



22 August 2005

Dr John Veale
Head of Payments Policy
Reserve Bank of Australia
65 Martin Place
SYDNEY NSW 2000

Dear John,

Proposed changes to credit card interchange standard

Visa International Service Association (Visa) welcomes the opportunity to comment on the Reserve Bank of Australia's (RBA) proposed changes to the credit card interchange standard published in a Consultation Document and the Draft Revised Standard for the Setting of Wholesale Interchange Fees in designated credit card schemes (Revised Standard) on 20 July 2005.

Despite Visa's continued opposition to the RBA's regulation of the payments system, it acknowledges that this proposal at least reduces some of the unfairness of the regulations under which it is obliged to operate. The majority of respondents to the RBA's first round of consultation in this regard agreed with the need for change.

In summary, Visa considers that the RBA should adopt its proposed "Option A", although it needs to be amended in relation to the way in which nominated scheme participants are selected. (The problem with the current proposal in this regard, together with other technical issues arising in the RBA's proposal is discussed in detail below.)

In this submission, Visa reiterates comments it has previously made to the RBA in relation to competitive imbalances and distortions and sets out its detailed consideration of the RBA's proposal, commenting again on the need for change. It also refers the RBA to its recent report entitled *Early evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes*, which can be found at http://www.visa.com.au/newsroom/reports_index.shtml.

VISA INTERNATIONAL
Level 42, AMP Centre
50 Bridge Street
Sydney NSW 2000
PO Box 25, Sydney
NSW 2001
Australia

Phone 02 9253 8800
Fax 02 9253 8801

Overview of Competitive Aspects

Visa's opposition to the regulatory regime is, and always has been, based upon a belief that regulators should only intervene where there has been clearly demonstrated market failure or there is substantial public benefit to be obtained by the intervention. Visa does not believe either circumstance existed in relation to the credit card payments system prior to the introduction of the RBA's 2002 regulations.

Moreover, even where regulatory intervention might be justified, if the intervention creates its own competitive imbalances and distortions, it must be called into question. The RBA's regulatory regime has had this effect in two significant ways:

First, and most obviously, imbalances and distortions arise as a result of the competitive advantage the regime has given to the closed (three-party) card payment schemes. This was apparent at the outset in relation to those schemes' proprietary cards and is even more apparent now that they have entered into issuing arrangements with banks – these “network” operations adopt all of the important commercial characteristics of “open” (four-party) card payment schemes. This is an anomaly that Visa continues to urge the RBA to remedy.

The second competitive imbalance is the one that the RBA's Revised Standard seeks to address – specifically, the consequence that the current cost-based formula rewards higher cost schemes over lower cost ones. Given the RBA's stated intention of encouraging more efficient and lower cost payment mechanisms, it must be assumed that this is an unintentional consequence that the RBA agrees needs to be corrected.

Cost-Based Formula Distortion

The principal practical effect of the distortion in the regulatory formula for setting a cost-based benchmark for interchange was stated in Visa's submission to the RBA dated 7 April 2005¹ – that is, that Visa is at a two basis points disadvantage against MasterCard (which is an almost four percent pricing disadvantage for Visa). This is a significant margin in any large commercial enterprise. It means that:

¹ In its 7 April 2005 submission to the RBA, Visa set out a number of reasons supporting its position. It does not propose to restate them now but does, however, maintain their validity.

- In negotiations with an issuer with higher than average eligible costs, the issuer **may** lose money in issuing MasterCard-branded cards – that is, if its eligible costs are higher than the relevant benchmark – but it **will** lose more money if it chooses to issue VISA-branded cards; and
- In negotiations with an issuer with lower than average eligible costs, the issuer will earn a higher margin of revenue over costs if it issues MasterCard-branded cards, rather than VISA-branded cards.

The main argument advanced against the change being considered by the RBA was that, by establishing a common benchmark for interchange, the RBA would remove a source of competition – that is, competition in the setting of interchange fees and the cost components that go to make them up. Visa's response to that argument is two-fold.

