2. Interchange Fees

Interchange fees have important implications for both the efficiency and competitiveness of the payments system. They have a significant influence on the pricing of payment services to merchants and consumers and thus, in turn, on the use and acceptance of those services. Despite this important role, interchange fees are, in the Bank's assessment, typically not subject to the same type of competitive forces that operate on other prices and fees.

The Bank is of the view that a change in current interchange arrangements in the EFTPOS and Visa Debit systems would help promote the overall efficiency of the payments system. It sees little justification for the current arrangements, which have contributed to the relative prices charged by financial institutions for various payment methods not reflecting the relative costs of providing those methods of payment. Much of the Bank's reasoning and the supporting evidence has already been set out in the document titled *Reasons for the Decision to Designate the EFTPOS Payment System*, published by the Bank on 14 October 2004. Notwithstanding that, this section of the Consultation Document presents the Bank's analysis of the public interest with respect to the reform of interchange fees. It then discusses various options for reform and presents proposed standards for interchange fees in the EFTPOS and Visa Debit systems.

2.1 Potential Justifications for Interchange Fees

The existence of interchange fees is not, in itself, inimical to the efficiency of the payments system. Indeed, in some cases, such fees may promote efficiency. There are a number of reasons why this may be so.

2.1.1 Maximisation of social welfare

In theoretical models it can be shown that a carefully chosen interchange fee can promote social welfare by promoting optimal use of a particular payment system. These models typically focus on credit card networks but are also broadly applicable to other card networks, including debit cards. Payment systems typically have two joint providers (the issuer and acquirer) and two joint users (the cardholder and the merchant). Without any one of these parties it is typically not possible to complete a transaction – for example, a debit card transaction cannot be completed without the participation of both the cardholder's bank and the merchant's bank. Because there are two joint providers, it is possible to redistribute costs through the use of interchange fees, thereby changing the prices charged to users and, potentially, improving welfare. This is especially so where the actions of one participant in the payment system affect others and where this effect is not taken into account when individuals make decisions. Thus, in the case of centrally set or multilateral interchange fees, the argument has been advanced that fees can be set in order to maximise the benefit to society as a whole.

While these theoretical models provide some insights, they rely on knowing the benefits received by all users of the payment system. Typically, the nature of these benefits is simply assumed to follow convenient functional forms for mathematical neatness. In addition, the current theoretical literature typically focuses on a *single* non-cash payment system rather than *multiple* systems as exist in the real world.

As part of its deliberations, the Bank considered the practicalities of applying these models to the setting of interchange fees in Australia. It concluded that the simplifying assumptions used in the models, together with the significant shortcomings in the available data, made it impractical to use these models in this way. The Bank is not aware of any payment system around the world where these models have been used to set interchange fees.[8]

2.1.2 Viability of the payment system

A more practical argument for the existence of interchange fees is that they can be needed to make a payment system viable.

Because payment systems generally require the cooperation of at least two institutions, both institutions need to be able to profitably provide the services at a price that their customers are willing to pay. In effect, this means that customers must be willing to pay at least their financial institution's costs in providing the service.

Problems arise, however, if either the acquiring institution or the issuing institution cannot recover all their costs directly from customers. If the benefit to the merchant is less than the acquirer's costs, the merchant will not be willing to pay a price for the service that will cover the acquirer's cost and the acquirer will not be willing to participate in the network. Similarly, if the benefit to the cardholder is less than the issuer's costs, the issuer will not be willing to offer the service.

When costs exceed benefits on one side of the transaction but not the other, interchange fees can be a means of establishing the system. These fees redistribute the revenue flows to allow both issuers and acquirers to offer the required services at a profit and therefore bring the system into existence.

The following example, which is summarised in Table 1, provides an illustration. Suppose that the cost of providing the system is \$8 (\$6 borne by the issuer and \$2 borne by the acquirer) and the benefit of the system is \$10 (\$5 to merchants and \$5 to cardholders). Total benefits are greater than total costs so the system would increase society's welfare (ignoring possible interactions with other systems). Without interchange fees, however, the system will not exist.

Table 1: Costs and Benefits – An Example

	Gross benefit (1)	Costs incurred (2)	Fees paid (3)	Fees received (4)	Net benefit (1)-(2)-(3)+(4)
Merchant	\$5	—	\$4	—	\$1
Acquirer	—	\$2	\$2	\$4	\$0
Issuer	—	\$6	—	\$2+\$4	\$0
Consumer	\$5	—	\$4	—	\$1

8 There have been arguments that the particular rules used by card payment schemes are 'close' to the social optimum. However, these arguments have always been advanced in the context of theoretical models that make very particular assumptions and, thus, render the conclusions fragile.

The issuer will need to charge at least $6 to cardholders and the acquirer will need to charge at least $2 to merchants. But the benefit to cardholders is $5 and they will therefore not be willing to pay $6, so issuers will not be able to recover their costs.

The system can be established, however, if an interchange fee of $2 is paid from the merchant's bank to the cardholder's bank. In this case, the merchant will pay $4 to its bank and have a net benefit of $1 and the cardholder will pay $4 to his or her bank and have a net benefit of $1.

In this example there is a range of interchange fees consistent with the operation of the system. In particular, any interchange fee between $1 and $3 will result in the payment system being used. More generally, depending on the relative sizes of the costs and benefits, the interchange fee needed for a system to operate could be paid to issuers by acquirers, or by acquirers to issuers. Importantly, there is a wide range of circumstances in which no interchange fee is necessary to ensure a payment system is viable.

This general justification for interchange fees is sometimes referred to as the 'balancing argument'. The principle is that, when the costs and revenues on each side of the system are out of 'balance' there needs to be a payment to balance the system and make it viable. This argument is typically applied to credit card systems given that the costs to issuers are generally significantly higher than the costs to acquirers, and it is argued that cardholders would not be prepared to pay enough to meet these costs. It is not normally especially relevant for debit card systems. In these systems, the costs of provision are typically more balanced between the two sides of the market and both acquirers and issuers can recover their costs from cardholders and merchants, reducing the need to rebalance the costs and revenues.[9]

The Joint Study investigated whether interchange fees in the EFTPOS system could be justified on the basis of the 'balancing argument'. It found that weighted-average acquirer costs of processing an EFTPOS transaction were 26 cents and weighted-average issuer costs were 15 cents. On the basis of these data and further analysis, the Joint Study (page 68) came to the conclusion that 'Application of formal interchange methodologies does not provide a convincing case for a debit card interchange fee, in either direction.'

To obtain more recent data, the Bank conducted a second survey of costs in the EFTPOS system in 2004. This survey covered issuers and acquirers accounting for 90 per cent of the transactions in the system. It found that on the acquiring side, the average cost for financial institutions was around 20 cents, compared with 26 cents in the previous study. This decline is accounted for by a fall in average telecommunication costs and one acquirer reporting significantly lower costs than in the Joint Study.

