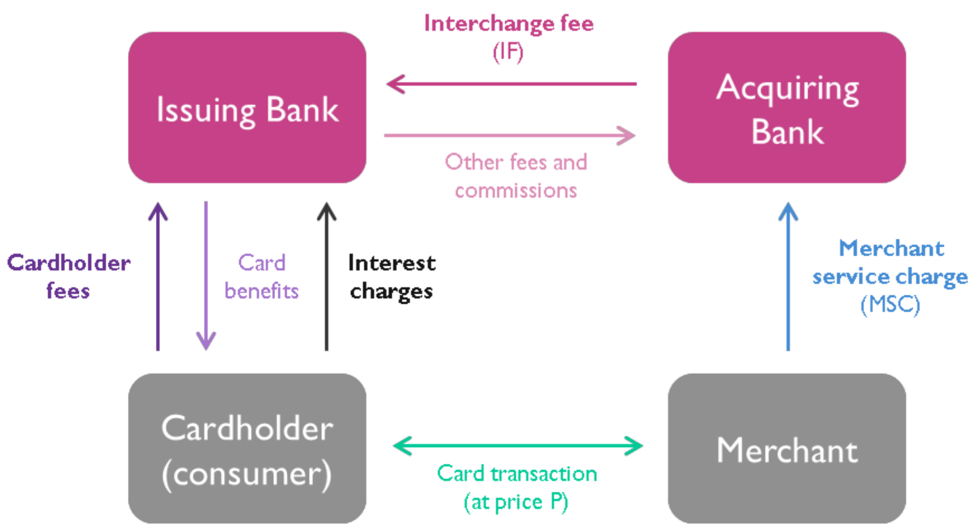
h. Any other related matters.

This submission relates primarily to item c) and specifically interchange fees. In this submission we will outline the benefits interchange fees provide to merchants and consumers, the detrimental effects of interchange fee caps, and the likely future impacts of further caps. These comments will range more widely than the narrow effect on interest rates but we believe it is important that the big picture be seen when considering the widespread impact of interchange fee caps on the credit and debit card payment markets.

An interchange fee is, to put it at its simplest, a fee paid by a merchant when the customer uses a credit or debit card to purchase goods or services.

In more detail, a merchant does not pay the interchange fee directly to the customer's bank. The payments system is an interdependent, interconnected cost sharing mechanism, with four main parties: the cardholder/consumer, the merchant, the cardholder's bank (the "issuing bank"), and the merchant's bank (The "acquiring bank"). The network (such as Visa and MasterCard) only plays a role between the issuing and acquiring bank.

Three main income streams support the system: interchange/merchant discount, interest and fees (annual fees, etc.) The networks set the interchange fees, but interchange fees are collected by the acquiring banks/processors that add a small fee—together with interchange, this is known as the merchant discount or merchant service charge. The interchange collected is then transmitted to the issuing bank. Interest and fees come primarily from consumers (including businesses who use cards for purchasing) and again are paid to the issuing bank. The issuing bank then pays the networks for the operation of the system, recovers its own costs and then hopefully has enough left over to make a profit.



Source: Europe Economics 2014, p.3

It is important to state at the outset a few facts about interchange fees that are often ignored or obscured.

Merchants around the world can — and do — directly negotiate with the networks to lower their interchange costs through a variety of incentive arrangements with networks, including deals in which the savings are rebated to the merchant.

Merchants also understand the exact breakdown of the fees they will pay based on the agreement they each negotiated with their acquiring bank, including the interchange fee.

Finally, it is important to note that even in countries that do not have the same sort of interchange fee caps that Australia has, interchange fees have not been going up. The weighted average of interchange fees in the US actually decreased between 2005 and 2010 (when caps on debit card fees were enacted), even with the significant advancements in technology, convenience, and new security and fraud protection measures — all advances that add significant value for merchants and consumers.

DISCUSSION

a) The Reserve Bank of Australia's cash rate announcement and associated changes in credit card interest rates

While we have no direct comment on the relationship between the RBA's announcement and recent changes in credit card interest rate, it is important to note two things.