First, even if the argument were true it would not change the commercial outcomes described above. They arise from pragmatic business decisions being made by issuers in an environment where regulation has effectively removed one of the main ways in which Visa can compete for business. Regulation that is so patently unfair as between competitors should not be allowed to remain unchanged – and by publishing its Revised Standard the RBA has recognized and acknowledged this point.

Secondly, in any event, Visa believes that quite the opposite is true. As already noted there is a risk in any regulatory regime that it can create perverse incentives for players who may seek to gain an advantage by exploiting opportunities created by the regulations, in this case enhancing their competitive position by raising their costs. By establishing a higher cost base among issuers, a scheme can set higher interchange rates. This will encourage issuers to promote card use for the higher cost scheme. The RBA has previously argued that higher interchange results in higher merchant service fees. If this is so, the incentive to promote higher cost schemes will result in higher merchant fees and higher costs to consumers.

As Visa noted in its previous submission, acquirers tell Visa that they rarely, if ever, in practice, promote the lower cost scheme by differentiating the merchant service fee paid for transactions processed on cards from different schemes. Instead, they blend the fee they charge the merchant. The outcome is that the lower cost scheme effectively subsidises the higher cost one.

Discussion of the RBA's Proposals

The RBA has identified two possible means by which the proposed changes could be implemented. As mentioned earlier, Visa supports the adoption of Option A.

The RBA proposes selecting nominated scheme participants such that:

“...when selected in order of their share of the value of credit card transactions in the Scheme in Australia...[they] are the minimum number of issuers to account for at least 90 per cent of those transactions”

Visa recommends an amendment to the way in which nominated Scheme participants are selected. Selection should continue in line with the current practice, which requires participation by nominated Scheme participants that represent at least 90 percent of credit card transactions by value in the Scheme. The reasons for this recommendation are discussed below.

Choice of nominated scheme participants

The first flaw in the RBA's proposed method of selecting nominated scheme participants is that it simply selects the largest issuers and precludes participants and the scheme from using a broadly representative sample of issuers.

Under the current regulation issuers selected as nominated scheme participants must represent, in aggregate, at least 90 percent of the value of transactions of the scheme, but the selection is not limited to 90 percent. If the scheme and its members believe that to get a truly and fairly representative cost-based benchmark smaller issuers should be included they will expend both the time and resources to include them. While the largest issuers still necessarily dominate the calculation of the cost-based benchmark, this existing selection method at least allows the schemes to nominate some issuers to reflect different cost structures based on size and the stages of product life cycles. A broader range of issuers better represents the diversity of costs in the market and disadvantages smaller issuers and new entrants to the market less than the revised proposal for selecting nominated scheme participants.

The second flaw in the RBA's proposed method of selecting nominated scheme participants, given that the RBA is currently proposing that the same cost data be used for setting a cost-based benchmark for debit card interchange rate, is that it is most unlikely result to result in any substantial Visa debit card issuers having its eligible costs included in the calculation. It means, if the debit proposal goes forward on this basis, that Visa debit card issuers will be further disadvantaged as they are predominantly smaller issuers, such as credit unions and building societies.

Practicality

The period used to calculate the 90 percent of value of transactions is specified as:

“the financial year prior to the date for which the applicable cost-based benchmark must be calculated”

For the 2006 cost based benchmark, for example, this is the financial year ended 30 June 2006. Consequently, the identity of the nominated scheme participants cannot be finalized until some time after 30 June 2006. While the identity of the four largest issuers can be assumed, the last one or two nominated scheme participants to achieve the required 90 percent will not be identifiable for some time after the end of the relevant period. This limits flexibility and the capacity to plan.