As with the Joint Study, the EFTPOS cost data supplied to the Bank on the issuing side are less comprehensive than on the acquiring side.

Overall, the recent data confirm the Bank's earlier conclusion that an interchange fee is not essential for the operation of the EFTPOS system. This conclusion is further supported by the observation that the Visa Debit system in Australia operates with an interchange fee

9 A significant reason for this is that debit cards do not typically provide an interest-free period.

paid in the other direction and that in Canada and the Netherlands debit card systems operate successfully without any fee at all.

2.1.3 Start-up phase – reimbursement of investment

A third argument for interchange fees, and one related to the balancing argument, is that, while a fee may not be required in the medium term, it may be required during the establishment phase. If cardholders and merchants do not take into account the positive network benefits of having a widely used card scheme, they may underestimate the potential benefits they would receive. Issuers and acquirers, in turn, may have substantial start-up costs and require a critical mass of cardholder and merchant participation to generate sufficient revenue to cover their costs. There is, thus, a 'chicken and egg' dilemma: cardholders and merchants have no incentive to join until the network is large enough, while financial institutions have no incentive to participate unless they can cover their costs. The more these institutions seek to cover their costs by charging their customers, the less likely are cardholders and merchants to participate. Absent interchange fees there may be no way to get the system running.

Provided at least one of the participants perceives benefits in excess of costs during the start-up phase, there is scope to encourage other participants through a transfer mechanism. Thus, in the case of the EFTPOS system, it has been argued that one reason for the particular flow of fees is that acquirer and merchant costs at the beginning of the system were particularly high and, in order to establish the system, there needed to be payments to them to ensure that they were willing to participate.

It is important to note that, once start-up expenditure is incurred and recovered, this justification for the payment of interchange fees is no longer relevant. Given this, it is difficult to apply this rationale for an interchange fee to the current situation. Both EFTPOS and Visa Debit networks are well established, having been introduced around 20 years ago. As such, consumers and merchants can readily assess the benefits they obtain from the network already in place and there are no significant establishment costs remaining to be recovered.

A variation on this argument is that there are periodic technology upgrades needed to maintain the system and that the cost of these upgrades justifies a continuation of the current structure of interchange fees. While terminals and processing equipment are currently being upgraded to use an improved encryption standard, the system costs involved do not appear comparable (in inflation-adjusted terms) to the costs incurred in the building of the EFTPOS system. In any case, the Bank's view is that they do not justify the payment of an ongoing interchange fee. Similar upgrades for debit and credit card systems have taken, or are taking, place in a number of countries. Some have used short-term levies on participants to fund incentives for investment in programs to introduce chip cards and terminals. These targeted levies and payments are independent of ongoing interchange fee arrangements. They are less likely to have longer-term detrimental effects on price signals and incentives and may be an appropriate way to promote the upgrading of relevant systems.

2.1.4 'User pays'

A final argument for the existence of interchange fees – one made by the merchants – is that these fees are a payment made by issuers to acquirers (and merchants) for banking services rendered by the merchant. In the case of debit cards it is argued that the particular banking service merchants provide is access to a deposit account, either to purchase a good or service, or to obtain cash. In particular, this argument has focussed on the provision of cash out by merchants.

The Bank, however, gives little weight to this argument, particularly as it considers only one side of a payment system. In reality, both merchants and cardholders benefit from the payment system and receive services jointly provided by both issuers and acquirers. The 'user pays' argument, as advanced above, ignores the costs incurred by issuers in providing a service to merchants – namely a convenient way for their customers to purchase goods and services. A true 'user pays' system might include payments from acquirers (and merchants) to issuers for the services they provide, in addition to payments flowing the other way. It might also consider any savings to merchants from lower cash-handling costs.

The fact that some merchants provide cash out facilities does not, in the Bank's view, provide a justification for the current level of interchange fees paid to acquirers. Around 85 per cent of EFTPOS transactions do not involve any cash out at all. The EFTPOS transactions that do involve cash out in conjunction with a purchase provide considerable benefit to merchants, who provide the service voluntarily, because they see it as in their interest to do so. In addition to the associated sale of goods and services, merchants potentially save cash handling costs. Finally, less than two per cent of EFTPOS transactions are pure cash out. It is hard to see that they can provide a basis for an interchange fee paid on the other 98 per cent of EFTPOS transactions.

2.2 Competition and Interchange Fees

The Bank's view is that current interchange fees in the EFTPOS and Visa Debit systems cannot be justified on any of the four rationales discussed above. It is possible, however, to make the alternative argument that, if interchange fees are subject to competitive forces, it can be presumed that their level is efficient. Indeed, this is the basis on which it is generally argued that there is no need to regulate most prices in a market economy. In normal competitive markets, prices are driven towards costs, promoting efficient outcomes.

The critical element in this argument is that prices are determined in a normal competitive market. The Bank has substantial concerns that this requirement is not met in practice for interchange fees.

When interchange fees are set *multilaterally*, as is the case with credit cards and Visa Debit, all issuers in the scheme pay the same interchange fees and this is reflected in merchant service fees. Merchants cannot force interchange fees lower by the threat of moving from one financial institution to another for supply of the scheme's services. As a result, the normal competitive forces do not exist.

When the fees are *bilaterally* set, as is the case in the EFTPOS system, the dynamics of competition are different, but again, normal competitive forces tend to be weak. In general, neither acquirers nor issuers are willing, or able, to initiate a process of competition over these fees.

The main reason for little competition emanating from the issuing side is that in any negotiation with an acquirer, an issuer cannot credibly threaten to end the current agreement if a lower interchange fee is not agreed to. Ending the agreement would mean that the issuer's cardholders were not able to use their cards at merchants serviced by the acquirer. For even the largest issuers, this would be seen as unacceptable as it would effectively mean that they could not offer a full-service transaction account. Indeed, during the genesis of the EFTPOS system, issuers did not offer universal merchant acceptance but were quickly driven to make arrangements with other banks to offer that service.

Similarly, an acquirer attempting to expand its business would have difficulty doing so if it were to offer, or agree to, a lower interchange fee. If the acquirer were receiving less revenue from interchange payments than its competitors, it would be unlikely to be able to offer merchants as competitive pricing as other acquirers. It would certainly not be able to do so profitably. Accepting a lower fee can hurt, not improve, the competitive position of acquirers.

One qualification to this arises from the possibility of large merchants bypassing their acquirers and connecting directly to issuers. Under such an arrangement, both issuer and merchant can be better off by sharing any margin earned by the merchant's existing acquirer. However, the gains to be achieved from this source are limited. Once the merchant has established a direct connection with issuers, there is unlikely to be any further significant competitive pressure on interchange fees. To date, only one large merchant has been able to undertake such negotiations and smaller merchants are typically not in a position to do so.