First, the United States, along with many other jurisdictions, has experience of what happens where usury laws impose a credit card interest rate ceiling. After a US Supreme Court decision in 1978, credit card companies were free to house themselves in states that did not have such laws and ceilings. The different experiences of credit card companies that rehoused and those that did not provide a natural experiment that shows what happens to the market in the presence of such a ceiling.

As Durkin et al. summarize, "Credit card issuers in the low-ceiling states continued to offer credit cards with low interest rates (as permitted by state law), but they rejected many more card applicants, charged higher annual fees, offered lower credit limits, and provided fewer card holder benefits than issuers in the high- and no- ceiling states."[i]

Secondly, as we will explain in more detail in section c) below, interest rates are just one of many sources of revenue for credit card-issuing banks. However, those other sources are under severe regulatory threat, which will, all other things being equal, increase the banks' reliance on interest rates as a source of revenue. Therefore, this inquiry should consider not just the visible effect of RBA cash rate announcements on interest rates, but the invisible effect of other threatened regulation such as the RBA's consideration of tighter interchange fee caps.

b) The costs to banks, credit providers, and payments systems

i. The Australian regulatory regime recognises the importance of certain costs to banks

The RBA's methodology for calculating interchange fee caps explicitly recognises the value of certain costs included in the interchange fee. These are:

> (i) issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;
>
> (ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;
>
> (iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and
>
> (iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the Reserve Bank of Australia over the three financial years prior to the date by which the cost-based benchmark must be calculated.[ii]

These costs directly benefit cardholders. They are not only protected from potential fraud by the security features of the card processors, but when fraud does occur they are not held liable and are reimbursed quickly. Finally, the interchange fee also allows for an interest-free period that prevents cardholders from having to pay interest on their credit-funded transactions. This is one of the most customer-friendly aspects of modern credit, and is preferable to the automatic interest paid under old style instalment loans or home equity lines of credit.

Without an interchange fee (or with a significantly reduced one), bank fees in general would need to increase and interest-free periods would shrink (see part c).

ii. Interchange fees help pay for the cost of innovation

The payments market is a fast-moving one with continuous innovation. Not only do security procedures have to be continually updated and reformed but also new forms of more convenient payment are being introduced all the time. For example, the contactless payment system known as "Tap n Go" has been a huge success in Australia, with over 28 million payments per month using Visa PayWave as of February 2014[iii].

Such innovation does not occur without an incentive to promote it, and interchange fees have generally been that incentive in the past. The rise of Apple Pay in the USA compared to Australia is a case in point. As Andrew Cornell of ANZ Banking Group notes,

> Apple Pay, the highest profile new player in payments, has taken off in the US but barely anywhere else. One theory is because interchange rates in the US are high enough – more than double Australia - that banks can offer Apple a clip of the deal, encouraging Apple to take a greater role in shifting payments on to bank systems and networks such as Visa and MasterCard through the use of Apple Pay.[iv]

Indeed, the RBA's Payment Systems Board recognises the role of interchange fees in innovation. It noted in its March issues paper:

> Interchange arrangements in the card systems will also affect the nature of new payment arrangements that are adopted by the payments industry. In particular, a more efficient and lower-cost new payment system might be hampered in its development to the extent that it had to match existing interchange payments to card issuing institutions to ensure the participation of banks in the new system.[v]

Without the incentive of revenue from interchange fees, financial institutions will have less reason to develop innovative and convenient products that encourage more use of cards and will instead focus on products that deliver more interest rate or fee income (see next section).

c) **<u>Transaction costs, including interchange fees, on the payments industry</u>**

In considering the role of transaction costs, it is important to recognise that interchange fees provide considerable benefits to the market, that current RBA regulations are proving detrimental to the market (we will consider the effects on consumers below), and that the shadow of future, harsher regulation is hanging over the industry, further influencing its choices.

