

# The Case for Credit Card Reform: A Primer for Students

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## Background

When you go to purchase any good or service, you, as a customer, have a choice of which *payment instrument* you use. The most frequently used payment instrument is cash; that is, paper dollars and metal coins that you carry around with you. Also popular – but less so these days – are checks. Checks are basically a written permission note from you to your bank to pay the merchant directly from your bank account. However, both cash and checks are declining in use relative to the use of plastic.

There are two plastic payment options (although often the same card can do both). First, there are *debit cards* or EFTPOS (electronic funds transfer at the point of sale). If you use a debit card, you effectively give the merchant the right to draw funds directly from your bank account to pay for a product. It is similar to checks in that you provide identification (namely, a pin number as opposed to a signature) but it differs in that you can't use a debit card unless you actually have the requisite funds in your account. For checks, you may have a day or so, to make sure the funds are there. For this reason, debit cards carry less risk for merchants than checks.

The second plastic option is a *credit card*. When you use a credit card, your bank promises to pay the merchant and you get billed by your bank. You may have to provide some identification (i.e., a signature) but not always (as with Internet transactions). But unlike checks there is no risk that the merchant might not be paid, although there is a risk the cardholder's bank may not be. Also, unlike other payment instruments, the cardholder has more time to pay the bill. Even if the cardholder does pay their entire credit card bill off each month they may have a week or two between the time of purchase and the date payment is due. This is a benefit to the cardholder who might be a little short of cash (say around Christmas) and for that reason it is also a benefit to merchants who offer credit card services.

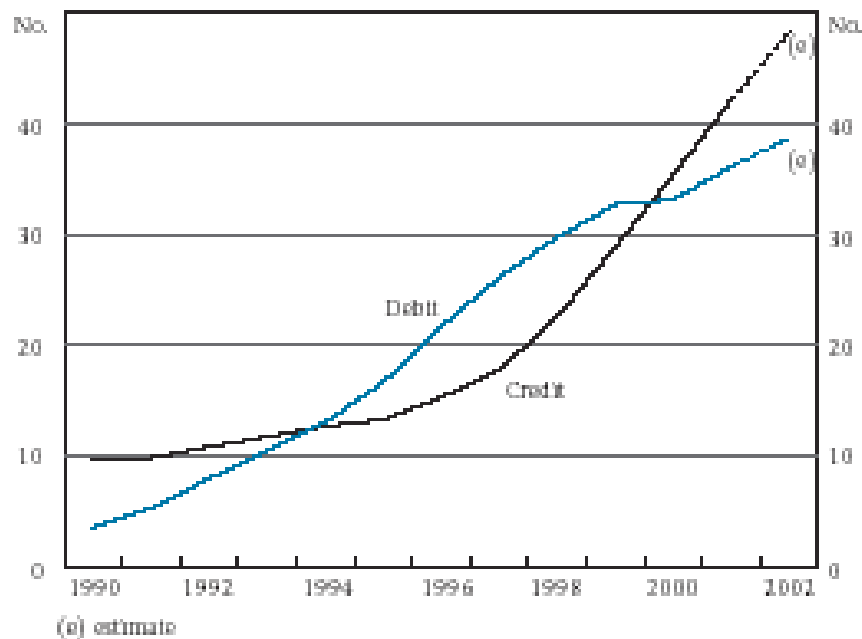
But your choice over payment instrument is driven by more than just convenience. For starters, while a credit card might be attractive, it is no free lunch. Banks charge you an annual fee to have one and if you do fail to pay your bill off each month, you face relatively high interest rates on accrued debts. On the other hand, however, in addition to convenience, many card *issuers* (usually, banks who offer you a credit card) give you frequent flyer or loyalty points if you

make credit card transactions. These entitle you to free air travel and other goodies (e.g., movie tickets and petrol vouchers). So once you have a credit card, there is a good reason to use it whenever possible. If you don't have any card debt you get convenience (more so for Internet and phone purchases where credit card is the only option) and an effective discount on goods through loyalty points.

### Policy-Maker Concerns

For this reason, it is not surprising that credit cards have really taken off. Figure 1 compares the growth in credit and debit card use. Credit cards had a head start but grew slowly in the early 1990s only to take off after 1998 due to the advent of loyalty points and the growth in Internet and phone sales. And it is this growth that has attracted the attention of the Reserve Bank of Australia (RBA) and Australian Competition and Consumer Commission (ACCC).