The rigidity of interchange fees in the EFTPOS and Visa Debit payment systems since the 1980s supports the assessment that neither have been the subject to normal competitive pressures. In both the credit and debit card systems, interchange fees have barely moved over the past decade despite significant changes in costs and the maturing of the systems.

2.3 The Detriment from Current Interchange Fees

The Bank's view is that the arguments in support of the current interchange fee are relatively weak. There is no evidence to indicate that a consideration of network efficiency was undertaken when the fees were initially set and normal competitive forces are weak or non-existent. Furthermore, there are identifiable distortions that these fees cause in the pricing and marketing of various payment instruments.

2.3.1 Prices and costs

As noted in Section 1, many users of credit cards typically face either a zero or *negative* effective price for each transaction. In contrast, users of the EFTPOS system face either a zero or *positive* price for each transaction, while users of the Visa Debit system typically face a zero per-transaction price.

These relative prices do not reflect the underlying relative resource costs of the various payment methods. While it is difficult to obtain precise dollar estimates of these costs, it is possible to form clear views about the relative costs of the various methods.

The difficulty in estimating *absolute* costs arises from the lack of data on the resource costs borne by the merchant and consumer in handling the various payment methods. In comparison with the costs of financial institutions – about which a reasonable amount is known – relatively little is known about these costs. They are, however, unlikely to differ significantly between credit and debit cards. If anything, merchant resource costs may be slightly lower for

EFTPOS given the shorter time it typically takes to complete an EFTPOS transaction compared with a credit card transaction.

According to the Joint Study, the combined issuer and acquirer cost of processing an EFTPOS transaction averaged 41 cents in 1999. The more recent cost study referred to above suggests a number a few cents lower. In contrast, the resource costs involved in credit card payments are significantly higher. Data presented in the Joint Study suggested that if the cost of the interest-free period and credit losses are excluded, the average cost was around $1.75. While some of these costs are fixed costs, associated with the initial issuing of the cards, the variable costs are still significantly higher than for the EFTPOS system.

The higher costs involved with credit cards have been confirmed by more recent data collected by the Bank as part of the credit card standard. According to these data, issuers' authorisation, processing and fraud costs amount to an average of around 30 cents per transaction. On top of this needs to be added the issuers' other costs, as well as the acquirers' costs. Given these data and industry consultations, the Bank is confident that the credit card system is a higher-cost system than the EFTPOS system.

While the Bank has not collected cost data explicitly for the Visa Debit system, many of the resource costs for Visa Debit would be expected to be the same as for Visa credit given that the two systems use the same technology and infrastructure. Notwithstanding this, Visa Debit might be expected to have lower average costs given that the card is used as part of an existing deposit account, rather than a stand-alone account.

The higher costs for credit and Visa Debit cards reflect a number of factors. One is that payments made using four-party credit card and scheme-based debit cards are processed through the relevant proprietary infrastructure set up by the individual credit card systems to ensure worldwide acceptance of their cards. The global nature of this infrastructure means that there are additional expenses, relative to the domestically based EFTPOS system.

A second is that the costs of fraud and fraud control are considerably higher for credit card and Visa Debit transactions, due to the fact that they are signature based and can be used in situations where the merchant cannot check the signature. EFTPOS transactions, on the other hand, have low fraud costs due to the EFTPOS system being PIN based.

Data published in the Joint Study indicated that fraud losses amount to around 0.07 per cent of the amount spent on signature-based cards. Subsequent data provided to the Reserve Bank by independent experts appointed by Bankcard, MasterCard and Visa in the course of implementing the interchange standard for credit cards show that, once explicit account is taken of both fraud losses and the costs of preventing fraud, the figure for total fraud-related costs is around double this. By way of contrast, the Joint Study reported that fraud costs in the EFTPOS system were averaged around 1 cent per transaction. More recent data from APCA suggest that fraud in the EFTPOS debit card system may be even lower than this.

Another reason for the cost differential is that the credit card system offers some additional flexibility and protections to cardholders. For example, credit cards can be used at some merchants that do not have an electronic connection to their acquirer and cardholders are protected in situations in which the merchant does not deliver goods and/or services as promised. While these additional features are of benefit to cardholders, they are associated with additional costs. Finally, as mentioned above, there are some additional costs associated with a credit card due to the fact that these cards are usually issued as a stand-alone product, rather than as part of an existing deposit account.

2.3.2 Interchange fees affect prices and promotion

An important reason for the higher-cost credit card system being offered to consumers at lower per-transaction prices is the existence of interchange fees.

Interchange fees affect merchants' costs of accepting the various cards, the prices that cardholders face for using different cards, and the incentives and promotional activities of the banks that issue them. The price effects are well illustrated by the recent changes to interchange fees following the Bank's reforms of the credit card schemes. These reforms have seen the average interchange fee across the Bankcard, MasterCard and Visa schemes fall by around 0.4 of a percentage point to around 0.55 per cent. Data collected by the Reserve Bank show that this fall in interchange fees was almost fully and immediately passed through into lower merchant service fees.[10] There have also been changes on the issuing side. Most major banks have reduced the attractiveness of their reward schemes, effectively increasing the per-transaction price of credit cards. There have also been increases in the fixed costs of holding a credit card with annual fees and fees for being a member of a reward scheme rising.

The recent experience in the United States, where both PIN-based systems and signature-based debit card systems operated by MasterCard and Visa exist, provides further evidence. Fees flow from acquirers to issuers in both systems. In the PIN systems the fees are flat and are relatively small, while in the scheme-based debit systems they are value based and relatively high. This has had two effects. The first is that the arrangements have enabled banks to offer rewards to customers using scheme-based debit cards, effectively making the price for using these cards negative. The second is that an increasing number of banks are charging customers who make PIN-based transactions, effectively encouraging them to use the system that provides the issuing banks with higher fees; these fees range from US$0.25 to US$1 per transaction.[11] No issuers charge transaction fees for scheme-based debit transactions.

The interchange fee differential has also had a significant influence on banks' choice of which product to issue. Prior to 1994 most regional PIN-based networks in the United States had either a zero interchange fee or a fee paid by issuers to acquirers.[12] However, they were losing market share to the scheme-based debit systems and many changed their interchange fees to increase payments to issuers (although they were not as high as for the scheme-based debit systems) to compete for issuance. Notwithstanding this, between 1993 and 2003 scheme-based debit cards increased their share of the number of debit card transactions in the United States from 39 per cent to 60 per cent as issuing banks were persuaded to issue scheme-based cards rather than PIN debit cards.[13] In effect, the expensive system has been driving out the cheaper one, even though the two systems provided essentially the same payment service.

