

**EFTPOS INDUSTRY WORKING
GROUP DISCUSSION PAPER:
Options for EFTPOS Interchange
Fee Reform**

Comments by
Visa International Service Association

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1 Why Visa is commenting on the Discussion Paper

In this document Visa International Service Association (**Visa**) comments on the July 2002 EFTPOS Industry Working Group Discussion Paper, *Options for EFTPOS Interchange Fee Reform (Discussion Paper)*.

Visa provides these comments in the context of the comment by the Reserve Bank of Australia (**Reserve Bank**) in the Consultation Document, *Reform of Credit Card Schemes in Australia* (December 2001) (**Consultation Document**) that the current practice in relation to interchange fees in Visa's debit card network 'imposes an inappropriate burden of costs on merchants and has no place in the Australian payments system'.¹

The comments in the Discussion Paper, apparently endorsed by the Reserve Bank, are inconsistent with the comments in the Consultation Document. There are matters referred to in the Discussion Paper which should cause the Reserve Bank to reconsider its proposed reform of the card networks that the Reserve Bank has purportedly designated.

Visa also urges the authors of the Discussion Paper to consider the importance of the principled approach taken by Visa in relation to economic issues of this type.

2 The background to Visa debit

The Discussion Paper relates to the EFTPOS debit network used by proprietary bank issued debit cards. This is to be distinguished from the Visa Debit network, which is quite separate.

As the Discussion Paper highlights, EFTPOS was introduced into Australia in 1984 and did not obtain large scale usage until after 1991.

Visa Debit, on the other hand was the first 'off-line' debit card to be issued in Australia in 1982, utilising the VisaNet authorisation and processing platform. There are a number of distinguishing features that Visa Debit has compared to EFTPOS debit.

- Visa Debit provides increased functionality over proprietary bank issued debit cards including the use in on-line, mail order and telephone transactions, and guarantees for payment (for example, car hire), use for recurring transactions (for example, insurance), use at point-of-sale outside Australia and cash advances at ATM machines outside Australia.
- Visa Debit provides significantly enhanced consumer protection features compared to proprietary debit cards, the latter being the subject of the rules formulated by the Australian Payments Clearing Association (**APCA**), for example, in the charge back rules.

¹ Consultation Document, pp127-128.

- Visa Debit has a broader domestic reach, there being approximately 50 percent more merchants accepting Visa cards (not counting multiple terminals) than there are merchants accepting proprietary debit cards through the EFTPOS network.
- Visa Debit provides a de facto multilateral approach to acceptance, as there is a single set of arrangements between issuing and acquiring entities. It thus avoids the transaction costs (notably the negotiation costs) and associated inefficiencies that are inherent in the bilateral approach and noted in the Discussion Paper.
- Visa Debit has **global** acceptance, compared to EFTPOS that can only be used in Australia.
- Visa Debit has extensive operational back-up because it uses the VisaNet processing system that has an extremely high level of availability – reliability of bilateral links² may not be as high as the reliability of VisaNet.

For the further reasons set out in this document, it is not appropriate for the Reserve Bank to draw any conclusions in relation to the Visa Debit network from its examination of the EFTPOS network. EFTPOS differs from Visa Debit and as a practical matter competes with it. It is desirable that different business models be allowed to develop in the marketplace in order that competition, rather than regulatory fiat, determines the most efficient way of providing services.

There is no reason for VisaNet to differentiate between debit and credit cards in any manner whatsoever. In Visa debit, the payment of interchange currently flows in the same direction and, in Australia³, at the same rate as for Visa credit as a result of application of a consistent set of principles for determining interchange rates. Contrary to the statement by the Reserve Bank in the Consultation Document, this practice is not ‘unacceptable’, but is the outcome of a principled and competitive approach to the setting of interchange, something the Discussion Paper implicitly recognises as being important.

This document comments on the importance of such a principled approach, and the implications that this has for the setting of debit interchange and competition and efficiency in the market for payment services to which the Reserve Bank must have regard under section 10B of the *Reserve Bank Act 1959* (**Reserve Bank Act**).

3 Adopting a principled approach to debit interchange

Visa has provided extensive comments and theoretical analysis to the Reserve Bank during the course of the joint study conducted by the Reserve Bank and the Australian Competition and Consumer Commission (**Commission**) and the Consultation Document.⁴ The theoretical framework set out by Visa is the same

² Reliability statistics are not available to Visa. However, the VisaNet system has an availability level approaching 100%.

³ Rates in other countries may differ for Visa credit compared with Visa debit. Any variation depends on the circumstances of the market.