Uncertainty regarding identity of the nominated scheme participants – even, in the future, possibly as regards the four largest issuers – is increased by recent market innovations that are creating significant variability in volumes. For example, some large issuers are now launching co-brand programs where a cardholder gets both a VISA-branded (or MasterCard-branded) card and an American Express or Diners card. Rewards programs attached to these cards encourage spending on the “closed” (and unregulated) scheme card, to maximize points. The extent to which such new product offerings will impact scheme volume for issuers will not be known until substantially after 30 June 2006.

Delaying selection of all nominated Scheme participants impacts planning and data collection and, consequently, adds needlessly to costs in the system. If an issuer may or may not be a nominated scheme participant it must decide whether or not to expend time to plan and collect data against that possibility. If it merely waits to see if it is included, then it will not be as prepared as it would like if it is included ultimately. For some issuers (large and small) collecting the data (and related statistics) is not straightforward. Internal policies may need to be reviewed and updated to comply with regulatory requirements, even if they do not fit well with business requirements. For example, issuers need to decide if losses from untraceable cardholders should be recorded as credit losses or fraud losses. Sampling must be implemented to support assumptions (for example, disputed calls at call centre) or new reporting methods may need to be established.

Even those issuers that participated in 2003 data collection for setting the cost-based benchmark may need to complete some or all of these actions. (They may have implemented workarounds or used less than optimal sampling in 2003). For this reason in late April 2005 Visa started preparations with its nominated scheme participants based on the existing selection criteria. The potential for late notification of the inclusion of some participants may mean that cost studies will have to be rushed with the attendant possibility for error. Under the current selection criteria these issues do not arise as nominated scheme participants are known well ahead of time and can prepare for the cost study well in advance of it being undertaken.

Furthermore, it is not clear what would happen should it be discovered after a participant had begun or even completed its study that there had been an error in calculating the market share of that or another institution. If there were a requirement to remove and replace that participant unnecessary time and money would be spent and timely completion of the study would be jeopardized.

There are a number of additional more technical issues concerning how nominated scheme participants (and “nominated participants” under Option B) may be chosen, especially in relation to the way market share is to be determined, that Visa would like to discuss in detail with the RBA. (Such a discussion is likely to be more efficient than detailed written submissions on these points.)

Concerns with Option B Related to Independent Experts

With the above caveat, Visa supports Option A. On the other hand Visa believes that there are a number of practical issues associated with Option B that make it unsuitable for adoption.

1. Visa has the same reservations about the selection of the nominated scheme participants as for Option A.
2. In addition, the last named participants under the proposed Option B will be at a disadvantage as to the selection of an independent expert. If there is to be one, to be selected by vote, the other participants will have had time to consider the issue. If each participant can select its own expert the last chosen may have their options limited.
3. The current wording of paragraph 14 is unclear and could lead to disputes. Paragraph 14 states that eligible data:

“...must be provided by the participant to an independent expert proposed by the nominated participants...”
It does not say whether selection of the independent expert is collective or individual. This would need to be specified.

4. If the RBA intends that selection of an independent expert be completed collectively (that is, selection of one independent expert), the following practical issues arise:
 - (1) Option B does not set out a process for selecting the independent expert: including coordination, participation, voting rights or timing.
 - (2) If one independent expert is to be selected by the nominated participants, they should all be in the position to discuss and influence the decision. However, as a result of the final list of nominated participants not being known until well after 30 June, not all nominated participants will be in the same position to influence selection of the independent expert. The last issuer(s) identified may find they only have the option of agreeing to the independent expert already chosen, especially given the time then left before the eligible data needs to be submitted to the RBA. They may feel forced to accept an independent expert, even though they would normally not like to provide their data to that independent expert – an outcome that is clearly unreasonable.
5. The other possibility, each nominated participant selecting its own independent expert, will result in between one (if an independent expert can act for more than one participant and all participants select the same independent expert) and five or six independent experts. There is the potential for some issuers to face an unreasonable outcome – because of their size and resultant certainty of participation, the largest issuers will be positioned better to appoint an independent expert than the last one or two participants that are identified in July 2006. This is because the largest issuers can proceed at an early stage to source an independent expert that meets their needs. The latest selected participants may find that their options limited severely if they wish to engage an independent expert that has the required skills and is not engaged already to complete the same task for one or more competitors. Again, Visa's concern is that Option B has the potential to treat nominated scheme participants differently, to the detriment of smaller issuers. The Revised Standard should treat all participants equally and provide them with an equal voice in an equal outcome.