---

10 Reserve Bank of Australia *Bulletin*, July 2004.

11 Dove Consulting (2002).

12 Fisher F, (2000).

13 Nilson Report, Issue 809, p6.

The same dynamic, although less dramatic, can be seen in Australia. Institutions that issue Visa Debit cards actively encourage their customers to use Visa Debit instead of EFTPOS. In some cases they also charge a fee for use of the EFTPOS system, whereas no fee is charged if the same transaction is made through the Visa Debit system.

In contrast to the US, Visa Debit has not substantially increased its market share in Australia over recent years. In consultation, some institutions have indicated to the Bank that one factor that has inhibited the growth of Visa Debit is the uncertainty over the regulatory environment. The Bank is concerned that, when that uncertainty is resolved, unless appropriate measures are put in place, the Visa Debit system will grow at the expense of the EFTPOS system, not because of its intrinsic strength as a product, but as a result of the higher interchange fees.

2.3.3 Prices of payment services affect consumer behaviour, merchants' costs and the general price level

The fact that cardholders often face negative prices for credit card transactions, but zero or positive prices for EFTPOS transactions, has encouraged the use of the credit card and, to a lesser extent, the Visa Debit system at the expense of the EFTPOS system.

If two goods or services provide very similar functions, but one is priced much lower than the other, it will tend to increase its market share. The effect of interchange fees on prices and on consumer choices is most clearly demonstrated by the experience of PIN-debit and scheme-based debit in the US mentioned above. It is also evident in the very rapid growth of credit card usage in the late 1990s in Australia.

Interchange fees also affect merchants' costs through influencing the merchant service fees they are charged. Unless merchants pass their merchant service fees onto consumers through explicit charges, these fees must be incorporated into the prices that merchants charge for goods and services.

The evidence reported above indicates that the cost to merchants of accepting credit and Visa Debit cards is considerably higher than of accepting EFTPOS. In the first instance, lower credit card and Visa Debit interchange fees would reduce merchants' costs, while lower EFTPOS interchange fees would increase merchants' costs. However, over time, to the extent that cardholders shift from credit and Visa Debit to EFTPOS in response to the shift in relative prices, merchants' overall costs would fall as a larger share of transactions are made using the payment method with lower merchant service fees.

2.3.4 Further considerations

Interchange fees affect the prices consumers pay, and therefore the incentive to use the various payment systems. Moreover, these fees are not subject to normal competitive pressure nor have they been set with the efficiency of the payments system in mind. Partly as a result of the fees, current price signals to users of card payment systems are out of line with the relative costs to society of providing these systems.

These factors lead directly to the Bank's view that current price signals are not promoting the efficiency of the overall payments system.

In reaching this view, the Bank considered the possibility that a change in interchange fees would not lead to a change in pricing of EFTPOS and Visa Debit transactions. Some submissions questioned whether competitive forces in retail banking were sufficiently strong to lead to a change in pricing, and noted that banks had not committed to any particular pricing restructure should EFTPOS interchange fees change. Notwithstanding these submissions, the Bank's view is that competition in Australian retail banking is sufficiently strong that a material change in banks' costs will, in time, find its way into a change in pricing or the extent to which various payment methods are promoted by financial institutions. Such a conclusion is consistent with recent changes in the credit card market and the general trend towards cost-based pricing.

The Bank also took account of the fact that a number of financial institutions currently offer EFTPOS transactions without charge as part of a bundled transaction account. In the Bank's view such arrangements are likely to come under pressure over time should the current interchange fees continue. Currently, financial institutions need to pay around 20 cents in an interchange fee for every EFTPOS transaction, but receive around 40 cents if the transaction is made with a Visa Debit card.[14] This difference in fees (if not compensated by charges to cardholders) is likely to create, over time, a strong incentive for institutions to migrate cardholders from the EFTPOS system to a scheme-based debit system.

The Bank also considered the possibility that a reduction in current interchange fees in the EFTPOS system would lead to reduced merchant acceptance of EFTPOS and, thus, increased use of other payment instruments, most notably credit cards. It gave little weight to this possibility however, given the strong incentives that merchants have to accept a wide range of payment instruments, and the fact that merchant service fees for EFTPOS would, for most transactions, likely remain below those on credit cards.

In reaching its opinion, the Bank also considered (as noted in Section 1) whether it was necessary to undertake further empirical work to determine the extent of substitutability between various forms of payment. It reviewed available evidence on reactions of Australian consumers to changes in the prices of payment and other financial services. It also reviewed evidence on the effects of interchange fees on prices and consumer behaviour in the United States and studies on reactions of consumers to price changes in other countries.[15] The Bank also considered the practicalities of obtaining reliable estimates of substitution possibilities using empirical techniques. In considering this issue the Bank noted that no such results had been published in Australia, that estimates elsewhere were very limited, and that obtaining reliable estimates was inherently difficult. The Bank also assessed the value of existing survey evidence and considered whether further survey work was required for it to form its views about efficiency and competition. It concluded that the existing evidence was sufficiently strong and that further survey work would have limited value.

Overall, the Bank considers that the various card-based payment systems are close substitutes for one another in a wide range of circumstances. Often the systems are operated by the one card, and where different cards are used they are sometimes visually indistinguishable from one another. Given this, the Bank's view is that the benchmarks discussed in Section 1 are

14 Assuming an average transaction size of $80.

15 See for instance Schneider I, (2004); Anon (2004); Green J, (2005) and references cited in footnote 2.

an appropriate basis upon which to assess the efficiency and competitiveness of the payments system.

Finally, the Bank considered the findings of the ACT which included the following:

We are not satisfied, on the evidence available to us, that the Proposed Agreement would result in significant increased use of EFTPOS. This is because there is no satisfactory evidence to show

(a) the extent of pass on of benefits to cardholders;

(b) signalling of any such benefits to cardholders; and

(c) resultant choice by cardholders of EFTPOS as against credit cards.

Encouraging a switch from credit cards to debit cards is not warranted on allocative efficiency grounds. They are simply different products.

In any event, a switch to debit cards is now occurring as a result of the RBA reforms.

There is real public detriment in the likelihood of a flow on of costs to consumers generally. The Proposed Agreement is likely to have the effect of passing on to the general body of consumers an annual cost of $170 million, or a substantial part thereof. This cost has up until now, following freely negotiated agreements, been incurred within the banking system and recovered from bank customers. We see little public benefit in allowing this change to come about by the means of a per se unlawful agreement.[16]

The Bank's assessment of the evidence available to it has lead it to reach different views to those of the ACT on a number of important issues.

First, as noted above, the Bank is confident that, given the competitiveness of retail banking in Australia, lower interchange fees in the EFTPOS system would lead to more attractive EFTPOS pricing for cardholders or more favourable promotion of EFTPOS by financial institutions.