⁴ *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (October 2000).

framework that is appropriate for the consideration of interchange fees in debit networks.

The debit network exhibits the same features and is driven by the same economics as credit networks. The market is multi-sided and has network features. An optimally efficient business structure is driven by the logic of the economic features of such a market and requires a complex mix of network economics and multi-product pricing.

Contrary to the statement in the Discussion Paper that the theory is difficult to 'operationalise',⁵ Visa has explained to the Reserve Bank in a confidential submission made in relation to the Consultation Document how its methodology for the calculation and setting of interchange does map the theory into a market-based setting of interchange that is both competitive and efficient. Visa's methodology is one of the key competitive tools that it uses to make the holding, use and acceptance of Visa cards desirable to consumers and merchants.

Visa is pleased to see in the Discussion Paper, at least implicitly, a recognition that interchange is an important competitive tool in markets that are multi-sided and demonstrate network effects. As stated in many of Visa's submissions to the Reserve Bank, and repeated here, the presence of interchange payments is not indicative of any need to regulate the marketplace. Rather, such 'payments' are common in markets with such economic features.⁶

The important point to note here is that competition and efficiency are **not** driven by focusing on achieving a particular, pre-determined outcome. Competition and efficiency **are** driven by competing providers of payment services focusing on adopting a business model that is appropriate for the economic dynamics of the marketplace. The marketplace can then identify, and reward, the business model most appropriate to consumer and merchant needs. The **principles** set out by Visa in its many submissions to the Reserve Bank provide the framework that Visa believes ought to inform the design of the business model appropriate for card networks.

In a market characterised by competition, an observer would expect to see more than one business model adopted. Depending upon the particular market circumstances, the observer would expect to see payments flowing in different directions among the different collaborators.⁷ Different suppliers, providing payment instruments with different functionalities and operating under different constraints, will have differing views as to which structure and level of payments is appropriate. The Reserve Bank in the position of an observer of the market cannot, therefore, draw any conclusions as to the appropriateness of the EFTPOS debit or the Visa debit interchange arrangements without a full investigation of those circumstances, informed by the economic theory that identifies the relevant features of the industry.

⁵ Discussion Paper, p12.

⁶ In addition to the Visa submissions, many illustrations of such payments are given by Jean-Charles Rochet and Jean Tirole, 'Platform Competition in Two-Sided Markets' (IDEI Discussion Paper, 26 November 2001): <http://www.idei.asso.fr/English/EPresent/index.html>.

⁷ See, for example, the different models given by way of example in Rochet and Tirole, *ibid*, pp3-4.

Visa is pleased to see that the Discussion Paper recognises:

- The difficulties of bilaterally-set interchange rates.⁸ These difficulties are more fully articulated by the paper provided to the Reserve Bank and reproduced in Volume III(2) of the Consultation Document.⁹
- The importance to the correct setting of interchange of the question of providing incentives to network participants.¹⁰
- The importance to the correct setting of interchange of the use of 'business judgment'.¹¹ The use of business judgment, and hence the impossibility of a central regulator prescriptively setting or restricting the setting of interchange rates is a matter that Visa has expressly identified in its confidential submission to the Reserve Bank.
- The importance, when considering the competitiveness and efficiency issues, of competition between instruments and networks.¹²

It is Visa's submission that each of these matters can only have been recognised by the authors of the Discussion Paper because of the implicit adoption as a correct framework of reference of the network pricing model that Visa advocates. Visa urges the Working Group and the Reserve Bank to expressly adopt that theory and to make recommendations consistent with it.

Such a consistent and principled approach would have the following features.

- A recognition that the particular **outcome** is not important, but the fact that the correct **principles** are utilised by competitors.
- The Reserve Bank should promote a process of setting interchange according to a **principled approach** that is **consistent with the economic dynamics of the industry** (networks, multi-product firms, competition among instruments and networks).

Such an approach will also have the best chance of leading to a competitive and efficient market outcome. A coordinated outcome that seeks to make the interchange 'consistent' across payment instruments and networks, as apparently advocated by the authors of the Discussion Paper¹³ is the very opposite of what a competitive and efficient market outcome requires.

From a competition and regulatory perspective, consistency and coordination across competing networks (as against within a single network) are not inherently desirable goals. A centrally coordinated setting of interchange across networks

⁸ Discussion Paper, p5.

⁹ John Small and Julian Wright, 'Decentralised Interchange Fees in Open Payment Networks: An Economic Analysis' (December 2000).

¹⁰ Discussion Paper, pp10, 12.

