SUBMISSION 2

Submission to the House Standing Committee on Economics, Finance and Public Administration "Review of the Reserve Bank & Payments System Annual Reports 2005"

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1. In this submission, I evaluate how closely the credit card industry's performance following the RBA reforms in 2003 has accorded with expectations generated during the reform process. I suggest that expectations of a dramatic impact have not been realised to date.

Expectations Prior to the Reforms

2. The RBA has enacted a dramatic set of reforms impacting upon the credit and card charge industry. On the 1st January, 2003, surcharging was permitted on card transactions. On the 31st October, 2003, the interchange fee was capped based on a calculation of issuer costs resulting in a reduction of approximately 50 percent. On the 23rd February, 2004, the credit card schemes were opened up to more competition.
3. As an economist who has studied regulated industries for many years, these reforms and changes were truly dramatic. In most regulated industries, when prices are regulated, they are regulated using a 'glide path' towards what the regulator regards as efficient. In contrast, the RBA jumped straight to its desired outcomes in a series of 'big bangs.'
4. At the time, the expectations in the industry were that these reforms – due to their dramatic nature – would have a big impact on the industry. Normally, this would be the case. The expectations of a large impact came from both sides of the regulatory table. Those in the card industry feared large scale change whereas the regulator wanted it to achieve its policy goals. Either way, it should have had a large impact on credit card usage – something that the RBA wanted to reduce in favour of other instruments.
5. Professor Stephen King (now a Commissioner at the ACCC) and I had predicted that these reforms would have limited impact. Our belief was

* The views in this submission are my own and do not necessarily reflect those of other individuals and organisations mentioned in this submission. My work in this area can be accessed at www.economics.com.au.

that there was sufficient competition in Australian retailing to ensure that the interchange fee was, in fact, *neutral*. What neutrality means is that even were the interchange fee to change dramatically, other prices in the system would adjust (particularly if surcharging was permitted) so that consumers and merchants faced exactly the same decision regarding whether to make use of credit cards or not. For example, a lower interchange fee would tend to lead to increased card fees for consumers (and lower loyalty rewards). However, it would also lead to a lower merchant service fee. So merchants would be more encouraging of consumer to use cards to offset the direct impact of higher fees on those consumers. In the extreme, these changes would balance out and we would see little change in historic patterns of card use.

6. Professor King and I argued that this implied that regulation of the interchange fee was likely to be superfluous and sub-ordinate to policies of permitting surcharging and encouraging competition.[1] We argued that the RBA should have done those things first to see if it could reach its desired goals and then re-examined interchange fee regulation at a later stage. In making this assessment we were comforted by the fact that the interchange fee had not changed for 20 years; in contrast to the US where it continued to rise steadily and looked like an abuse of market power.

7. We did argue, however, that given that it wanted to regulate the interchange fee, the RBA's formula – based primarily on issuer costs – was a conservative approach. To see this, let a be the interchange fee.[2] If a non-neutral and the regulator wanted to minimise transaction costs (not consumer welfare), then they would set a to send price signals to consumers and merchants. (Let c_A be acquirer costs and c_I issuer costs).

    a. If b_c where average consumer benefits and b_m average merchant benefits, this would involve trying to achieve $\alpha b_c = (1-\alpha)b_m$ (α consumer share of benefits)

    b. When consumers choose to use credit cards, the cost imposed by consumers on merchants is $(c_A - b_m)$.

    c. To internalise this cost you would set $a = b_m - c_A$ to compensate.

    d. This gives: $a^* = \alpha c_I - (1-\alpha)\, c_A$.

[1] See Joshua Gans and Stephen King, "The Role of Interchange Fees in Credit Card Associations: Competitive Analysis and Regulatory Options," *Australian Business Law Review*, Vol.29, No.2, April 2001, pp.94-122; and "A Theoretical Analysis of Credit Card Reform in Australia," *Economic Record*, Vol.79, No.247, December 2003, pp.462-472.