Second, as noted above, the Bank is confident that, over time, cardholders would respond to changes in prices and the promotion of payment instruments by financial institutions. If current arrangements were to be maintained there is a strong possibility of a migration of debit card users from the EFTPOS system to scheme-based debit systems through a combination of more attractive pricing and positive marketing of scheme-based debit by financial institutions.

Third, the Bank's view is that a switch to EFTPOS from credit cards is warranted on allocative efficiency grounds. The EFTPOS system is a lower-cost system than the credit card system, yet for many cardholders, EFTPOS is more expensive to use. As noted above, while the Bank recognises the differences between credit and debit cards, it views the two types of cards as highly substitutable in many circumstances.

Fourth, the Bank does not agree with the conclusion that consumers will suffer a detriment from higher prices as merchants pass on higher EFTPOS costs. As noted above, in assessing the likely effect on merchants' costs of any standards, the Bank considered how the use of various payment instruments is likely to evolve over time, not just the current situation. If the existing arrangements were to continue, the likely migration away from EFTPOS to Visa Debit

16 Australian Competition Tribunal (2004).

by debit card users would put upward pressure on overall merchants' costs. A change to existing arrangements would lessen this possibility. Further, to the extent that revised arrangements lead to increased use of debit cards at the expense of credit cards, merchants' overall payments costs are likely to fall, not rise.

The Bank also considered the ACT's concerns that the data in the Joint Study may be out of date. In particular, the Bank undertook an additional survey of costs of EFTPOS acquirers and issuers to assess the extent to which costs had changed since the Joint Study. These updated data, combined with the data obtained as part of the credit card standards, and other information available to the Bank, gave the Board confidence that the broad conclusions of the Joint Study remained valid.

2.4 Consultation

The Bank has received numerous submissions on EFTPOS and Visa Debit over the past year. These submissions stem from the Bank's letters of December 2003 to participants in the EFTPOS and Visa Debit systems; the decision to designate the Visa Debit system in February 2004; the invitation to comment on possible designation of the EFTPOS system in June 2004; and the decision to designate it in September 2004. Moreover, as early as September 2001, the issuers of Visa Debit had submitted a discussion paper to the Reserve Bank that covered many of the issues under consideration. In each case, those making submissions have been offered the opportunity to discuss their submissions with Bank staff.

The views put in submissions and consultations fall broadly into two categories: those that argue that it is not in the public interest to set a standard for interchange fees for the EFTPOS and Visa Debit systems and those that argue that doing so is in the public interest. In the latter category two main approaches have been suggested. The first is to regulate interchange fees for both EFTPOS and Visa Debit consistently with those of credit cards. The second is to use a methodology consistent with that of credit cards for Visa Debit, but to set interchange fees in the EFTPOS system to zero.

Throughout the process, submissions have generally focused on the level of interchange fees in a particular system with few submissions considering the interactions between systems. The Bank has made requests of a number of participants that they consider the likely effect of interchange fees across payment systems in their submissions. To date there have been few responses on this issue.

2.4.1 EFTPOS

(i) No standards for interchange fees

The views of the merchants on EFTPOS interchange fees are clear – they see no need to change the current system.[17] They argue that the system is 'financially safe for use by participants' and 'efficient' and that there should, therefore, be no standard imposed on EFTPOS interchange fees. The merchants see the current interchange flow as appropriate because they argue that merchants provide services to issuers and their cardholders. In addition, the merchants argue

17 Australian Merchant Payments Forum, 15 October 2004; Coles Myer, 15 October 2004.

that the current interchange fee finances the development and maintenance of the system and without it, investment in the system would fall, ultimately impairing the efficiency of the system. They have also argued that any change in interchange fees will not result in a change in prices to cardholders and that, even if prices did change, consumers will not respond.

(ii) Zero interchange for EFTPOS

A number of submissions argue that interchange fees in the EFTPOS system should be set to zero.[18] In some cases, the submissions see a conceptual case for a small interchange fee paid to issuers (the reverse of the current situation), but on pragmatic grounds argue for a zero fee. Most submissions proposing a zero interchange fee argue that the fee should be set to zero, rather than abolished, allowing the possibility that the fee could be changed in the future.

One of the suggested advantages of a uniform zero interchange fee is that it would help put small institutions on a level playing field with larger issuers. The smaller institutions argue that, because of their negotiating position, they have to pay higher interchange fees than large institutions, and that this higher cost puts them at a competitive disadvantage.

While not arguing for zero interchange fees, APCA has made an argument for standardised interchange fees on the grounds that an effective access regime requires standardisation of an important condition of access, namely, the interchange fee.

(iii) Consistency with the credit card interchange standard

A number of submissions argue that all interchange fees should be set on a consistent basis using the methodology used for credit cards.[19] Such an approach would see all interchange fees set by reference to issuers' eligible costs, and would result in a change in the direction of interchange fees in the EFTPOS system.

This view was advanced by smaller institutions in particular. They see this approach as delivering relatively low interchange fees (to issuers) in the EFTPOS system, somewhat higher fees in the Visa Debit system and the highest fees in the credit card systems. This outcome reflects both the cost categories included in the Bank's standard on interchange fees in the credit card systems and the level of those costs in the various systems.

Finally, most submissions support the APCA process for EFTPOS access reform. Nevertheless, four submissions on the subject of designation argued that the Reserve Bank should take over the reform of access. A number of organisations feel marginalised by the current process and argue that, because of vested interests, it will not deliver the best possible outcome.

2.4.2 Visa Debit

Although the Joint Study focussed on interchange fees in the EFTPOS system, it noted that while a Visa Debit transaction accesses the same account as an EFTPOS transaction, it attracts the same interchange fee as a credit card transaction. This is despite Visa Debit not

18 See submissions by Bank of Queensland Limited, 15 October 2004; Commonwealth Bank of Australia, 15 October 2004; MoneySwitch Ltd, 15 October 2004; St George Bank Limited, 15 October 2004.

19 See submissions by Australian Settlements Limited, 9 July 2004; CreditLink Services Ltd, 16 July 2004; Credit Union Services Corporation (Australia) Limited, 9 July 2004; National Australia Bank Limited, 9 July 2004; and Westpac Banking Corporation, 9 July 2004.

offering cardholders the possibility of interest-free credit. The Joint Study concluded that there was no case for the current interchange arrangements, although it did not suggest how the issue should be addressed.

After the release of the Joint Study, the Bank wrote to Visa International to emphasise the Bank's concerns about the interchange arrangements for Visa Debit. After a response from Visa noting that it had no power to intervene in the practices of its members, the Bank wrote to the issuers of Visa Debit to ask them to put more appropriate arrangements in place for Visa Debit interchange fees. The Bank noted that there were practical and technical issues to be addressed and that the issuers would need to work with Visa International to address these issues. Through 2002 and 2003, Visa and the Visa Debit issuers worked towards identifying an acceptable means of determining an interchange fee.

