

29 April 2005

Dr John Veale  
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Sydney NSW 2001

Your ref: Media Release No. 2005-02 dated 24/2/2005

Dear Dr Veale,

**Submission to the RBA on the Proposed Draft Standards  
for EFTPoS and Visa Debit Reform**

We refer to your notices dated 23 February 2005 issued by the Governor of the RBA entitled:

- Propose Standard No. 3 – The setting of interchange fees in the EFTPoS payment system
- Propose Standard No. 4 – The setting of interchange fees in the Visa Debit payment system
- Propose Standard No. 5 – The 'honour all cards' rule in the Visa Debit and Visa Credit card systems and the 'no surcharge' rule in the Visa Debit system

In response to your invitation to interested parties, we provide below our comments on the above proposed standards.

Proposed Standard No. 3 – The setting of interchange fees in the EFTPoS payment system

After due consideration of draft Standard No. 3, we do not oppose the changes proposed with respect to how EFTPoS interchange fees will be set. This said, we would like to see the Bank (or whom ever may be the most appropriate regulatory body), take an active role in ensuring the proposed savings are passed back to consumers.

Proposed Standard No. 4 – The setting of interchange fees in the Visa Debit payment system

Under the methodology described in the proposed standard, we note that the benchmark interchange fee is to be calculated using data for the reference year supplied by the credit card schemes designated by the Bank and to whom Standard No. 1 applies.

In the bank's consultation document (dated February 2005) under section 2.7.2 (headed: Visa Debit p.36), we note that the Bank provides two key considerations for using eligible cost data not exclusively based on the costs of the current issuers of the Visa Debit product. These are:

- "If the standard were based on the costs of the 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; and
- 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."

Commenting on the latter of these two considerations first, we agree with the Bank's conclusion that there is merit in having the same interchange fee arrangements for like products. The alternative will result in rewarding inefficient schemes for their inefficiencies. That is, it would not be unreasonable to expect an issuer to change their issuing strategy to favour a scheme who may pay a higher interchange fee on the same product. To allow such an artificial advantage to exist is inconsistent with a central premise for reform being the promotion of efficiency in the Payment System.

Commenting on the first of the Bank's two considerations, we cannot agree with the rationale outlined as justification for the use of data supplied by credit card issuers in the calculation of the interchange fee for Visa Debit.

From the consultation document it appears that the essence of the Bank's concern is that because the current issuers of Visa Debit are small issuers, it is quite likely that if data is sourced from these, the resultant interchange fee will be higher. The higher interchange fee reflecting the differences in scale between the smaller Visa Debit issuers and the larger credit card issuers. Further, because the resultant higher interchange fee for Visa Debit is based on the higher cost structure of smaller issuers, should a larger issuer seek to issue Visa Debit in the future, they could be significantly overcompensated for their costs.

There are two important hypotheses here, namely that using the eligible costs data of current issuers is quite likely to result in a higher interchange fee because of scale differences, and that larger issuers will issue Visa Debit (particularly at the expense of EFTPoS). We will comment on each of these separately.

With regards to the first hypothesis, we agree that calculating the benchmark interchange fee using current issuer data is likely to produce an interchange fee that is higher than what is proposed in the consultation document and your media release. However, we do not agree with the Bank that this is reason

enough to use data that is sourced from a group of institutions who do not issue Visa Debit and as such, their cost bases are not representative of that of the current issuers of the Visa Debit product.

A differentiating factor between a small issuer and a large issuer is the lower per unit cost that a large issuer is able to obtain because of its scale. This advantage is not one typically available to a small issuer. To deny a smaller issuer the ability to recover the additional cost they incur because of their lack of scale, we believe is both deceptive and misleading. The Bank in its consultation document has not provided any detail that would support the view that if we ignore this important cost disparity, we do not place the smaller issuer at a significant disadvantage to the larger issuer. The current position is designed with the larger issuer in mind and has no regard for the smaller issuer.

Furthermore, we note that the benchmark interchange fee will be calculated by using the weighted average of the cost base using credit card data multiplied by the average value of a Visa Debit card transaction (refer paragraph 11 c of the proposed draft Standard No. 4). The application of this formula, in our opinion, lacks consistency. That is, it uses credit card data to calculate the cost base (which will invariably result in a lower actual cost than is truly reflective of the costs of an actual issuer of Visa Debit), and applies this against an average amount for a Visa Debit transaction, which is smaller than that which corresponds with the average transactional amount applicable to the credit card product for which the cost data refers. For the smaller institutions this is a double negative. That is, while scale is ignored to calculate costs, scale is taken into account when we consider the average transaction size. This inconsistency lacks integrity and creates an artificially low interchange fee that unlike for credit cards, does not reflect the true economics of the Visa Debit product. We strongly urge the Bank to reconsider its methodology with a view of restoring integrity by removing the inconsistencies highlighted.