If the RBA decides to proceed with Option B, Visa believes that the Revised Standard be amended to make it clear that each nominated participant has the ability to select its own independent expert. No nominated participant should be forced to provide all its data to an independent expert selected without its agreement.

6. Both the independent expert and the nominated participants are required to submit the eligible cost data and the associated total value of transactions. Under the current wording of the Standard, schemes and nominated Scheme participants, the owners of the data, are required to submit the data, not the independent expert. If Option B is adopted, Visa believes that the owners of the data should continue to be responsible for submitting their own data. Data owners should also answer any questions about their data. The independent expert is engaged by the nominated participants to complete the very specific role of determining if the nominated participant's data is eligible or not. Its role does not need to be extended to provision of something it does not own. (Of course, the independent expert may assist the nominated participant to answer questions if thought appropriate by the nominated participant.)
7. The timetable for calculation of the common cost-based benchmark is probably not achievable. Currently Option B requires that:
 - Nominated participants provide data to an independent expert from, say, mid July 2006 (after they are selected and notified they are a nominated participant) until mid September 2006
 - The independent expert reviews the data to determine if it is eligible and, if so, it is provided to the RBA by 15 September 2006
 - The RBA is to calculate the common cost-based benchmark by 15 September 2006
 - The RBA publishes the common cost-based benchmark by 30 September 2006

The timetable does not allow the RBA time for review and query eligible data. (Option A allows two weeks for this to be done.)

Other Practical Concerns - Both Options A and B

1. An acquirer is defined as "... a participant in any of the Schemes that provides services to a merchant to allow that merchant to accept a credit card". "In Australia" should be retained from the current Standard to make it clear that the Standard only relates to acquirers in Australia.
2. The term "value of credit card transaction" is used in the definition of "nominated Scheme participants" and "nominated participants". This may refer to either gross or net sales. This needs to be clarified.
3. Paragraph 9 states that the existing standard will be effective until 30 October 2006. This needs to be changed to 31 October given that paragraph 11 states that the new cost-based benchmark is effective from 1 November 2006.

4. The combination of paragraphs 10 and 11 indicates that the weighted average interchange rate must not exceed the cost-based benchmark on 1 November 2006. This date does not align with the proposed Standard No. 4 – the Setting of Visa Debit Interchange Fees, which specifies 31 October 2006. Whilst Visa is comfortable with 1 November 2006, please align the dates that new interchange rates apply for credit and debit. It would be difficult to make changes to systems on two consecutive days.
5. Visa does not see the need to publish the credit common cost-based benchmark. Publishing interchange rates achieves transparency. It does not disclose potentially commercially sensitive information, which might be the case if the credit common cost-based benchmark were published. Visa assumes the RBA is only considering publishing the common cost-based benchmark and not the supporting eligible cost data. If this assumption is incorrect, then Visa's concerns about confidentiality are heightened greatly.

Visa expects that from the merchants' perspective the desire is for information that potentially impacts costs to them. The common cost-based benchmark is not particularly relevant in this context and to publish this along with the interchange rates well be both confusing and unhelpful. At the very least, if both are to be published, they will need to be accompanied by an explanation in an attempt to reduce confusion arising from publication of two different sets of numbers.

Conclusion

For the reasons set out above and those expressed in Visa's 7 April 2005 submission to the RBA, Visa urges the RBA to proceed with the proposed Revised Standard. It should adopt Option A, subject to the comments above regarding selection of nominated scheme participants and other practical matters.

Yours sincerely



Bruce Mansfield
General Manager, Australia & New Zealand
Visa Asia Pacific