The Bank discussed its concerns regarding Visa Debit with industry participants at the end of January 2004 and again in the context of discussions following the designation of the EFTPOS system in September 2004. In these discussions there was widespread, although not universal, acceptance that it was inappropriate to include interest costs in the calculation of any cost-based interchange fees in the Visa Debit system, given that there was no possibility of interest-free credit.

Notwithstanding this general view, Visa argued in its submission of January 2004 that the interchange fee for Visa Debit should be close to, if not identical to, the interchange fee for Visa credit. The general basis of this argument is that Visa Debit cards were more similar to credit cards than to EFTPOS cards and, thus, should have similar interchange fees. Visa also argued that this similarity meant that any significant divergence in interchange fees for Visa Debit and credit cards would encourage issuers to switch towards credit cards and thus, when the competitive responses of issuers were considered, that a significant differential in interchange fees could not be sustained in the marketplace.

Echoing Visa's arguments, smaller issuers have claimed that if interchange fees in the Visa Debit system are reduced too far, they would consider encouraging their cardholders to move to credit cards rather than EFTPOS. They also argue that reducing the Visa Debit interchange fee will harm the competitive position of small financial institutions since they are the main issuers of Visa Debit. The building societies claim that if the interchange fee drops much below the credit card interchange fee, it would negatively affect their profitability and their ability to compete with larger institutions.

The merchants' position on Visa Debit is that there should be no difference in the interchange fees between Visa Debit and EFTPOS. However, their view on whether it is appropriate to set a standard for interchange has varied over time. Earlier submissions argued for setting an interchange standard that would ensure the interchange fee for Visa Debit is identical to that for EFTPOS transactions, which would in turn remain bilaterally determined and paid by issuers to acquirers. The submissions were not clear on how this would be achieved, given that the Visa Debit interchange fee is currently determined multilaterally. In arguing their case, the merchants claimed that differences in interchange fees between the two debit systems were encouraging the growth of scheme-based debit over the EFTPOS system. In their most recent submissions the merchants were silent on whether there should be a standard for Visa Debit interchange.

MasterCard argues that the Bank should consider the effect of reform on potential new entrants. It argues that the set-up costs for new issuers are such that they might be unwilling to issue a new debit card if interchange fees were too low. As a result, MasterCard is concerned that interchange fees for scheme-based debit cards that are lower than the current credit card interchange fees would limit the ability of potential competitors to Visa Debit to enter the market.

Many of the arguments raised in consultation have been addressed above. Others are addressed in more detail in the discussion of the Bank's preferred response.

2.5 Possible Regulatory Responses

In assessing possible regulatory responses the Bank has thought it important to consider the EFTPOS and Visa Debit systems together, particularly given the similarities in the two systems. Four broad options have been considered with the Bank also considering combinations of these options. The four options are:

(i) No change

This would leave interchange fees in the debit card systems unchanged.

(ii) Zero except where justified by the balancing or other arguments

This would involve setting interchange fees to zero, except where a fee was required according to the 'balancing' or other arguments discussed above.

(iii) Apply the credit card standard to all systems

This would see the credit card standard applied to Visa Debit and EFTPOS. As a result, issuers of Visa Debit and EFTPOS cards would receive an interchange fee that covered their authorisation and processing costs as well as their fraud and fraud mitigation costs. There would be no payment to cover the costs of the interest-free period, as this is not a relevant consideration for debit cards.

(iv) Narrow the differential

This would involve setting interchange fees for both EFTPOS and Visa Debit closer to zero but would keep the direction of fees unchanged.

2.6 Discussion of Options

On the basis of the discussion above, the Bank's opinion is that no change is not an appropriate option. The Bank is of the view that a narrowing of the current differentials in interchange fees in the EFTPOS and Visa Debit systems would have important effects on price signals and the behaviour of cardholders and institutions that would promote the efficiency of the payments system.

In contrast, the merchants have argued that altering interchange fees in the EFTPOS system will not have the effect that the Bank expects as it is unlikely to lead to changes in the prices of EFTPOS payment services and, even if it does, consumers are unlikely to respond.

For the reasons discussed above, the Bank does not find this argument convincing. Given that retail banking is relatively competitive, changes in banks' costs of providing payment services are likely to lead to either a change in the price of those services or a change in the intensity with which they are marketed. Moreover, if the current regulatory uncertainty was removed and interchange fees were to remain at current levels, an incentive would exist for issuers to migrate debit card users from the EFTPOS system to scheme-based debit systems.

The merchants also argued the changes to credit card interchange fees have been effective in changing the prices charged for the use of the credit card system and that further reform is unnecessary. While the Bank recognises that the earlier reforms have served to increase the effective price of credit card transactions, credit cards remain a significantly cheaper payment option than EFTPOS for many people. A change in the interchange fees in the EFTPOS system would represent a further step in promoting a better alignment of prices and costs.

The Bank also gives little weight to the merchants' argument that a reduction in interchange fees would cause investment in the system to fall reducing its overall efficiency. All participants in the EFTPOS system – merchants and acquirers included – have an interest in, and directly benefit from its efficiency, security and fraud resistance. While the Bank recognises that a change in interchange fees could alter how investment to promote those objectives is paid for, the international experience shows that the investment needed to maintain and upgrade such systems takes place with a variety of interchange fees. The available evidence does not support the proposition that such investment depends on the payment of current levels of interchange fees by issuers to acquirers.

The second option – setting interchange fees to zero except where justified by the balancing or other arguments – has considerable appeal. Given the discussion in Section 2.1, the implementation of this option would likely see a zero interchange fee in the EFTPOS system and possibly a zero fee in the Visa Debit system. A significant advantage of this approach is that it is consistent across the two debit card systems. It could effectively remove interchange fees as a direct influence on pricing of debit card payment services, leaving pricing to be determined by costs and market considerations.

Despite the appeal of this option the Bank has some reservations about its implementation at this time. A number of submissions to the Bank noted that, given the current credit card interchange fees, setting a low (or zero) interchange fee in the Visa Debit system could induce Visa Debit issuers to promote credit cards rather than EFTPOS cards. There have also been suggestions in some submissions that setting interchange fees to zero goes beyond the powers of the Bank, given that it could be viewed as the setting of a price.

The third option – using the credit card standard for all payment systems – also has some appeal on the grounds of consistency. However, it too faces a number of difficulties. First, it would involve reversing the direction of interchange fees in the EFTPOS system. This would change long-standing business arrangements, and may cause substantial disruption to some institutions. Second, this approach would entrench the credit card interchange standard to a degree that the Bank does not believe is justified. At the time the standard was introduced it was described as providing the basis for a transition to a lower level of interchange fees, not as a standard to apply for all time and to be applied to other systems. Given this, the Bank does not see it as desirable to apply the credit card standard to the debit card systems.