1. Benefits of Interchange Fees to the market

It must be recognised that interchange fees deliver significant benefits to merchants represented by an increase in sales, a guarantee of payment, and a shifting of the problem of credit risk to financial institutions. These benefits to merchants should be taken into account when assessing the overall costs and benefits of credit cards in the Australian market.

i. Credit cards allow larger purchases

Credit and debit cards were adopted in order to reduce the need for consumers to carry large amounts of cash around to make purchases, minimising the chances for loss or theft, and providing greater convenience for the merchant than checks[vi]. The consequence is that consumers are able to offer larger sums for purchases than they would otherwise be willing and merchants are more willing to accept them. This is borne out by research for the RBA, which suggests that credit card sales at large merchants are on average three times as big as cash-only transactions[vii]. The average cash payment in the sample was $27, compared with the average debit card payment of $66 and the average credit card payment of $83[viii]. This suggests that merchants' sales would suffer if consumers were discouraged from using credit and debit cards because of higher interchange fees.

ii. Businesses get guaranteed payment

A significant benefit to merchants is that, if the charge is approved, they are paid for their goods or services by the card holder's bank regardless of whether or not the card holder had sufficient cash-at-hand to pay for the goods or services in question. This guaranteed payment results itself results in higher sales. As Professor Todd Zywicki of George Mason University points out,

> For merchants that would not otherwise have operated their own credit systems, the bank guarantee facilitates transactions that would not otherwise have occurred because of the unavailability of credit. For small merchants (and consumers, of course) this benefit could be enormous, creating more product market competition and opening up entire new lines of business to entrepreneurs otherwise foreclosed from them. For these merchants, too, however, there is also a benefit from sales made (and profits earned) that would not otherwise have been made. Credit losses represent sales that, by definition, the consumer was unable to pay for, but for which credit was extended anyway.[ix]

This guarantee is a major reason why stores have shifted away from their own credit schemes to those offered by financial institutions. The interchange fee helps to pay for this guarantee.

iii. The credit risk borne by the financial institutions is significant

The average transaction of $139 studied by the RBA included 78c in write offs and credit collections, meaning that for every $100 in transactions, 56c are written off as bad debts[x]. For MasterCard and Visa transactions, the costs are higher, at 63c per $100[xi]. The RBA's current cap on interchange fees remains at 0.5c per transaction, which represents 50c per $100[xii]. The RBA does not allow these costs to be taken into account when calculating the costs of interchange fee regulations[xiii], but the cost is evidently higher than the revenue gained from the interchange fee for every transaction. In other words, despite all the other benefits provided by interchange fees, the interchange fee itself fails to cover the cost of one single element of the transaction – the credit risk. That risk is born by the financial institutions.

Indeed, according to RBA research, banks have written off around 3% of all credit card balances as losses in recent years (a figure that neared 4% after the financial crisis)[xiv]. The approximate amount of debt outstanding and collecting interest rates on Australian credit cards has been around $33 billion for the past two years[xv]. Without the interchange fee, banks would almost certainly look to shift this risk back to the merchant. Either merchants would accept the risk and pay the cost, denting their bottom lines by more than the total they pay in interchange fees, or they would look to mitigate the risk by making less risky sales, again denting their bottom lines in lost sales while increasing policing costs.

2. *Impact of Interchange Fee Regulation on the Market to Date*

Revenue streams for card products have been changing over the years even in the absence of regulation. There is evidence that regulation has further affected the balance of these revenue streams, forcing financial institutions to raise fees and rates to make up for lost revenue from capped revenue streams. Meanwhile, the RBA's intention to shift payments from credit cards to debit cards and to EFTPOS has not been achieved. The RBA's efforts amount to social engineering and interference in a functioning market that have not only failed but are unjustifiable in a liberal market-based economy.

i. The changing nature of revenue streams

In the USA, before the adoption of limited interchange fee caps, we are able to see that interchange fee revenue became increasingly important as a source of revenue from card products. Revenue from interest rates dropped from 80% of all card revenue to banks in 1990 to just over 60% in 2010 (the data stops in 2010, when interchange fee caps were enacted)[xvi]. Over that same period, interchange fee revenue rose from 10% to almost 25% of the total. As Durkin *et al.* note, "This does not reflect simply rising fee rates from that source but rather that more consumers are using cards for more purchases, and so there are more fees total." Revenue from other sources – annual fees, penalty fees, cash advance fees, and "enhancements" such as rewards – remained steady at around 15% of revenues for the decade 2001-2010 after having risen slightly in the previous decade.