[2] To see this argument in more detail look at Joshua S. Gans and Stephen P. King, "Approaches to Regulating Interchange Fees in Payments Systems," *Review of Network Economics*, 2(2), June 2003, pp.125-145.

e. If α = 1 and c_A = 0, then RBA standard of c_I is 'approximately' optimal and previous standards were excessive.

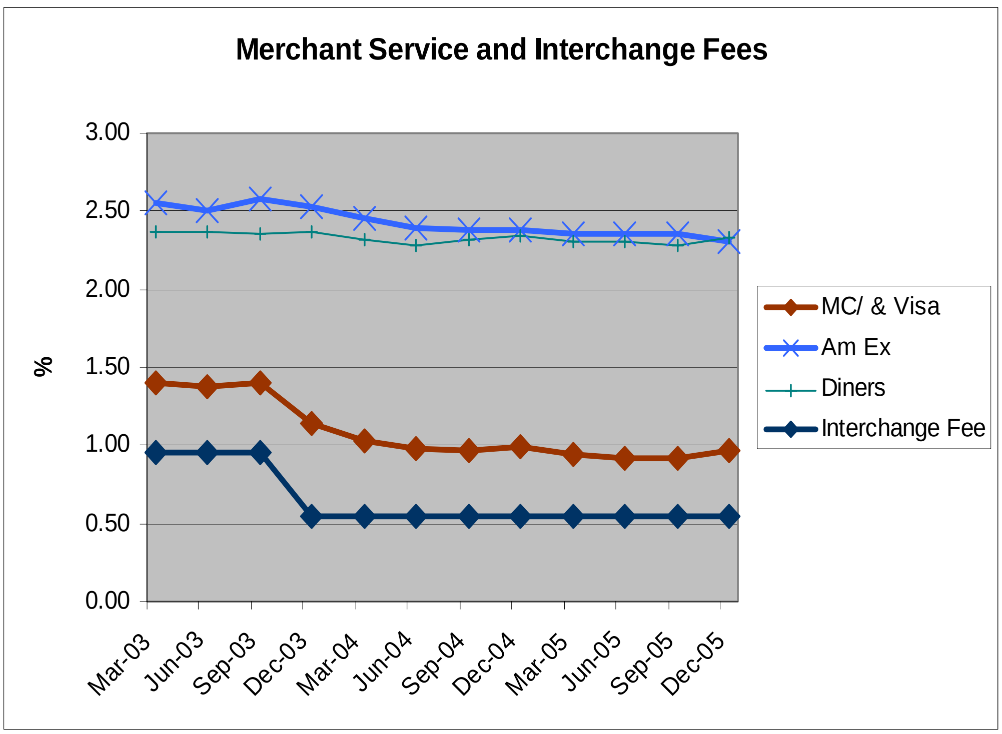
8. Thus, the RBA had set the capped fee as high as they possibly could.

What Happened?

