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CLIENT ADVICE

21 MAY 2015

TO
Client: Senator Sam Dastyari
Attention:
Tel:
Email:

The Australian Credit Card Market

You asked for material on a number of questions in relation to credit cards in Australia and internationally. In the interests of providing you with material quickly, there are initial notes prepared in the time available—I can provide more detailed material in relation to particular aspects if you would like.

Key Points

- It is difficult to provide a comparison of credit card interest rates between countries. I have provided indicator rates for credit cards below, drawing on statistics from several central banks. I have not been able to identify whether the underlying products are at all similar.
- The available evidence suggests that the margin between credit card rates and the cash rate in Australia has increased over time. Economic analysis suggests that there is an asymmetry in how rate changes are reflected in credit card rates, with increases passed through more quickly and to a greater extent, while reductions are passed through less, and more slowly.
- Based on my initial research, it appears that the reason interest rate cuts are not fully reflected in credit card rates is not because of a lack of competition, but because of other factors in the market. The economic literature suggests a number of reasons this may occur; if you would like I can provide more briefing on this aspect.
- Although credit cards are widely used in Australia, it is difficult to identify the extent to which they may be

used by individuals facing financial hardship. If you would like I can search for more material in this area.

Contents

Credit card rates and fees

One of the better sources on credit card data is the Reserve Bank of Australia (RBA). A recent paper by the RBA provided statistics on a number of aspects.[1]

Credit card fees

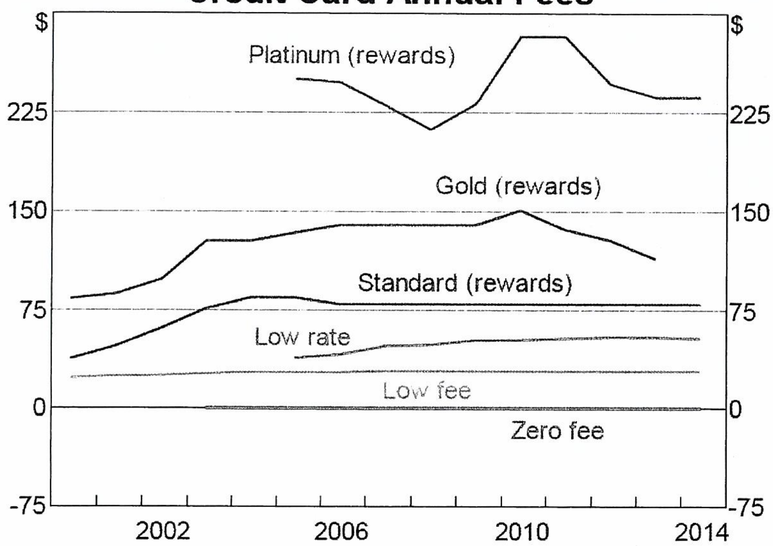
The RBA surveys a number of credit card fees, as reflected in the chart below. The RBA paper notes that 'Annual fees appear to have risen somewhat around the time of ... [previous] reforms, but have since been reasonably stable and have tended to decline in real terms'.[2] However, it also notes that

> ... care should be taken with any data on annual fees since the population of card types has changed substantially over time. For example, 'gold' cards were originally offered as premium cards, with higher fees and higher rewards, but are now viewed as similar to 'standard' rewards cards, having been supplanted in the hierarchy by 'platinum' and 'super-premium' cards.[3]

1. Reserve Bank of Australia (RBA), *Review of Card Payments Regulation: Issues paper*, March 2015.
2. Ibid., p. 17.
3. Ibid., p. 17.

This means that evaluating credit card fees can be difficult, because consumption has shifted over time. While fees for a given card may have declined in real terms, where banks have marketed and households have shifted to higher-end cards, the fees spent on credit cards by a given household may have increased.

Graph 5
Credit Card Annual Fees



Source: RBA

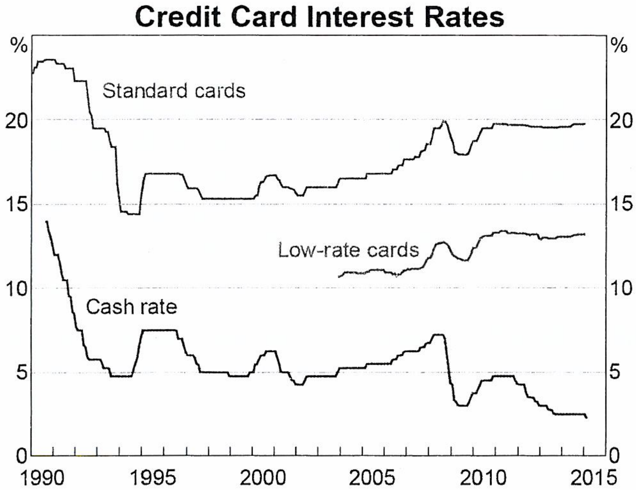
Source: Reserve Bank of Australia, *Review of Card Payments Regulation: Issues paper*, March 2015, p. 18.