The data also shows us that penalty fees rose as a component of this last category over 1990-2009, but fell back in 2010 as new regulations took effect, while annual fees and membership revenue had declined but rose in 2010. In effect, penalty fees had substituted for annual/membership fees before the advent of the new regulations. Banks needed to substitute for the lost revenue from penalty fees, so raised annual fees. In essence, the costs incurred by those who breached their cardholder agreement were spread across a much wider base of cardholders as a result of new regulations.

As interchange has become an increasingly important source of revenue vis-à-vis interest rates, we can expect to see the same sort of pattern repeat if interchange fees are capped. Banks will raise interest rates and fees to compensate for the loss of revenue. As we will see, there is plenty of evidence that this has happened from around the world.

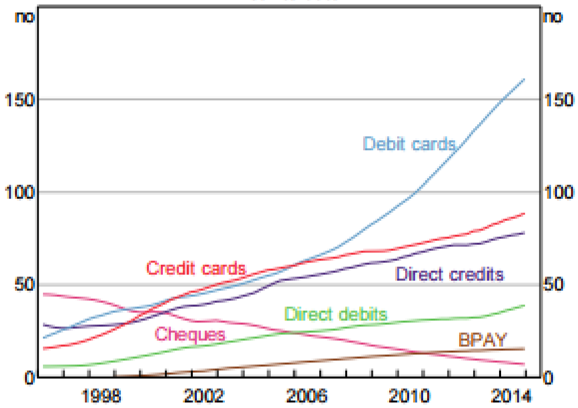
ii. The market has not responded the way the RBA intended

Under the Payment Systems (Regulation) Act 1998, the RBA and specifically its Payment Systems Board has the authority to regulate payments systems to improve "efficiency" and "promote competition." Under its previous regulations, the RBA intended to promote efficiency and competition by incentivising cardholders (as a result of increased fees, as noted above) to move from credit cards to scheme debit cards and from scheme debit cards to EFTPOS. Indeed, there seems even to have been a protectionist angle to the RBA's regulation. It admits in its issues paper: "In the Bank's view, if the arrangements remained unchanged, it was highly likely that the international scheme systems would grow at the expense of the EFTPOS system, simply because of the structure of interchange fees."[xvii]

The market's invisible hand has resisted this attempt to guide it.

According to RBA data, credit card and scheme debit card use continues to rise (see graph), while EFTPOS use is in decline.

Graph 1
Non-cash Transactions per Capita
Year to date



Sources: ABS; APCA; BPAY; RBA

Source: RBA, Issues Paper, p.13

While debit card use has increased significantly, credit card use has also continued to grow. Debit's rise comes not as the expense of credit cards, but of the favoured EFTPOS system. As the RBA admits:

> In the debit card market, there has been a steady fall in the market share of the domestic EFTPOS system and a rise in the share of the MasterCard and Visa schemes. While EFTPOS has long been priced more favourably for merchants, interchange fee differentials have made issuance of international scheme cards more attractive for banks and other financial institutions. In addition, the greater functionality of the international scheme cards (eftpos is still working to develop online and contactless functionality) has also contributed to the shift in market shares.[xviii]

The RBA's attempt to reallocate market resources from "international" credit and debit card schemes to EFTPOS has clearly not succeeded. EFTPOS lags behind the international schemes in terms of rewards, convenience, and innovation. This is not a market failure, but a market success. The RBA's desire to promote "efficiency" is in fact nothing more than an attempt to "nanny" the consumer. It has fallen foul of the needs and desires of millions of Australian consumers who want something more from their card than the relative allocation of costs viewed as optimal by the RBA.