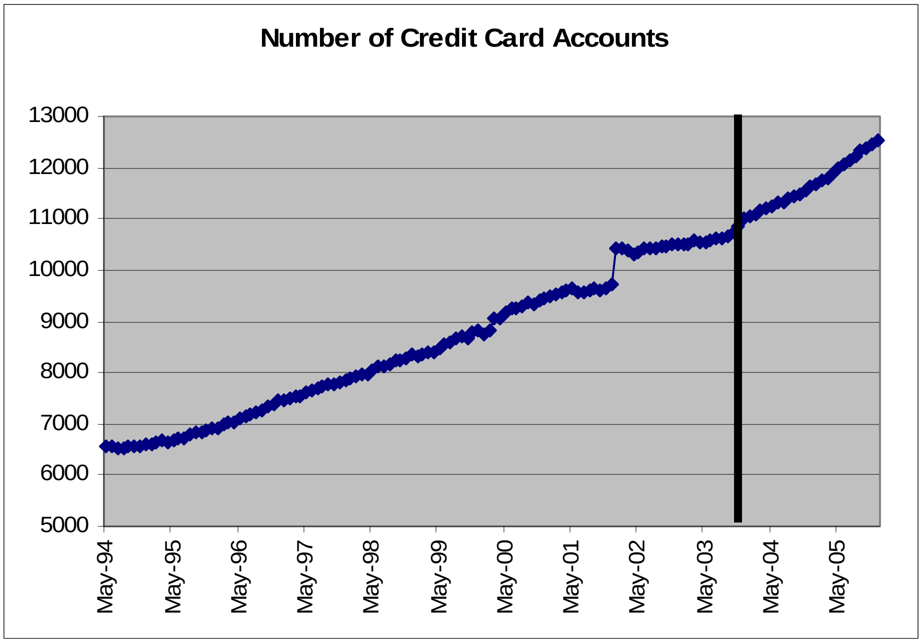
9. I have not conducted a proper – econometric analysis – of what has happened following the reforms (that is not my area of competency). To my knowledge, no one has despite the ready availability of data for the purpose.

10. However, I have taken a casual look at the data and can report my observations here.

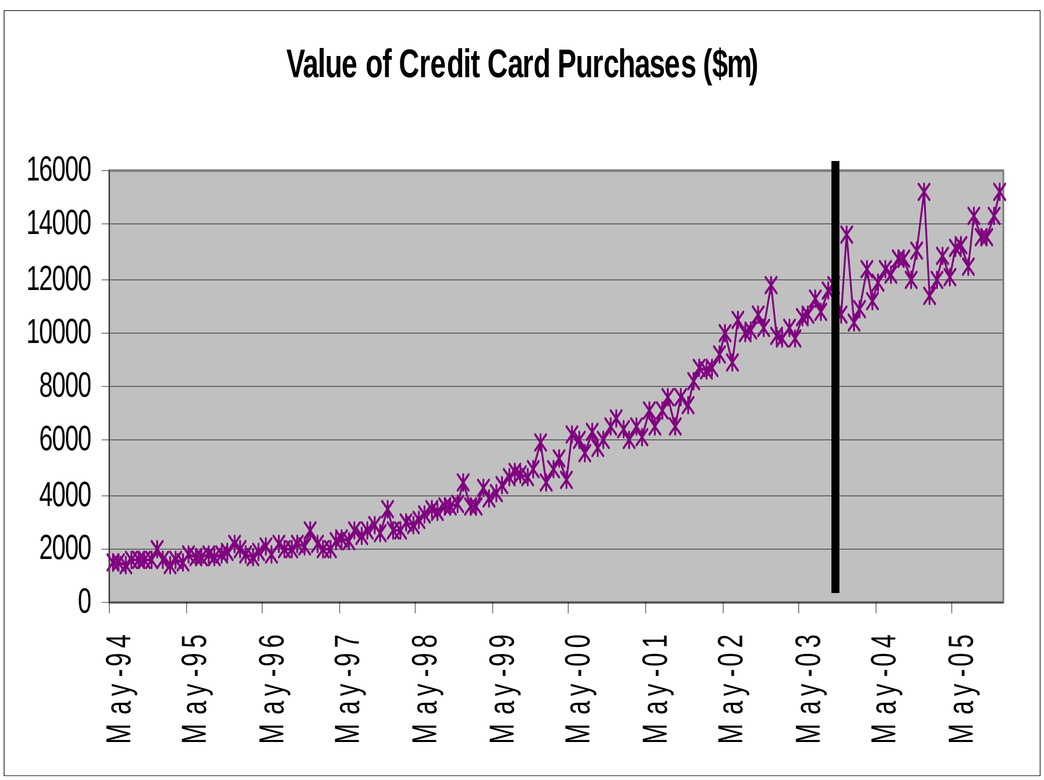
11. First, following the reforms, the interchange fee fell. As can be see from the following graph (utilising RBA data), merchant fees fell correspondingly and also modestly for American Express and Diners Club.