Credit card rates

The RBA included a summary of the reported interest rates over time; however it noted that:

> … these data are advertised 'ongoing' interest rates rather than the average interest rate actually paid. They do not take into account special balance transfer offers that cardholders may receive for switching their debt to another issuer, with most banks currently offering such programs, often with zero rates for 12 months or more. Furthermore, interest on credit card debt is only paid by some cardholders ('revolvers'), who account for less than 30 per cent of credit card holders according to the Bank's 2013 Consumer Use Survey.[4]

Graph 6
Credit Card Interest Rates



Source: RBA

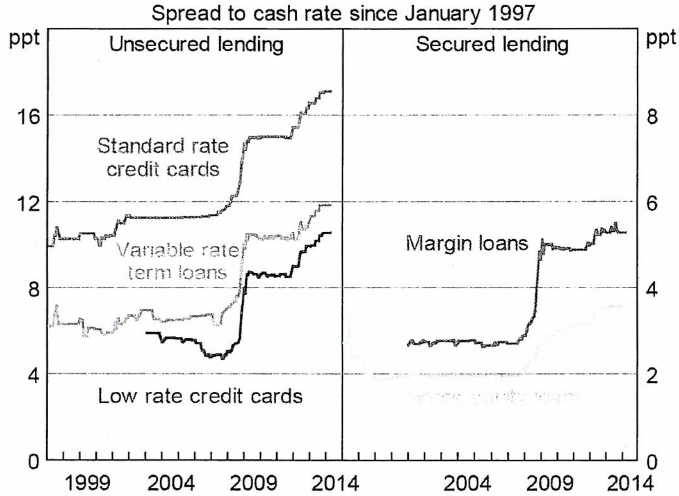
4. Ibid., p. 18.

Source: Reserve Bank of Australia, Review of Card Payments Regulation: Issues paper, March 2015, p. 18.

The RBA also noted that 'As in many other countries, credit card interest rates in Australia do not always track movements in other rates particularly closely'.[5] The RBA also provides a calculation of the margin in its FSI submission, which shows that for both low-rate and standard-rate credit cards, the gap between the cash rate and average credit card rates increased significantly at the start of the global financial crisis; and after a period of stability, began to trend upwards in recent years. As per the chart above, this reflects the fact that decreases in the cash rate have not fully passed through to credit card rates (as measured by the RBA average rates).

Graph 6.7
Personal Lending Rates

Spread to cash rate since January 1997



Sources: CANSTAR; RBA; bank websites

Source: Reserve Bank of Australia, Submission to the Financial System Inquiry, March 2014, p. 162.

This pattern of 'sticky' interest rates has received some attention from economists. An analysis of credit card rates in Australia summarised:

> ... lenders behave asymmetrically in response to changes in the Reserve Bank of Australia's (RBA) cash rate. The RBA's rate rises are passed on to borrowers much faster than rate cuts and the aggregate credit card interest rate showed a very resilient degree of downward rigidity. Overall, based on the estimated short-run dynamic model, banks immediately pass on 112% of any RBA's rate rises, but only 53.7% of any rate cut.[6]

For a discussion of the potential causes of this asymmetry, see 'Competition in the Australian credit card market', below.

International comparisons

As discussed, it is difficult to make a direct, meaningful comparison of credit card rates between jurisdictions, given the wide range of variables involved (time periods, conditions on the cards, etc.). However, the central banks for a number of jurisdictions do report an indicator variable for credit card rates in their jurisdictions. I have summarised these below – however please note, as discussed, these are at best indicative, and it is not possible to be certain to what extent they reflect the same or different underlying credit card products.

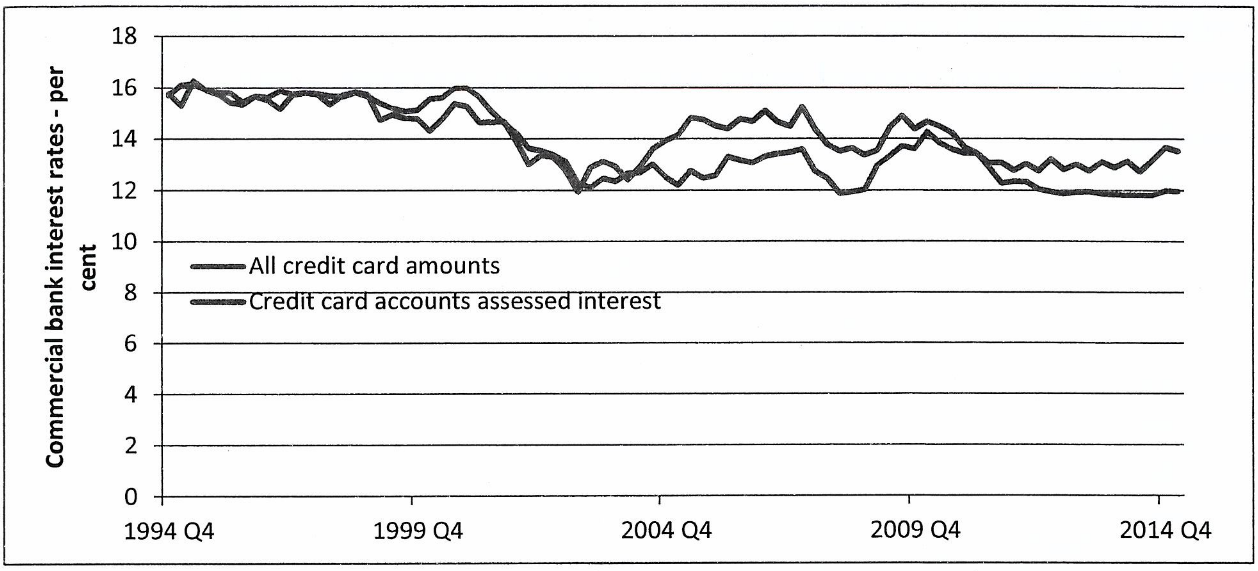
United States

Statistical data from the United States does not disaggregate by different card types, but does include a measure of the average interest rates on credit cards which are assessed interest (card holders have paid interest on that