In a liberal market-based economy, the information provided by the market as to the wants of consumers should direct regulators away from ill-considered interventions.[xix] It is unfortunate that the RBA feels it needs to double down on regulation in order to achieve a goal that all its previous regulation has been unable to achieve. All this regulation has done is to introduce inefficiencies along the lines of the windfall for merchants and raised cost for consumers discussed elsewhere.

3. *The likely future effect of further regulation*

Despite claims to the contrary, small merchants will not necessarily benefit from the service fee caps.

While larger merchants will undoubtedly benefit from tighter interchange fee caps, as they have in the past all around the world, small merchants will not necessarily find their ability to minimise payment costs improved. As the Community Owned Bankers Association notes:

> Strategic merchants will continue to hold the dominate share of the card payment transactions. More importantly, these strategic merchants will continue to have the market power to minimise their card transaction costs relative to other, smaller merchants. A lowering of the interchange fees will reduce the capacity of smaller card issuers to continue to offer low-rate cards. However, it will not necessarily improve a small merchant's ability to compete with strategic merchants and to minimise their payment costs.[xx]

Again, this is consistent with evidence from around the world. Brad Hubbard of the University of Chicago found that small-ticket merchants found their costs increased as result of the American debit card interchange fee caps.[xxi]

d) The costs to consumers

Before considering costs to consumers of various aspects of credit provision, we should first consider the benefits to consumers. Cardholders benefit from costs associated with credit, including interchange fees. Interchange fees facilitate access to credit, and thereby access to capital. This is additional to the benefits from eligible costs and innovation already mentioned.

1. Benefits to Consumers

Credit is an important part of the modern economy. It enables people of moderate means to manage their cash flow to avoid having to save up for things that are of immediate need, whether it be a new washing machine, to repair a vehicle that has suffered mechanical failure, or simply to pay the electricity bill to keep the lights on and avoid reconnection fees when cash flow is tight. Consumers value these benefits. A 2012 survey of American consumers by Thomson Reuters and the University of Michigan found that 82 per cent said that credit cards make managing their own finances easier[xxii]. According to Durkin et al., "When asked further why credit cards have made managing finances easier, the majority of respondents…stressed aspects of flexibility, especially expenditure and payment smoothing, that credit cards permit.[xxiii]" Similar surveys compared to earlier forms of consumer credit such as instalment loans or home equity lines of credit found a remarkable uniformity of satisfaction over the years since 1977, indicating that consumers find credit *per se* helpful regardless of the form it takes[xxiv].

Moreover, credit represents not just access to funds for consumer expenditure but also access to capital. Many entrepreneurial small businesses have been founded around the world on the basis of funds borrowed from credit cards. Thomas Durkin cites the example of two global brands that were founded in this way:

> Sergey Brin and Larry Page used plastic to start Google® in the mid 1990s. They ran their credit cards to the maximum and, mindful of their limits, they chose to buy used computers and use open-source software. The two worked on the BackRub® search engine, then set out to sell licenses to the technology. Their immediate goal was to move out of the dorms and pay off the credit card debt they had amassed trying to expand their network. YouTube® founders, Steve Chen and Chad Hurle also relied on personal finances in the early days of their video-sharing business. As one industry observer noted, investment from Sequoia Capital® came "...just in time for Steve to avoid having to increase his credit-card limit yet again to pay for various tech expenses."[xxv]

Without the access to capital provided by credit cards, many small businesses would have difficulty getting started. The cost of this benefit to the economy is literally incalculable.