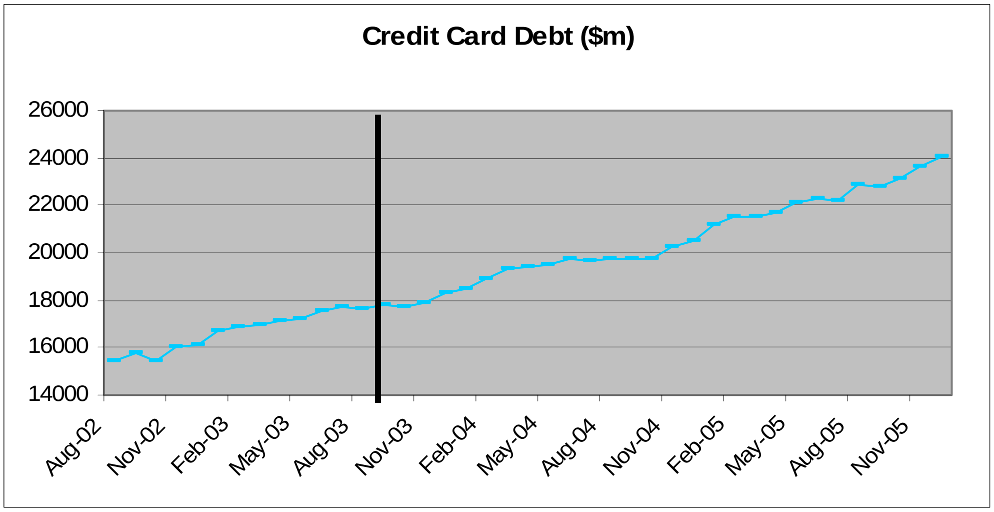
12. Nonetheless, the number of credit card accounts has continued to rise steadily. [The anomaly in the data was due to a definitional change].