The Bank's preferred approach is the fourth option mentioned above – namely determine standards that would move the EFTPOS and Visa Debit interchange fees closer together, but maintain their current directions. In its deliberations, the Bank considered a number of ways in which this could be done, including determining standards that would move both interchange fees or, alternatively, determining standards that would move just one of the interchange fees. Given the arguments discussed above the Bank does not see a strong justification for the current level of interchange fees in either system and so its preferred option is to propose standards that would adjust fees in both systems.

This option is consistent with an evolutionary, rather than revolutionary, approach to reform. It would reduce the influence of interchange fees on the pricing and promotion of payment services, while at the same time avoid significant disruption to existing business arrangements.

The proposed standards are detailed below. It is proposed that the maximum interchange fee in the EFTPOS system be based on acquirers' eligible costs, with the eligible costs being restricted to processing and switching costs. In the Visa Debit system, it is proposed that the benchmark would be based on the processing and authorisation costs in the credit card standard. It is proposed that both fees be flat fees.

Based on the Bank's current information these standards, if implemented, are likely to result in a maximum interchange fee (being paid to acquirers) of around 5 cents in the EFTPOS system and a maximum fee (being paid to issuers) of around 15 cents in the Visa Debit system. On a transaction of $80, this would see the differential in interchange fees fall from around 60 cents to a maximum of around 20 cents.

The Bank has considered the implementation and compliance costs associated with these proposed standards, should they be introduced. It is of the view that these costs would not be significant or unreasonable, given the improvements in efficiency these reforms are expected to generate. The Bank also considered whether there was a strong possibility that the changes in relative prices expected to flow from the proposed reforms could encourage the use of means of payment that would lead to a less efficient payments system. Its view was that there were no grounds for expecting this to be the case.

The Bank recognises that, if the standards are implemented, different interchange standards would apply in the credit card, Visa Debit and EFTPOS payment systems. In particular, in each of these systems different costs will be included in the eligible costs. To a significant extent this outcome reflects the combination of the starting points in the three systems being so far apart, and the Bank's preference for a gradualist, rather than revolutionary approach. Historically, interchange fees have been set in quite different ways and at different times and on different bases. This has significantly complicated the reform process. Using the same methodology for all three standards, at this point in time, could involve very large, and potentially disruptive changes to at least one of these systems.

This gradualist reform process has meant that the Bank has taken a pragmatic approach to developing standards, including the selection of eligible costs. Nevertheless, in the Bank's opinion the proposed debit card standards and the existing credit card standards are important steps in reducing the distortions in the payments system caused by interchange fees that are either unnecessary or too high.

Notwithstanding the pragmatic approach to date, the Bank sees considerable merit in moving to a consistent methodology over time. From this perspective, option (ii) above has considerable appeal. At the time that the credit card standards were finalised, the Bank indicated that it would review the eligible costs included in the standard in 2007. It is the Bank's intention to examine the arrangements for both debit and credit card systems as part of this review, with a view to considering whether the arrangements in the different payment systems should be put on a more consistent basis.

2.7 Draft Standards for Interchange Fees

The draft standards are presented below. The Bank proposes to publish guidance notes to accompany any final standards determined following the consultation process. It will do so at the time it releases its final standards. It welcomes industry input into the content and form of guidance notes during the consultation period.

2.7.1 EFTPOS

The proposed EFTPOS interchange standard constrains the setting of interchange fees in the system on the basis of acquirers' eligible costs, in much the same way as the interchange standard in the credit card schemes uses issuers' eligible costs.

If this standard were implemented, interchange fees would continue to be set on a bilateral basis but any interchange fees paid to an acquirer would be subject to a cap determined by industry-wide costs. An issuer and an acquirer could agree to lower interchange fees or to none at all.

To reduce the industry's compliance costs, the 'nominated EFTPOS acquirers', whose costs will be used as an input to the standard, are those who account for 90 per cent of transactions acquired in the EFTPOS system. The Reserve Bank collects the data that will be used to identify those institutions. Around 5 institutions are expected to be required to provide data.

To provide efficiency incentives, the standard uses the eligible costs of the three 'nominated EFTPOS acquirers' with the lowest eligible costs.

Because there is no central administrator of the EFTPOS system, the Reserve Bank or its agent will calculate the benchmark cap and the Bank will publish it on its website.

Standard No. 3

The Setting of Interchange Fees in the EFTPOS Payment System

Objective

The objective of this Standard is to ensure that the setting of interchange fees in the designated EFTPOS payment system promotes:

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the payment system operated within Australia known as the EFTPOS system, which was designated as a payment system on 9 September 2004 and referred to below as the EFTPOS system.
3. In this Standard:

   an 'acquirer' is a participant in the EFTPOS system that provides services to a merchant to allow that merchant to accept a debit card;

   'cash out' means the provision of cash to a cardholder by a merchant, as a result of a debit card transaction at the merchant;

   'debit card' means a card issued by a participant in the EFTPOS system that allows the cardholder to make payments to merchants for goods and services or obtain cash out using the EFTPOS system by accessing a deposit account held at the participant;

   'debit card transaction' or 'transaction' means a transaction in Australia between a debit cardholder and a merchant involving the purchase of goods and services and/or the provision of cash out using a debit card;

   'financial year' is the 12-month period ending 30 June;

   an 'issuer' is a participant in the EFTPOS system that issues debit cards to its customers;

   'merchant' means a merchant in Australia that accepts a debit card for payment of goods and services and/or that provides cash out;

a ‘merchant principal’ is a participant in the EFTPOS system that is a merchant that sends transactions directly to issuers rather than through an acquirer and takes on the responsibilities usually undertaken by an acquirer;

‘nominated EFTPOS acquirers’ are those acquirers and merchant principals determined by the Reserve Bank, selected in order of their share of the number of transactions, who comprise the minimum number of such acquirers or merchant principals required to account for at least 90 per cent of the number of transactions acquired in the EFTPOS system in the ‘reference year’;

‘reference year’ is the financial year prior to the relevant year;

‘relevant year’ is the financial year in which the benchmark is calculated;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. This Standard refers to wholesale fees, known as ‘interchange’ fees, which are payable between an issuer and an acquirer or merchant principal, directly or indirectly, in relation to a debit card transaction in the EFTPOS system.
5. Each participant in the EFTPOS system must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, the Standard is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.
8. This Standard comes into force on [1 July 2006].

Interchange Fees

9. Issuers and acquirers or merchant principals in the EFTPOS system may agree to pay an interchange fee between themselves. If such a fee is paid by an issuer, the total fee for each transaction must not exceed the benchmark published by the Reserve Bank in accordance with paragraph 15.