5. Ibid., p. 18.
6. A Baladkhani, S Anwar and A Arjomandi, 'Downward stickiness of interest rates in the Australian credit card market', *Journal of the Asia Pacific Economy*, 19 (1).

card).[7] Figure 1 below shows a relatively static measure over time. Their data appears to be based on voluntary reporting from a number of financial institutions.[8]

Figure 1 United States credit card rates – Federal Reserve average measure

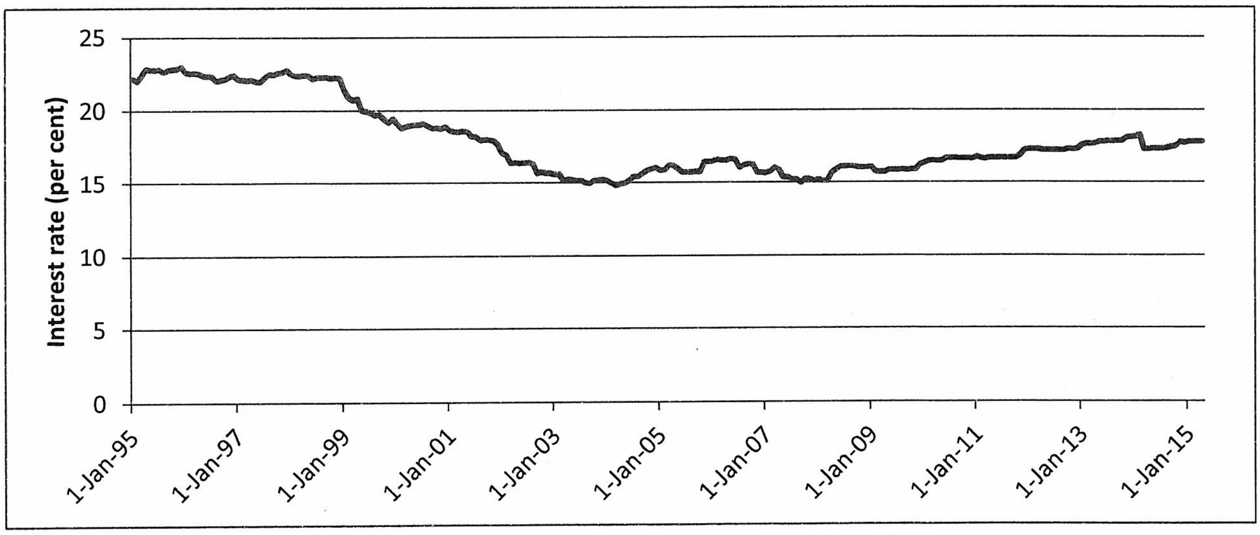


Source: Board of Governors of the Federal Reserve System, 'Historical Data: Terms of Credit at Commercial Banks and Finance Companies', Board of Governors of the Federal Reserve System website, accessed 22 May 2015.

United Kingdom

Similarly, the United Kingdom publishes an indicator reflecting credit card rates (Figure 2 below).[9]

Figure 2 United Kingdom credit card rates – Bank of England average measure



Source: Bank of England, 'Statistical Interactive Database', accessed 22 May 2015.

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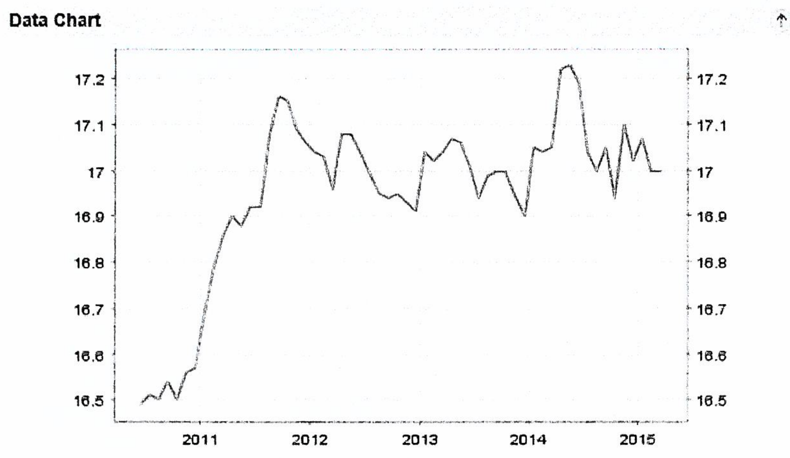
7. 'Transactors' are individuals who use a credit card to buy, but make payments before any interest is incurred; 'revolvers' are individuals who actually pay interest on their card borrowings – see more information below, under 'Credit card use in Australia'.
8. The 'all credit cards' interest rate is the 'average annual percentage rate ... offered to all credit card holders and is independent of the manner in which the accounts are actually used'. The interest rate for cards which are 'assessed interest' is the average annual finance rate offered by banks, 'weighted by their total balances for accounts with finance charges'. 'The panel is a simple of 50 credit card issuing banks, consisting of the largest issuers of credit cards and a randomly drawn sample representing the remainder of the bankcard industry. Participation is voluntary; as of November 2011, approximately 40 banks report regularly' (Board of Governors of the Federal Reserve System, 'Consumer Credit – G. 19', Board of Governors of the Federal Reserve System website, accessed 22 May 2015).
9. This reflects the 'annual percentage rate' that applies to 'standard credit card purchases'. 'If an institution offers more than one card, preference is given to the one deemed to be the most widely available. The credit card rate series is weighted by monthly gross credit card advances reported' – this means that the rate reported reflects the total, rather than something closer to the assessed interest rate (Bank of England, 'Explanatory notes - Quoted household interest rates', Bank of England website, accessed 22 May 2015).