Looking next at the second hypothesis, namely that larger issuers will issue Visa Debit (particularly at the expense of EFTPoS), we question the real likelihood of this occurring. Clearly, for the Bank to make this statement and then proceed to make a decision to use credit card data for the calculation of the cost base for Visa Debit, it must expect that larger issuers will commence issuing the Visa Debit product. This is an important decision made by the Bank which will determine the level of interchange that will apply to the Visa Debit product, yet in the consultation document, there is no evidence provided that gives any basis to how the Bank has come to its conclusion concerning the likelihood of larger issuers issuing Visa Debit. Given the importance of this hypothesis, we do not consider it unreasonable for the Bank to have provided the evidence that would support its view.

With respect, while there is always a chance that a larger issuer may decide to commence issuing Visa Debit, the evidence thus far does not support this. Rather, the evidence suggests that larger issuers are less likely to issue Visa Debit post-reforms, given that conditions pre-reforms were more favourable than those likely to exist post-reforms. With this in mind, unless there is substance behind the Bank's view, we believe it is wrong to base a cost base benchmark on opinion. Even so, in the event that a larger issuer was to commence issuing Visa Debit, the option always exists for the Bank to recalculate the cost based benchmark taking into account the perceived economies of the larger issuer.

Notwithstanding this, it is important that we consider what it means for a large issuer to commence issuing Visa Debit. Based on the Bank's hypothesis, we assume that the Bank's view would be that the incremental cost of issuing Visa Debit for a large issuer would be insignificant relative to the benefit it would derive. We would challenge this assumption. That is, normally Visa Debit issuers in other countries tend to keep Visa Debit quite separate to the credit card product. Typically the products run on two different systems. One reason for this is that the Visa Debit accesses a Demand Deposit Account (DDA), which normally resides on a different system to the credit card product. As such, a modification to the system where the DDA is hosted may be required to enable, for example, authorisation strategies to work against this type of account. In order to fund the modification, a relevant project will be raised and subsequently prioritised. In the event the project receives priority and is brought to market, if the costs of this is taken into account, it would be quite likely that the scale advantages they may enjoy for credit cards will not exist for Visa Debit.

Lastly, we note that under Standard No. 1 the definition of eligible costs includes the costs of fraud yet for Visa Debit it does not. In our opinion, this again is a significant decision made by the Bank which invariably has a significant impact on the cost benchmark. Despite this, in the consultation document the Bank fails to provide any clear rationale justifying the exclusion of these costs.

We believe that it is important for consistency to exist between the credit card product and Visa Debit. If we believe that credit card data makes an acceptable proxy for the calculation of a cost benchmark, then why would we exclude a component of the cost base? We cannot see a valid reason for the exclusion and therefore, remain of the view that fraud costs should be included under the eligible cost section of the proposed draft standard.

#### Proposed Standard No. 5 – The 'honour all cards' rule in the Visa Debit and Visa Credit card systems and the 'no surcharge' rule in the Visa Debit system

Commenting firstly on the 'no surcharge' rule in the Visa Debit system, we agree with the Bank's view as expressed in section 3.4 second paragraph (page 43 of the Consultation Document) that removal of the no-surcharge rule is essentially a housekeeping matter. Consequently, we do not oppose the removal of this rule.

We note that the draft standard proposes an effective date of 1 July 2006 for this change. While we are not uncomfortable with this timeframe, we would also support an earlier effective date. Given that at present there is no practical ability at the merchant's counter to differentiate between Visa Debit and Credit, by default Visa Debit is already subject to surcharging. Therefore, we do not see an early adoption of this change as causing much concern.

It is mentioned throughout section 3 of the Consultation Document that there is a need to be able to separately identify the Visa Debit product both at the physical and electronic level. We would not oppose the separate identification, particularly if it leads to differentiated merchant service fees that recognise the reduction in interchange fees proposed under draft Standard No. 4.

This said however, we are concerned that large acquirers may refuse acquiring services for their merchants for the Visa Debit product as a means to avoid having to make changes to terminals to allow for separate identification of the product and hence, cater for differentiated merchant service fees. In this regard, we note the Bank's comments on page 45 of the Consultation Document first paragraph, "...any action by large acquirers to refuse Visa Debit acquiring services to their merchants...would seem to be likely to raise further regulatory attention", and rely on the Bank to ensure that such behavior, were it to surface, is promptly addressed by the Bank in order to maintain a competitive and efficient payment system.