¹¹ Discussion Paper, p12.

¹² Discussion Paper, pp8, 10 and 12.

¹³ Discussion Paper, pp5, 6.

that have differing characteristics and with the effect of removing the incentives and ability to compete can be harmful and compromise the achievement of the objectives that are set out in the Discussion Paper.

For example, it appears to Visa that there are important circumstances which distinguish its debit product from the proprietary debit products being offered as branded products by the banks and which use the EFTPOS network. The following example shows that it is both rational and efficient for interchange to flow one way in the EFTPOS network and in the opposite direction in the Visa Debit network.

- EFTPOS has historically provided banks with the means to reduce the costs of transactions in banking (notably by reducing consumers' cash holdings) and the costs that banks incur in the **issuing** function for EFTPOS are likely to be very low. However, on the **acquiring** side of the market, accepting EFTPOS at least initially entails some costs to merchants and are not likely to have much sales stimulation impact. As a result, it is arguably rational for interchange arrangements to flow from issuers **to** acquirers.
- In Visa Debit, in contrast, in addition to covering costs and risks participating institutions need incentives if they are to issue Visa Debit, whereas Visa believes that merchants on balance benefit from acceptance of the full range of Visa products. It is therefore rational and efficient for interchange to flow **from** acquirers to issuers. The interchange fee arrangements of Visa Debit are suited to Visa's competitive context.

There is no clear sense in which society would gain if uniformity were brought to these arrangements by administrative means – that is, by regulation. Rather, market forces should be allowed to select among the alternative approaches, with regulation only being used where market forces have plainly failed. Visa does not believe that the case has been made out that market forces are not working and that they cannot or should not work in this area.

4 Some other specific comments

Visa makes the following further specific comments on the Discussion Paper.

- It has been noted above that the apparent goals of consistency and coordination across competing approaches to which the authors of the Discussion Paper give credence are not self-obviously desirable as they can reduce the level of competition. These statements are to be compared to the second approach mentioned, 'to set fees competitively relative to interchange fees in competing payment instruments and networks' (sic).¹⁴ In Visa's view, the competitive setting of interchange fees is not an approach that is different to one that sets fees to maximise incentives to the industry players. Indeed, as made clear in this document, the two things are the same, for networks faced with competition will design fee arrangements that best align the incentives of potential users with those of

¹⁴ Discussion Paper, p12.

network providers. Visa therefore does not know what the authors of the Discussion Paper mean by this statement.

- Whether interchange fees are zero or not is irrelevant.¹⁵ The Reserve Bank should carefully note that a zero interchange rate does not mean that there is no interchange. An agreement to have no interchange¹⁶ is, in Visa's view, an agreement to have a particular, essentially arbitrary interchange fee (zero), and is likely to be **worse** competitively speaking than a multilaterally set interchange rate according to the principles set out by Visa. This is because of, among other things, the lack of flexibility, recognised by the authors of the Discussion Paper,¹⁷ that such an agreement would necessarily seem to build into the industry. Such a lack of flexibility precludes a response to the market that is allowed by a multilateral intra-network setting of interchange rates. Visa therefore strongly disagrees with the comments that such a 'solution' is the least problematic competitively speaking, and does not understand the basis for these comments. They seem to be inconsistent with much of what appears elsewhere in the Discussion Paper in relation to the nature of competition in the market.
- In order to obtain any proper understanding of the competitive outcome of any recommendation in relation to debit interchange, a full competition and welfare analysis needs to be undertaken. The comment in the Discussion Paper about competition in a market¹⁸ begs the question of what market or competition analysis has or should be done.
- Designation of a 'payment system' under the *Payment Systems (Regulation) Act 1998* does not itself give any immunity from the prohibitions under the Trade Practices Act. Visa has noted this previously in relation to the purported designation of the credit card networks and has received no response from the Reserve Bank as to how it will deal with this matter. It is Visa's submission that, at the very least, a regulation under section 51(1)(IC) of the Trade Practices Act must be passed.

5 Conclusion

Visa will respond to any inquiry by the Reserve Bank in relation to Visa Debit at the appropriate time.

If the comments in this document are accepted by the Reserve Bank, it will acknowledge that the comments made by it in the Consultation Document were inappropriate and should be withdrawn.

Visa urges the Working Group and the Reserve Bank to adopt a principled and consistent approach to the setting of debit interchange.

¹⁵ Discussion Paper, pp6, 7.

¹⁶ Discussion Paper, p11.

¹⁷ Discussion Paper, p12.

¹⁸ Discussion Paper, p8.