Europe

The European Central Bank also publishes a measure of the interest rate on 'extended credit card debt' in its statistical bulletin (see Figure 3 below). Even more so than in other jurisdictions, the heterogeneity of the European Union market means that the rate is at best a summary of a wide range of rates.[10]

Figure 3 Interest rate on 'extended credit card debt' – European Central Bank measure

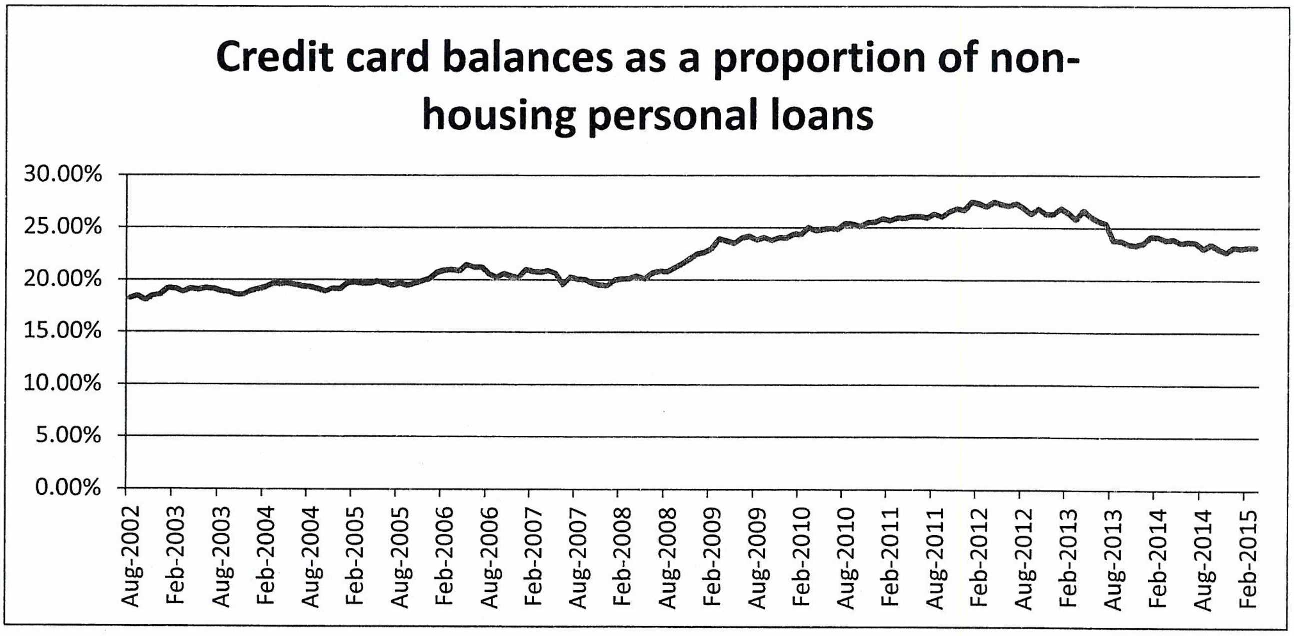


Source: European Central Bank (ECB), 'Bank interest rates – extended credit card credit to households – euro area', *Statistical Data Warehouse*, ECB website, accessed 22 May 2015.

Credit card use in Australia

Prevalence

There are a range of measures of credit card borrowing by the Australian population. It remains an important form of borrowing – one estimate suggests it comprises around a quarter of non-housing loans to households (see chart below).[11]