**Figure 1: Number of Credit and Debit Card Payments per Year**



Source: RBA (2002, p.5)

But it is natural to ask: what is the problem? Products grow and become more popular all the time and credit cards are just one of them. But that doesn't mean that there is a concern for policy-makers?

In the credit card case, however, there were two things that were troublesome. First, alongside the growth in credit card use is a growth in the total debt level of consumers. While in Australia these amounts are small, in the U.S., an average household has about \$10,000 in credit card debt. So the RBA worries that we are

heading in that direction. Second, while convenient for consumers, merchants have to pay fees whenever there is a credit card transaction. Indeed, in Australia, the *merchant service charge* that a merchant pays for card transactions ranges from about 2.5% to 5% of the purchase price whereas debit card transactions are either free or, in fact, for larger retailers, attract a rebate. Those retailers receive payments when debit cards are used and make payments for credit card sales. Moreover, as there are only a few providers of credit cards (namely, Visa, MasterCard and Bankcard and perhaps American Express and Diners' Club too), merchants feel compelled to offer credit card services; fearing that if they do not they will lose too many customers. The concern of merchants troubled the ACCC who worried about a lack of competition and also some of the cooperative arrangements in the credit card industry. So, all in all, the RBA and ACCC were worried that there might be too much credit card use and that the practices of credit card associations were the cause of this. And in 2002, the RBA used its new powers under the *Payment Systems (Regulation) Act (1998)* to do something about it.

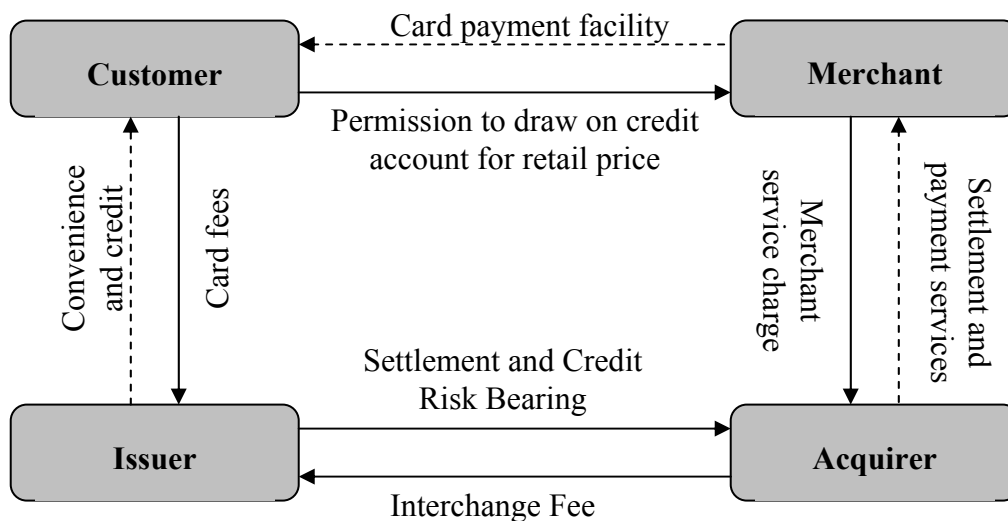
### **How Credit Card Associations Work**

To understand more about the nature of the potential problem with credit cards, as well as the 2002 reforms, you need to know a little more about how credit card associations work. A typical credit card transaction has two consumers (the customer and the merchant) and two producers (the card issuer and the merchant acquirer). When a customer pays for a good for a credit card, the merchant can request for payment from its own bank (the acquirer). For this service, it pays the acquirer a merchant service charge. The acquirer then goes to the customer's bank (the issuer) and asks for the requisite payment. This, in turn, attracts a charge – the interchange fee – that is paid by the acquirer to the issuer in return for collecting payment from the customer. A big reason for this payment is that it is the issuer who bears the risk that the customer may default on payment; something that merchants bear with checks and a risk that doesn't exist with cash or debit cards. Finally, the customer pays their credit card bill back to their own bank (the issuer) and incurs any fees or interest payments that might arise.