2. Costs to Consumers

Cardholders are paying more for their cards, the cost of using cards has gone up for consumers but declined for merchants, and merchants have received windfall profits but have not passed on the savings to consumers. Moreover, further regulation could have a significant detrimental effect on access to credit for the poor.

i. Cardholders are paying more for their cards

Between 2002 and 2008, the RBA estimates that the average payment card fee rose by $40 per account, indicating that (with 12 million accounts held in 2008) cardholders are paying $480 million more to hold their cards than they did before the regulations took effect in 2003[xxvi]. To its credit, the RBA expected this to happen, and so this point is uncontroversial but important.

ii. Merchants have benefited at the cost of consumers

In 2012, the RBA itself admitted that costs to consumers have gone up while costs to merchants have gone down:

> Overall, reward points and other benefits earned from spending on credit cards have become less generous while annual fees to cardholders have increased. At the same time, merchant service fees – the fees charged to a merchant by its acquirer – have declined, with the benefit likely to have been passed on to all consumers, not just those who pay by credit card.[xxvii]

The last point is only half true. Merchants have indeed benefited from a significant windfall in reduced service fees. According to CRA International's review of the effect of the regulations in 2008, merchants were saving approximately $676 million annually as a result of reduced fees, meaning that over the 12 years of fee regulation they have saved over $8 billion (in 2008 prices) in costs.

However, there is little evidence that these cost savings have been passed on to consumers as price cuts or better products, as the RBA claims. Reviewing the evidence, Europe Economics notes, "As in the Spanish case, no evidence was found neither [sic] of a reduction in retail prices nor of an improvement in the quality of products."[xxviii]

This is consistent with evidence not just from Spain but from the USA following the imposition of debit card interchange fee caps after 2010. Analysing the effect of the regulations through an event study analysis, Evans et al. concluded:

> There is no reason to believe that merchants would give this windfall back to consumers or the banks could absorb the full loss in their profits. A wealth of economic studies shows that does not happen in the real world. Consumers got the short end the stick though. Merchant [sic] are not giving enough of their gains back to consumers to compensate for the higher fees and reduced services that consumers are getting from banks as a result of the interchange price caps, nor, as we have shown, are merchants expected to do so.[xxix]

They found that the relatively modest American fee caps resulted in a net decrease of consumer welfare of $22 to $25 billion.[xxx]

For the Australian cardholder to break even, $480 million of the merchants' $676 million cost reduction would have to be passed on – about 70%. Studies have shown that even in highly competitive markets, merchants rarely pass on more than 50 percent of savings. The evidence from around the world suggests much less after interchange fee caps, probably because the average saving per transaction is quite low.

CRA concluded on this aspect in 2008:

> Recognising that it is difficult to isolate price effects, the fact remains that no evidence has been presented that would allow one to conclude that the undeniable losses to cardholders have been offset by reductions in retail prices or improvement in the quality of retail service. In contrast, we know with confidence that merchants have been beneficiaries of the RBA's intervention. We know this from the fact that merchants were in favour of the past reductions in interchange fees and now would like even further reductions. It is extremely unlikely that merchants would be taking this position if reductions in merchant service charges resulting from the RBA's regulations were simply passed through to consumers in the form of lower prices and/or higher quality service.[xxxi]

There is no evidence we are aware of to change this conclusion.

3. ***Likely Future Costs to Consumers***

The RBA's proposed further regulation of interchange fees will have several negative effects that can already be foreseen. It will likely continue the process of shifting costs from merchants to consumers, not just increasing interest rates and fees, but also reducing interest-free periods. It is also possible that the regulations will have a particularly heavy effect on the poorest consumers. Smaller banks will also have reduced capacity to offer low-cost cards.

i. Interest Rates and Fees Will Increase

Community-owned banks have already warned the RBA that they will be disproportionately affected by the Bank's proposals and will almost certainly have to raise interest rates and fees on their customers:

> Given the major banks' dominance of the credit card market, through their roles as card issuers and acquirers, reducing interchange fees for issuers is likely to have disproportionately greater impact on smaller card issuers that do not compete in the acquiring market.
>
> In this scenario, customer-owned banking institutions would likely need to increase credit card interest rates and fees. Merchants would continue to receive benefits provided by issuers however the costs of these benefits will be borne by a small issuer's customers.[xxxii]

This mirrors evidence from the USA, where smaller financial institutions rely more on interchange fees than interest rates (and were therefore exempted from the interchange fee caps enacted in 2010):