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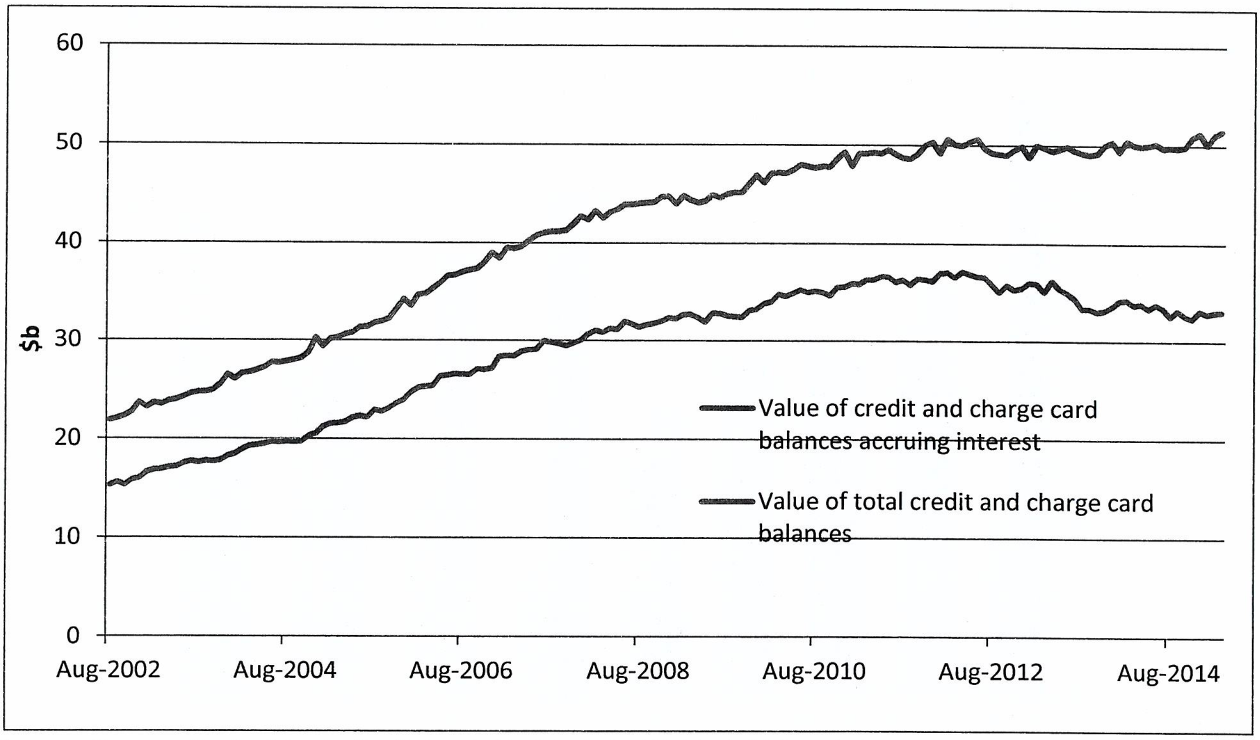
10. 'Euro area MFI [monetary and financial institutions] interest rates are calculated as a weighted average (by corresponding business volume) of the euro area countries' interest rates for each category' (European Central Bank, *Statistics Bulletin*, S89, accessed 22 May 2015). Importantly, it appears that different aspects of credit card debt are treated differently in the statistical records of individual European Union nations, which means that the European Central Bank's measure is relying on data that may be inherently incomparable – 'The MFI [monetary and financial institutions] interest rate statistics are therefore not fully harmonised in this respect, which needs to be accepted at this stage' (European Central Bank, *Manual on MFI interest rate statistics*, October 2003, p. 64).
11. Housing loans are much larger, by value, because of the size of the average mortgage compared to most other loans from banks to individuals.

Source: Parliamentary Library estimates based on Reserve Bank of Australia datasets C1 and D2 (RBA, 'Statistical Tables', RBA website), updating estimates from A Baladkhani, S Anwar and A Arjomandi, 'Downward stickiness of interest rates in the Australian credit card market', *Journal of the Asia Pacific Economy*, 19 (1), p. 57, Figure 3. The estimate is based on credit card balances accruing interest, not the total value of credit card balances as reported by the RBA.

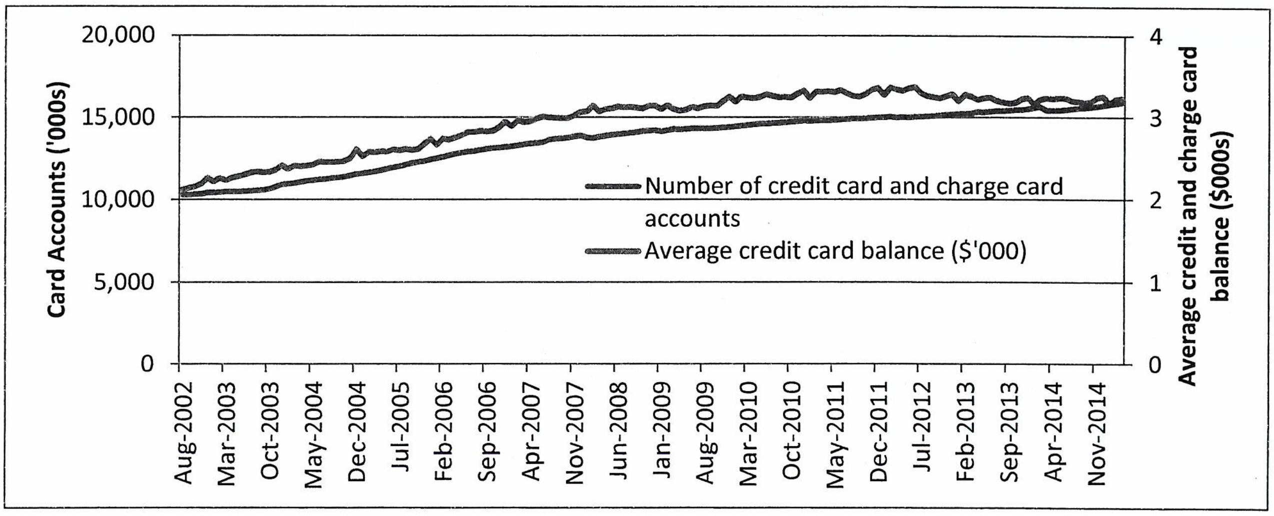
The data also suggests that while overall credit card balances have grown, there has been (at the national level) a slight decline in the value of balances accruing interest.



Source: Reserve Bank of Australia, Dataset C1, 'Statistical Tables', RBA website.

Estimating the number of individuals with accounts is more difficult. The ANZ *Survey of Adult Financial Literacy in Australia* estimated that 64 per cent (of a 2014 sample of 3,400 individuals) had credit cards, down from a 71 per cent survey result in 2011.[12]

RBA data (below) also shows the total number of credit card accounts (some individuals may have multiple cards), and I have derived an approximate measure of the average card balance.