Commenting on the proposed change to the 'honour all cards' rule, we acknowledge the Bank's position concerning its desire to separate acceptance of all issuers from acceptance of all products. More so, the Bank's intention to remove the aspect from the rule that acceptance must extend to all products.

After considering the Bank's argument, we cannot accept that removal of this aspect of the 'honour all cards' rule is in the public interest. In practical terms a merchant would not see value in accepting Visa Debit as a payment instrument from their customer if the cost of acceptance was unable to be recovered. In this case being able to decline acceptance would enhance the efficiency of the payment system by discouraging the use of inefficient payment instruments. From the merchant's perspective this is a valid response that leads to a more efficient payment system.

However, under this option, we fail to recognise the impact this option may have on the consumer. Section 1.5 of the Consultation Document outlines the public interest test. Here, under sub-section (a) we suggest that the public interest is upheld when our payment system is financially safe for use by participants; efficient; and competitive. The consumer like the merchant is also a user of the payment system and hence a participant. Therefore, just as the Bank has considered the public interest test from the perspective of the merchant, we believe it is only fair that the public interest test should also be applied from the consumer's perspective.

For the consumer, a competitive payment system is one that caters for a wide range of payment options. Visa Debit, certainly amongst the customers of smaller financial institutions, is a mainstream payment product. For these consumers it offers them the same payment functionality as a credit card without the need to go into debt. If the Bank's preferred option is enforced, will the consumer judge the payment system as being competitive, if when they present their Visa Debit card to a merchant for payment, it is rejected? Clearly, they will not and hence this option fails the public interest test.

Efficiency in the payment system for a consumer is the confidence that when making a payment, the cost associated with the payment instrument selected will be fair and reflective of the true cost of using the instrument chosen. In this case the consumer would be looking for any surcharge levied by the merchant against any particular payment instrument to be reflective of the true cost. In this case option one, which is not favoured by the Bank, satisfies both parties. With the ability to surcharge, a merchant has the right to recover from the consumer the additional costs associated with the payment instrument chosen by the consumer. If the surcharge applied is too high, the consumer has the right to refuse to proceed with the transaction. Conversely, the merchant has the ability to offer different payment options that lower the cost associated with

any one payment instrument. In this way the market is operating efficiently with buyer and seller searching for the equilibrium point where the competing markets force find balance. Ultimately, the merchant like the consumer has the right to refuse the sale. Not because of the instrument chosen, but because the consumer won't pay the price demanded by the merchant and hence, the transaction is value destroying for the merchant.

In this case the issue is not about acceptance but rather a consumer's willingness to pay the asking price. If on the other hand there is insufficient elasticity in the price to allow a merchant to apply a surcharge or the surcharge applied is more than the market will tolerate, then we have a price efficient market between buyer and seller and to allow a merchant to reject acceptance (i.e. discriminate between payment instruments) would only serve to introduce inefficiency.

If we apply the public interest test to this situation from the consumers perspective, if they present their Visa Debit product and it is rejected by the merchant because he or she sees no value in accepting the card (and won't exercise their right to surcharge), will the consumer judge the payment system efficient? Unlikely.

For a consumer to judge the payment system financially safe for use, they must have full confidence that the system will allow secure transactions irrespective of the method used for payment. With respect to the Visa Debit product, it is a safe payment instrument which affords the consumer a number of benefits that uphold the integrity of the transaction (e.g. chargeback rights). For the merchant, Visa Debit offers him or her a payment guarantee which adds certainty of payment and confidence. Therefore, having the ability to use Visa Debit as a payment instrument promotes the safe use of the system and the public interest is upheld.

In looking at reforms, there has been much consideration with respect to the financial institutions that issue cards and the merchants that accept them. However, little seems to be mentioned about the consumer and the likely effect reform will have on them. As demonstrated above when the Bank's preferred option is considered from the consumer's perspective, it is difficult to see how removing the product aspect of the 'honour all cards' rule can be judged to be in the public interest. With the introduction of surcharging we remain of the view that the mechanism exists for a merchant to recover the costs of using a more expensive payment instrument.

We note that the Bank believes this option will have limited benefits because it is unlikely that most merchants would take advantage of the ability to differentially charge for Visa Debit cards. While this may be true, this after all is the merchant's choice. He or she has complete freedom to make that choice and live with the consequence of that choice. We cannot accept that a merchant electing not to surcharge makes the payment system less efficient. Further, giving the merchant the right to not accept the Visa Debit product takes the choice to use the product away from the consumer. What makes this decision more correct than having the merchant recover any costs associated with a payment instrument via a surcharge?

Should you require any further information or wish to discuss any comment made in this letter, please do not hesitate to contact me on (07) 3258 4250.

Yours faithfully,

Manuel Garcia  
Chief Executive Officer