> Credit unions and community banks had a higher portion of cardholders who did not carry a balance or incur penalty fees, according to representatives of financial institutions, so they had to rely more on interchange fee revenues than revenues from fee income and interest payments.[xxxiii]

Visa too has warned that financial institutions will need to respond as already outlined:

> Cap reductions will not only impact the respective position of merchants in the payments system, issuers too will need to respond. Issuing banks normally adjust their business models to ensure cost recovery through changes to product fees and charges and if interchange revenue is radically reduced by regulation they may need to respond in some of the following ways:

- increasing Credit card interest rates;
- increasing annual fees; and/or
- introducing a transaction fee; and
- diluting the loyalty program offerings and benefits.[xxxiv]

All the evidence from all over the world suggests that further caps on interchange fees will increase fees and costs to consumers. As this appears to be the RBA's goal, the inquiry should consider this a given if the Bank goes ahead with its proposed regulation.

Some financial institutions offer longer interest-free periods than others. Again, community-owned banks are more likely to have to reduce the length of these periods if their interchange fee revenue is reduced.

ii. These Cost Increases Will Harm the Poorer Bank Customers

One further point for this inquiry and the RBA to consider is the effect of the price increases discussed above on the poorest in society. This welfare cost is particularly badly felt among marginal groups like the "underbanked" and "unbanked" (those who cannot afford the full services of a bank account and rely on products like prepaid debit cards or payday loans). Research from America has shown that interchange fee caps on banks contributed to a *million* poorer Americans being forced out of the banking system altogether.[xxxv] Further increases in costs to consumers may indeed force some people down the chain

Credit → Debit → EFTPOS

But it might well have the effect of adding another link to the chain

Credit → Debit → EFTPOS → Unbanked

If this is the case, and evidence from America suggests it might well be, then the effect of interchange fee regulation will not just be to increase credit card rates and fees on the wealthy, but to force thousands of people at the margins of society into greater poverty.

iii. Effect on smaller banks and low-cost cards

Lowering interchange fees will mean some, predominantly smaller, banks will have a reduced capacity to provide low-cost cards because of the need to cover the previously-eligible costs of transaction processing and authorisation. The Community Owned Banking association warned the RBA:

> To continue to offer market-leading, low-cost credit cards, it is vital that COBA members be able to rely on the current level of interchange fees to cover the eligible costs of issuance.
>
> Transaction processing and authorisation, fraud and fraud prevention and the provision of an interest-free period are significant costs that, if not recovered through interchange fees, would reduce the capacity of customer-owned banking institutions to offer affordable, low-cost credit cards.[xxxvi]

It should be noted that one of the effects of the regulation to date has been to squeeze low- and medium-cost cards to the benefit of premium cards that are excluded from the regulation, like those offered by American Express. The market share in terms of purchases of these premium cards has increased from 14% to 20% since the introduction of the regulations.[xxxvii]

e) <u>What impact competition and price signals have on the credit card market; and</u>

f) How the enforcement of responsible lending laws and the national consumer credit regime affect consumer costs

We have no further comment on these items beyond repeating the points we have already made.

g). **How consumer choice of credit card products can be improved, with reference to practices in other jurisdictions**

This brief survey of the available evidence from around the world suggests that interchange fee caps not only place upward pressure on credit card interest rates, but also have a variety of additional effects that decrease overall welfare. We hope that the Senate will take all of these aspects into account and conclude that in the interests of credit card holders, merchants, and financial institutions, interchange fees should be subject to no further regulation from the RBA.

We therefore recommend that the Senate report that

i) No action should be taken to impose an interest rate ceiling on credit card products
ii) Legislation be introduced to forbid the RBA from imposing any further counter-productive caps on interchange fees, and preferably to direct it to remove the existing caps
iii) The RBA should be mandated to consider the effect of any further regulation of credit cards on access to credit for the poor and on community-owned banks
iv) The RBA be instructed to end its social engineering project on approved forms of payment and allow the market to develop according to consumer demand.

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