Source: Reserve Bank of Australia, Dataset C1, 'Statistical Tables', RBA website.

12. ANZ, *ANZ Survey of Adult Financial Literacy in Australia*, May 2015, p. 53. The survey also reported 15 per cent held a store card, up from 13 per cent in 2011.

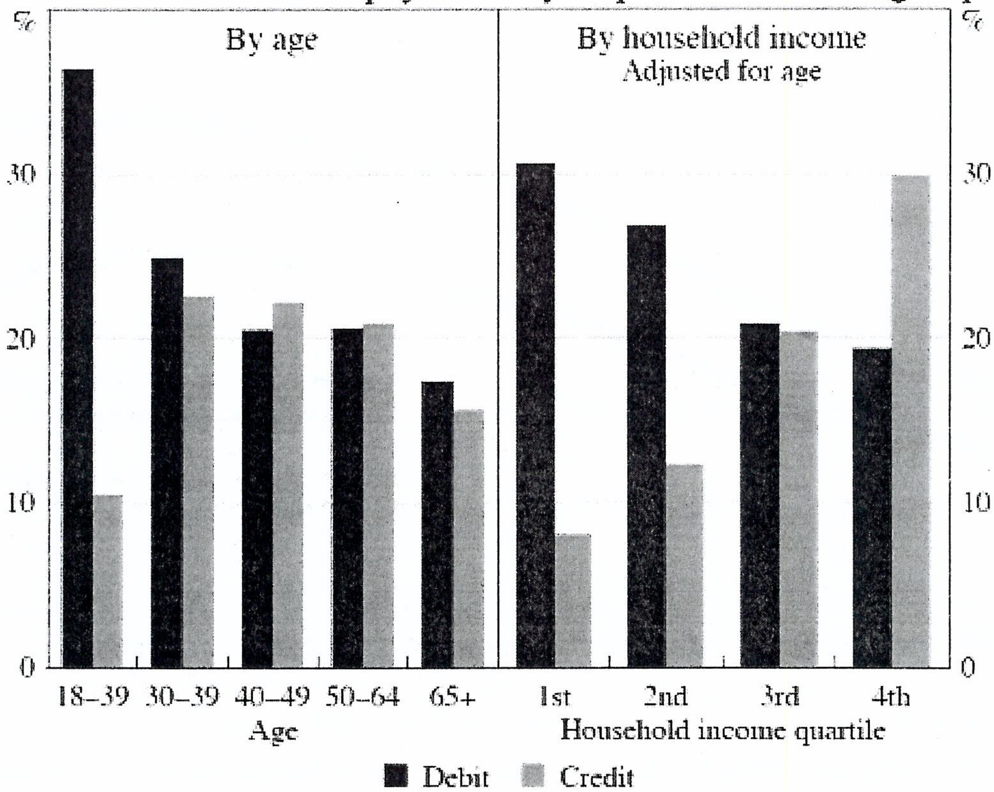
Client in confidence

Demographic patterns

On average, older individuals and richer households tend to use credit cards more frequently (as a proportion of total payments – however this may not reflect the relative importance of credit cards for a given household's financial situation).

Figure 4: Use of Debit and Credit Cards – 2013

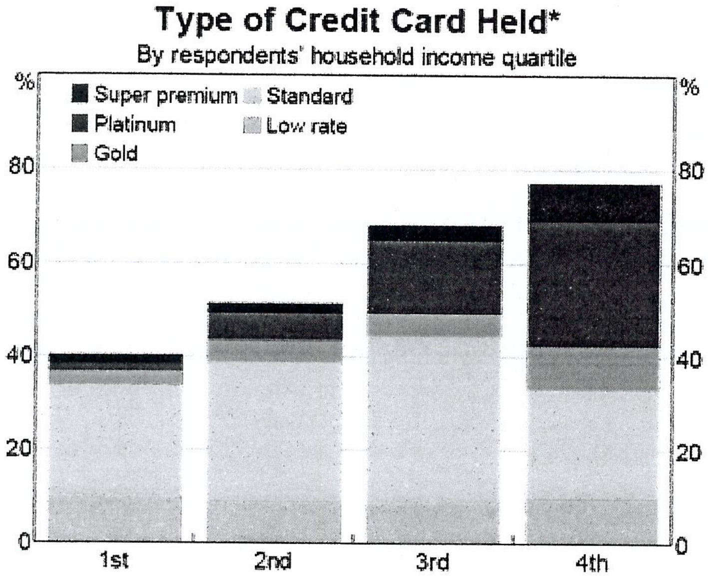
Per cent of number of payments by respondents in each group



Source: Colmar Brunton

Source: C Ossolinski, T Lam and D Emery, <u>*The Changing Way We Pay: Trends in Consumer Payments*</u>, RBA Research Discussion Paper, June 2014, p. 18.

Richer households, in addition to using credit cards more, tend to have a higher proportion, particularly of premium cards (see figure below).



* Card products not identified by survey respondents are proportionately included across each remaining product category

Sources: Colmar Brunton; RBA

Source: RBA, 'Developments in the Cards Payments Market', *Review of Card Payments Regulation*, March 2015.

Individuals experiencing financial hardship

It is difficult to estimate the exact extent to which individuals facing financial hardship rely on credit cards. In part this relies on how 'financial hardship is defined'. At the broadest level, some estimates treat all individuals who make interest payments on their credit cards as being unable to repay the credit in time – however this likely overstates the number.