Methodology

10. The benchmark for the EFTPOS system is calculated by the Reserve Bank as follows:
    a. for each of the nominated EFTPOS acquirers, the aggregate value of eligible costs in the reference year is to be divided by the number of debit card transactions in the reference year. This ratio is to be expressed as a number of cents per transaction;

b. the benchmark is to be calculated by the Reserve Bank as the aggregate value of eligible costs in the reference year of the three nominated EFTPOS acquirers with the lowest ratios as calculated in 10a, divided by the number of transactions undertaken by the same three nominated EFTPOS acquirers in the reference year. The result is to be expressed as a number of cents per transaction, rounded to the nearest cent.

11. Eligible costs are those directly related to processing and switching EFTPOS transactions incurred by an acquirer or merchant principal when performing the business responsibilities usually undertaken by an acquirer.

12. Data on eligible costs must be drawn from accounting records of the nominated EFTPOS acquirers, prepared in accordance with generally accepted accounting principles and Australian accounting standards.

13. Data on eligible costs must be provided by each nominated EFTPOS acquirer to the Reserve Bank of Australia, or its agent, by [15 August] in the relevant year.

14. The Reserve Bank, or its agent, will review the data to determine if the costs included are eligible costs and the Reserve Bank will use the eligible costs to calculate the benchmark in accordance with paragraph 10.

15. The Reserve Bank will publish the benchmark for the EFTPOS system by [15 September] in the relevant year.

16. Interchange fees in the EFTPOS system must conform with the benchmark from [31 October] in the relevant year.

Initial and subsequent benchmarks

17. For the initial benchmark the relevant year is the financial year [2006/07].

18. The benchmark is to be recalculated in the financial year [2009/10] and every three years thereafter.

Transparency

19. Acquirers and merchant principals in the EFTPOS system must report to the Reserve Bank the weighted average interchange fee they received and the range of interchange fees received in the previous financial year by [30 September] each year. The weights to be used in this calculation are shares of transaction value to which each interchange fee applies. In the first year, this requirement applies to the [8] months ending [June 2007].

20. The Reserve Bank will publish the industry weighted average of interchange fees on its website.

2.7.2 *Visa Debit*

The proposed Visa Debit interchange standard constrains the interchange fee for Visa Debit card transactions on the basis of eligible costs. The fee is to remain multilaterally determined.

In drafting the standard, the Bank has been mindful of the administrative costs imposed by regulation. Partly reflecting this, the draft standard is based on the processing and authorisation costs used in the credit card interchange standards. Institutions do not need to calculate additional cost data for the purposes of this standard.

Unlike the credit card standard, however, the proposed eligible costs are not exclusively based on the costs of the current issuers. This reflects two considerations.

First, if the standard were based on the costs of current issuers alone, the result could be quite a high interchange fee given that most existing issuers are quite small. Should larger issuers seek to issue Visa Debit cards in the future, they could be significantly overcompensated for their costs.

Second, the Bank took account of the possibility that MasterCard may at some stage in the future consider introducing a scheme-based debit card in Australia. Given the strong competition on the issuing side, the Bank sees merit in having the same interchange fee arrangements apply in both schemes. In order to achieve this, the Bank proposes that the standard uses the costs of all issuers collected as part of the credit card standard, not just issuers of Visa credit cards.

The proposed interchange fee is flat, rather than a percentage based fee. The usual justification for a percentage fee is that relevant costs are predominately related to the size of the transaction. In the case of Visa Debit, the processing and authorisation costs are unrelated to the size of the transaction. Accordingly, and in line with the EFTPOS system and debit card systems in a number of countries, the Bank is proposing a flat fee expressed as a number of cents per transaction.

Standard No. 4

The Setting of Interchange Fees in the Visa Debit Payment System

Objective

The objective of this Standard is to ensure that the setting of interchange fees in the designated Visa Debit payment system promotes:

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the payment system operated within Australia known as Visa Debit, which was designated as a payment system on 18 February 2004.
3. In this Standard:

   an 'acquirer' is a participant in the Visa Debit system that provides services to a merchant to allow that merchant to accept a Visa Debit card;

   'credit card transaction' has the meaning it has in Standard No. 1;

   'Visa Debit card' means a card issued by a participant in the Visa Debit payment system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods and services by accessing a deposit account held at the participant;

   'Visa Debit card transaction' means a transaction in Australia between a debit cardholder and a merchant involving the purchase of goods and services using a Visa Debit card;

   'financial year' is the 12-month period ending 30 June;

   an 'issuer' is a participant in the Visa Debit system that issues Visa Debit cards to its customers;

   'merchant' means a merchant in Australia that accepts a Visa Debit card for payment of goods and services;

   'reference year' is the financial year prior to the relevant year;

‘relevant year’ is the financial year in which the benchmark must be calculated;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. This Standard refers to wholesale fees, known as ‘interchange’ fees, which are payable between an issuer and an acquirer, directly or indirectly, in relation to a Visa Debit card transaction.
5. Each participant in the Visa Debit system must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, the Standard is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.
8. This Standard comes into force on [1 July 2006].

Interchange Fees

9. The weighted average of interchange fees in the Visa Debit system in Australia must not exceed the benchmark calculated in accordance with paragraphs 10 and 11 below. The weights to be used in this calculation are shares of transaction values to which each interchange fee rate applies.

Methodology

10. The benchmark is to be calculated by the Reserve Bank using data for the reference year supplied by the credit card schemes designated by the Bank and to whom Standard No. 1 applies.
11. The benchmark is to be calculated as follows:
    a. A cost base is to be calculated for each designated credit card scheme. It is determined by dividing the costs of processing and authorisation described in paragraphs 11(i) and 11(iii) of Standard No. 1 in the reference year by the total value of credit card transactions in the reference year.
    b. A weighted average of the cost bases in the designated credit card schemes will be calculated. The weights to be used are the shares of the value of credit card transactions in each designated credit card scheme in the value of total credit card transactions in the three designated credit card schemes in the reference year.
    c. This weighted average will be multiplied by the average value of a Visa Debit card transaction in the reference year to yield a benchmark expressed as a number of cents per transaction.

12. The Reserve Bank will calculate the benchmark by [15 September] of the relevant year and publish it on its website.
13. Interchange fees in the Visa Debit system must conform with the benchmark from [31 October] in the relevant year.

Initial and subsequent benchmarks

14. For the initial benchmark the relevant financial year is [2006/07].
15. The benchmark is to be recalculated in the financial year [2009/10] and every three years thereafter.

Transparency

16. The administrator of the Visa Debit system must publish the interchange fees applying to Visa Debit transactions on its website.
17. The administrator of the Visa Debit system must certify in writing to the Reserve Bank by 30 September each year, that interchange fees in the Visa Debit system complied with this Standard over the previous financial year. In the first year, this requirement applies to the [8] months ending [June 2007].