13. As has the total value of credit card purchases …

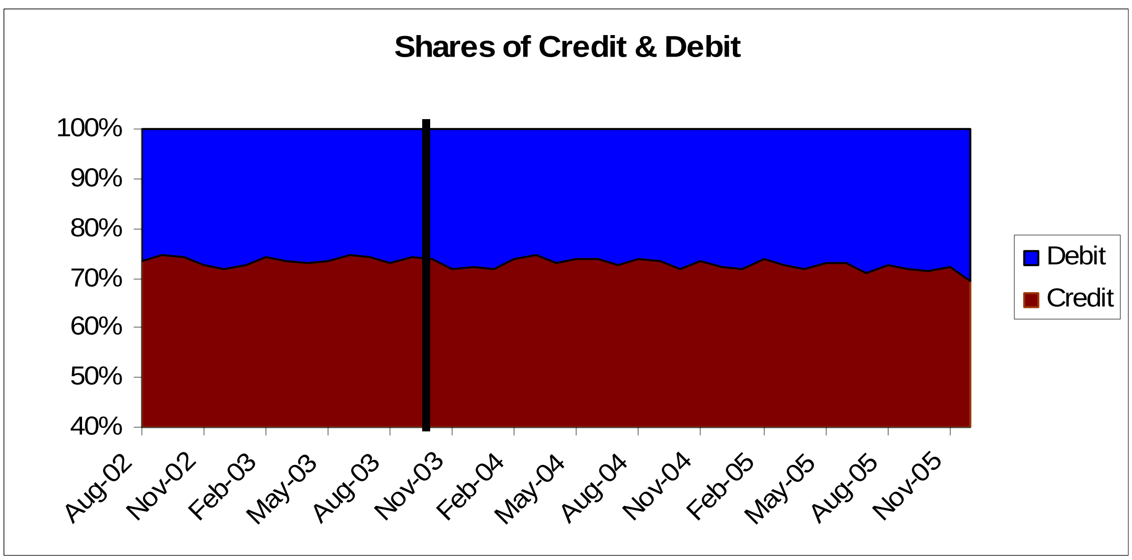


14. And credit card debt …



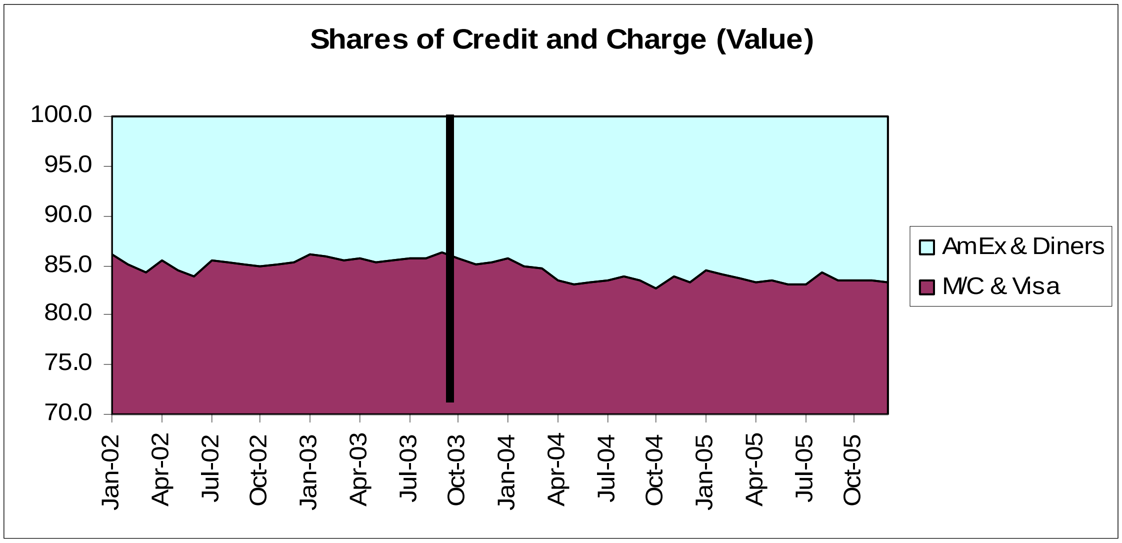
15. Thus, the dramatic reforms do not appear to have hit the usage of credit cards to any great or at least significant degree.

16. What about the choice of payment instruments? In terms of the shares of credit and debit cards, the reforms have had no significant impact.



17. There appears to be a recent drop off away from credit cards but that could easily be accounted for by seasonal or other factors. It is hard to imagine that the major impact of the reforms occurred sharply two years after the reforms.

18. However, when it comes to the choice between credit and charge cards (such as Amex or Diners), there has been a larger shift of a couple of percent towards charge cards. Of course, given that these types of instruments are very similar, the immediate impact of a price change would be expected to be more dramatic.



19. In summary, while there were reforms that involved seemingly dramatic changes there has been little in the way of corresponding real behavioural change.
    - No apparent change in credit card usage (numbers, value)
    - Continued credit card debt
    - Constant relative use of credit and debit
    - Small shift towards charge cards
    - Few instances of surcharging

20. There is, however, evidence that the changes in the interchange fee have been neutral. The neutrality hypothesis suggests that if there is a change in one price then it will be *completely passed-through* with changes in other prices.

21. For example, this appears to have happened with the change in merchant service charges. The margin to acquirers (that is, the merchant service charge less the interchange fee) has remained at about 0.4% of the transaction value before and after the reforms.

Conclusion

22. Credit card reform is not a competition policy issue. Indeed, competition policy instruments – such as price regulation – appear to be ineffective.
23. If the government is concerned that consumers are either choosing expensive forms of payment or incurring too much credit card debt then this is an issue for consumer protection policy. As such, perhaps it is an issue that could be referred back to the ACCC.