There are a number of different estimates, which vary in terms of timing and methodology:

- A 2012 study of individuals borrowing from payday lenders found that less than seven per cent (of a sample of 112) had a credit card, but over 60 per cent had a poor credit rating.[13]
- The RBA estimated that 'interest on credit card debt is only paid by some cardholders ... who account for less than 30 per cent of credit card holders'.[14]
- An article in *The New Daily* cites a figure of two million 'revolvers' (individuals who 'regularly carry outstanding balances and thus pay interest on their credit cards').[15] However this likely reflects the total number paying some interest, and not necessarily those experiencing financial hardship.
- The ANZ *Survey of Adult Financial Literacy in Australia* found that 23 per cent of credit card holders 'had been charged interest on their balance in some months', from a 2014 sample of 3,400 individuals. They noted that 'This was most common amongst single parents with household incomes of $65,000 or less (34%) and amongst those people with mortgages of $300,000 or more and household incomes below $100,000 (43%)'.[16]

Competition in the Australian credit card market

The issue of competition in the Australian credit card market is complex – we can provide more detailed material over a longer time frame if you are interested. When evaluating competition in the market for credit cards, it is important to note that credit cards offer a combination of two products – both a payment card (similar to a debit card), and a credit facility.

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13. M Banks, G Marston, H Karger and R Russell, *Caught $hort: Exploring the role of small, short-term loans in the lives of Australians – Final Report August 2012*, p. vii.
14. Reserve Bank of Australia (RBA), *Review of Card Payments Regulation: Issues paper*, March 2015, p. 18.
15. Reserve Bank of Australia (RBA), *Review of Card Payments Regulation: Issues paper*, March 2015, p. 18, fn. 17; G Lekakis, 'Australia's most predatory credit cards revealed', *The New Daily*, 11 February 2015. Note the RBA's estimate (cited above) that only around 30 per cent of credit card holders pay interest on their cards.
16. *ANZ Survey of Adult Financial Literacy in Australia*, op. cit., p. 56.

Credit card markets

One journal article credit card markets as relatively competitive, stating that:

> Credit card suppliers generally operate within a competitive market with many financial institutions offering their credit cards with limited barriers to entry.[17]

Given this, the challenge is to understand 'why credit card interest rates (compared to other lending rates) are so high and so sticky downwards, while banks enjoy high profits at the same time'.[18] A number of factors have been proposed to explain this, which include:

- Search costs (effectively, the time needed to find the best card), switching costs (the costs associated with changing card), and adverse selection[19]
- Rational or irrational borrowers
- Fixed and variable interest rates
- Tacit collusion between banks
- Option value of credit lines, or
- Credit card penalty fees and risk.[20]

I can provide more material on the economic literature in this area if you are interested; there appears to be at least some research on the reasons why competition does not occur in credit card markets.

Payment cards

The market for payment cards reflects the fact that a credit card, as well as providing a loan, also provides a payment mechanism – in this sense, credit cards and debit cards are, broadly speaking, a single market. There is a useful 2010 speech by an RBA Assistant Governor.[21] This summarised some of the factors which may impact on the payment card market (including both debit and credit cards):

> One of the first things I learned when I started to work on card payments is that the economics of this industry are not simple. In the simplest markets, we can think of supply and demand as being determined by a set of independent decisions made by producers and consumers. People will base their decisions on factors like price, quality and the cost of production. If it's a competitive market, we'd expect it to have certain characteristics, such as that: other things equal, a lower price means more demand; producers compete to offer the product at the lowest price they can; and the price mechanism promotes efficiency by guiding resources to their best use.
>
> In practice, no market will meet those conditions perfectly. But the card-payments market has some particular qualities that make it very different from the stylised description I've just given.
>
> First, the card payments market is subject to network externalities, which is another way of saying that the cost-benefit decisions made by the various players are highly interdependent. The value of the service I get from being part of a card network depends, in part, on the size of the network. Cardholders value having a particular card in their wallet because they know the card is widely accepted. And merchants value the capacity to accept a card because it's widely held. This aspect of the market adds a level of complexity to the pricing strategy, because the suppliers of card services will want to take those externalities into account. They have an incentive to adopt pricing strategies that promote the size of their networks.

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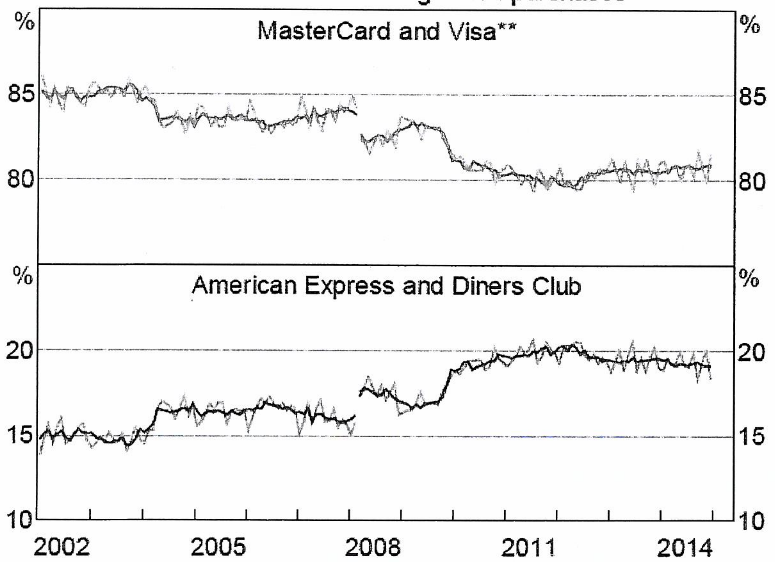
17. A Baladkhani, S Anwar and A Arjomandi, 'How to capture the full extent of price stickiness in credit card interest rates?', University of Wollongong Economics Working Paper Series 2012.
18. Ibid., p. 2.
19. Adverse selection in this context relates to the fact that low rates may be more likely to attract high-risk individuals, which reduces the incentive for banks to lower rates (for a more detailed discussion of this aspect, see Baladkhani, Anwar and Arjomandi, 'How to capture the full extent of price stickiness in credit card interest rates?', op. cit., pp. 2-3).
20. Ibid., p. 2.
21. M Edey, *Competition and regulation in the card payments market*, speech, 15 March 2010.