But there are also a couple of twists in this story as the card associations (i.e., Visa and MasterCard) impose conditions on merchants who offer credit card services. First, a merchant must accept all credit cards from that association. So while Australian banks such as the National Australia Bank and Commonwealth Bank may issue MasterCard credit cards, a merchant cannot choose which of these cards to process even if they involve different fees that the merchant must pay. The *honour all cards* rule assists in cardholder acceptance of a credit card as they know it can be used throughout the world for any merchant who elects to process that brand. Second, the merchant is not allowed to pass on any fees it

pays to a customer who wants to use a credit card. So even though for a given sale, a credit card may incur a, say, \$1 cost for the merchant over cash, the merchant cannot charge the customer explicitly for that additional cost. If it wants to recover that cost, the *no surcharge rule* says that it must come from all of the merchant's customers regardless of whether they use credit cards or not; something that seems a little unfair to cash and debit card users although they might also be able to shop elsewhere.

**Figure 2: Parties to a Credit Card Transaction**



### The Interchange Fee

The final piece in the puzzle comes when you consider who sets all of these fees and charges. For cardholder fees and merchant service charges, these are freely chosen by issuers and acquirers respectively. Issuers face competition for customers and acquirers for merchants and this prevents these fees from rising (although in Australia these are dominated by the four major banks whereas in, say, the US, there are thousands of issuers). But the interchange fee is not set by competition. It was set two decades ago when card associations first came to Australia by a collective agreement of the initial member banks. And the ACCC and RBA are worried it might be set too high.

What happens as the interchange fee rises? First, it is a cost component for acquirers so they will naturally pass this on to merchants in the form of higher service charges. This makes merchants even more reluctant than ever to accept credit card services but if their customers demand those facilities they may face little choice. Second, this improves the revenue issuers receive from card

transactions. So issuers are going to want to encourage more transactions by lowering their fees or offering other incentives such as loyalty points.

Thus, if merchants have no choice but to accept higher fees and cardholders are being given more incentives to use credit cards, overall credit card usage will rise; consistent with RBA concerns outlined above. Notice, however, that if merchants could charge customers a surcharge for credit cards, this story would unravel. A higher interchange would raise merchant service charges but at the same time credit card users would face surcharges. Simple arithmetic tells you that the surcharge will just about offset any lower fees or incentives cardholders may be receiving so, on average, they won't increase card usage by much or at all. That is, while changes in interchange fees might change all of the fees and charges, they might not change customer behaviour – that is, they might be *neutral*. And, if this is the case, then whether they are collectively set or not is not much of a concern for policy-makers.

In any case, unlike the US, Australian banks have not opted to raise the interchange fee even as customers became more demanding about their ability to use credit cards. Although, it is still possible that the fee was set too high, initially.

### **The Reforms**

In the end, the RBA opted to do three things. First, it moved to free up access to competing issuers and acquirers in card associations so that the discipline of competition was maintained as much as possible in the system. Second, the RBA abolished prohibitions on surcharging as of the 1<sup>st</sup> January, 2003. Finally, in late 2003, the RBA will ensure that the interchange fee is lowered.

The overall effect of this is still unclear. While prohibitions on surcharging have been removed, there has not been a great move to pass on credit card costs to customers. One reason for this is that retailers get some benefits when customers use credit cards and so do not want to discourage it. Another is that it is hard to impose a surcharge of only a few percentage points for simple administrative reasons (although there is nothing stopping them imposing a greater charge than their costs; after all, if you use a credit card in a taxi you pay 10 percent more). Nonetheless, surcharging may become more widespread over time as merchants get more comfortable with the idea.

The reduction in the interchange fee will have an immediate effect on fees and charges. You can expect to pay more in card fees and to find loyalty schemes less attractive. Merchants are going to face fewer charges when they offer credit card services and any merchants who were undecided will probably decide to offer them. In any case, the drive to surcharge will be reduced. However, if surcharging becomes more widespread, then the change in the interchange fee will not really mean much in terms of the use of different payment instruments.

**Some Possible References:**

ACCC: [www.accc.gov.au/new/rba\\_refo\\_mer.htm](http://www.accc.gov.au/new/rba_refo_mer.htm)

RBA:

[www.rba.gov.au/PaymentsSystem/PaymentsPolicy/CreditCardSchemes/index.html](http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/CreditCardSchemes/index.html)

CoRE Research (Some explanatory papers in the credit card reforms): [www.core-research.com.au](http://www.core-research.com.au)