> The second difference is that card payments services are a joint product. The purchaser of the service, in any given transaction, is not the only one who benefits from it. When a card is used to make a payment, it delivers a service jointly to both the payer and the receiver of the funds.
>
> Thirdly, the card payments market, particularly in the credit cards space, has evolved in such a way as to have a very unusual characteristic. That is, that the decision-maker in a transaction – the person who decides which payment method to use – is generally not the person who is on the receiving end of the price signal. To be specific, it is typically the purchaser who decides whether to use a card (and which card to use), but it's the merchant who, in the first instance, pays the fee associated with that decision.
>
> So, in a world where cards are widely held and widely accepted, the effective demand for the service is determined mainly by the cardholders, while the price is charged to the merchants.[22]

The speech also noted that the credit card market in Australia is highly concentrated, with approximately 80 per cent share held by the two largest issuers. MasterCard and Visa continue to hold a significant portion of the market, as per the chart below.

Graph 4
Market Shares of Card Schemes*
Value of credit and charge card purchases



* Excludes scheme debit after March 2008, which resulted in a 1.5 percentage point break; darker lines are seasonally adjusted estimates
** Includes Bankcard before 2007
Source: RBA

In relation to interchange fees (see surcharging, below), he also stated: 'One of the consequences of the industry structure that I've just described is that competitive discipline on interchange fees has been weak'.[23]

Source: Reserve Bank of Australia, Review of Card Payments Regulation: Issues paper, March 2015, p. 16.

Credit cards – costs to financial institutions

The table below from an RBA paper on *The Evolution of Payment Costs in Australia* provides a useful estimate of financial institution credit card costs, 'Dollars per transaction, at average transaction value'.[24] By their estimates, 'Credit collections and write-offs' form a reasonably large component of the average cost per transaction (approximately $1.01 from $2.95 of the weighted average dollar cost per transaction, at average transaction value).

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22. Ibid., pp. 1-2.
23. Ibid., p. 2.
24. C Stewart, I Chan, C Ossolinski, D Halperin and P Ryan, The Evolution of Payment Costs in Australia, RBA Research Discussion Paper, 2014.

Table A3: Financial Institutions' Credit Card Costs Dollars per transaction, at average transaction value	2006	2013	
	Weighted average	Weighted average	MasterCard & Visa
Total costs	**2.40**	**2.95**	**2.68**
Total resource costs	1.46	1.73	1.76
Payment function	0.59	0.72	0.72
Issuer	0.40	0.43	0.43
Authorisation and transaction processing	0.08	0.06	0.07
Scheme fees	0.11	0.21	0.20
Fraud prevention[(a)]	0.11	0.03	0.03
Other issuer costs	0.10	0.14	0.14
Acquirer	0.19	0.28[(c)]	0.28
Scheme fees	0.02	0.12[(c)]	0.12
Other acquirer costs	0.17	0.16[(c)]	0.16
Credit and rewards functions	0.87	1.01	1.04
Credit collections and write-offs	0.64	0.78	0.83
Cost of capital (credit risks)	0.19	0.22	0.19
Cardholder rewards programs (operating costs)	0.04	0.01	0.01
Transfers	0.94	1.22	0.93
Issuer	0.92	1.21	0.93
Chargebacks and issuer fraud losses	0.01	0.09	0.04
Cardholder rewards	0.62	0.74	0.56
Cost of funds	0.30	0.38	0.31
Acquirer	0.02	0.01[(c)]	0.01
Memo items:			
Interchange fees	*0.69*	*0.86*	*0.86*
Average transaction value[(b)]	*132*	*139*	*131*

Notes: (a) The 2007 study did not separately identify the net losses from fraud and the costs of fraud monitoring, mitigation and investigation

(b) Of underlying transactions

(c) Data only include costs for MasterCard and Visa; for confidentiality reasons, American Express acquirer data have been suppressed

Source: Authors' calculations based on survey data

Other issues

Surcharging

An issue which has received significant attention in recent years is surcharging in relation to different payment cards. I can provide more briefing on this aspect if you would like.[25]

Use of credit cards by small business

Small businesses are very likely to use credit cards as a form of debt financing; the RBA's submission to the Financial System Inquiry cited a 2012 survey showing that 73 per cent of small businesses used credit cards as a form of financing.[26]

25. Additionally, useful summaries are available recent RBA speeches (G Stevens, *Observations on the Financial System*, speech, 28 April 2015; M Edey, *Card Payments Regulation: From Wallis to Murray*, speech, 21 May 2015).
26. RBA, *Submission to the Financial System Inquiry*, March 2014, p. 124.