Visa Debit Australia

Discussion Paper
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AUSTRALIAN ASSOCIATION OF PERMANENT BUILDING SOCIETIES

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1. Executive Summary

1.1 Background & Objective

Over the last 18 to 24 months, various regulatory agencies in Australia have been conducting inquiries into aspects of card-based payment products in Australia.

On 12 April 2001 the Reserve Bank of Australia (RBA) announced that it would designate the domestic credit card network with the scope including interchange fees, access and surcharging. The Visa Debit Card was not included in the RBA credit card scheme designation and has not yet been the subject of much analysis, but the regulators have expressed an acute concern related to the Visa Debit interchange fees. The parties to this document are committed to interchange fees for Visa Debit that are defensible under public scrutiny and hence have given the response to the regulators' concerns a high priority and focus.

As a first step in response to those concerns, this document provides information on the Visa Debit Card product in Australia and the perspective of the Visa Debit Card issuers that authored this report. This document also provides recommendations on an appropriate way forward that is consistent with the regulators' concerns in regard to card-based payment products and provides an opportunity for a fair assessment of the Visa Debit product. If any changes are required, it is proposed that this is done in a manner that is commercially sound and within the context of sound economic principles.

1.2 Description of Visa Debit in Australia

The Visa Debit Card was launched in 1982 by smaller financial institutions such as credit unions and building societies. At that time these institutions, precluded from providing credit card facilities, wanted to enable their customers to use a payment card when making purchases at merchants.

The number of Visa Debit cards has increased over time to achieve a total of approximately 2.7m cards on issue in late 2000, but they only represent approximately 6% of the combined dollar amount of spend conducted via debit and credit cards in Australia.

Visa Debit in Australia is a unique product that combines aspects of a typical debit card and of a typical credit card:

- It has the acceptance attributes of a credit card, e.g. can be used for making purchases in a card-not-present environment such as Internet purchases
- It has the payment features of a debit card, e.g. "buy now, pay now" and not "buy now, pay later"[1]

[1] Financial institutions often offer an overdraft facility with a transaction account. This in effect provides the Visa Debit Cardholder with extended credit functionality but it is not an inherent feature of the Visa Debit Card.

- Different metrics in actual use confirm the unique nature of Visa Debit when compared with EFTPOS and Visa Credit, e.g. the average transaction value of Visa Debit purchases is mid-way between EFTPOS and Visa Credit

- The processing of a Visa Debit Card transaction is similar to the processing of a Visa credit card transaction

- The Visa Debit product also shares a set of cost characteristics with Visa Credit (e.g., fraud associated with signature-based products) and another set of cost characteristics with EFTPOS (e.g., absence of credit losses).

1.3 Visa Debit Interchange Arrangements

The current interchange fee for Visa Debit is similar to the credit card interchange fee and dissimilar (in level and direction) to the EFTPOS interchange fee.

The treatment of Visa Debit interchange varies around the world. In some markets, Visa Debit interchange is set at the same level as Visa Credit (e.g., Canada), and in others there is a different interchange fee for Visa Debit compared to Visa Credit (e.g., UK). There are marked differences in the structure and features, and therefore the underlying costs, of the Visa Debit product across different markets. Because there is no one accepted international standard for setting payment systems interchange fees, local market considerations and industry structure are major determinants of the way in which interchange fees have been established.

The comparison of interchange fees with other known markets shows that interchange is positive (ie. from aquirer to issuer) for both debit and credit card products, except Australia. It is also worth noting that to the collective authors' knowledge, EFTPOS in Australia is the only card product in the world that attracts negative interchange[2]. This comparison of interchange fees with other markets therefore suggests that a detailed review of the interchange fees for debit products in Australia (Visa Debit and EFTPOS) is warranted.

1.4 Considerations for Setting Visa Debit Interchange

There are five specific items that frame the Visa Debit interchange issues:

- The Australian Competition and Consumer Commission (ACCC) / RBA Joint Study (the *Joint Study*)[3] in which Visa Debit issuers were described as being "*over-compensated*"

- The communication from the ACCC to the Australian banks (dated March 2000) that indicated the ACCC believed that the process for setting credit card interchange fees was a breach of the *Trade Practices Act 1974*

- The letter from the RBA Governor to the Visa Debit issuers that states "*a more efficient and defensible*" interchange arrangement is needed

[2] Whereby issuers pay an interchange fees to acquirers, and acquirers pay a fee per transaction to some large merchants.

[3] *Debit and Credit Card Schemes in Australia; A Study of Interchange Fees and Access*; Reserve Bank of Australia (RBA) and Australian Competition and Consumers Commission (ACCC); October 2000.

- The Australian Bankers' Association (ABA) submission to the RBA that summarises the required key attributes that were identified by the ACCC for a credit card interchange fee methodology

- The methodology proposed in the ABA submission for the setting of an efficient pricing envelope based on avoidable costs.

A consistent efficient pricing framework should be used for all card-based payment products. However, the underlying cost structures of the different card-based payment products will vary. This will result in different underlying interchange costs and end points for the efficient pricing envelope. Therefore, a consistent interchange methodology can be applied across all card-based payment products and the inherent differences in costs structures of these products will result in different efficient pricing envelopes for each card-based payment product.

The efficient pricing envelope described in the ABA submission is the only interchange framework methodology to date that appears to meet efficient pricing principles. Visa Debit issuers do not exclusively endorse that framework and would consider other efficient pricing interchange frameworks if they meet efficient pricing principles and were consistently applied to all card-based payment products.

Under the approach submitted by the ABA for credit card interchange, the efficient pricing envelope would be:

- At the upper bound, the stand-alone cost of offering the customer only the Visa Debit Card product. Under this scenario, the transaction account is established and maintained only to fund Visa Debit transactions

- At the lower bound, the incremental costs to offer the Visa Debit product in addition to a transaction account.

While the resulting interchange fee cannot be determined without a careful and thorough study of relevant costs, it would appear with some certainty at this time that the resulting Visa Debit interchange fees:

- Would meet efficient pricing principles
- Would be greater than zero
- Could be different from the Visa Credit interchange fee.

It would be reasonable to assume that if Visa Debit interchange fees were reduced they would be offset by the introduction of cardholder fees. The impact on cardholders and financial institutions could be significant. If this transition were made in an orderly manner, any impact on cards on issue or transaction volumes, while not necessarily desirable, would be consistent with sound economic and commercial principles.

In order to mitigate the commercial impact of changes to the Visa Debit interchange fees, it is prudent, logical, and economically sound to:

- Review and reform EFTPOS interchange at the same time as Visa Debit

- Provide for an appropriate transition period.

In summary, it is important to achieve consistency of efficient pricing across all card-based payment products:

- EFTPOS and Visa Debit interchange fees should be evaluated concurrently
- Any changes to Visa Debit interchange fees should be made in the same timeframe as changes to EFTPOS and, ideally, credit card interchange fees. This will minimize distortion of pricing signals resulting from unnecessary differences in the timing of those changes
- An adequate transition period should be provided to allow the change in pricing signals to be adequately absorbed and integrated in the marketplace.

1.5 Conclusion

The Visa Debit issuers[4] recognise that a detailed review of Visa Debit interchange arrangements is required, but there is an equally compelling case for a concurrent review of EFTPOS debit interchange arrangements. If appropriate within an efficient pricing interchange framework for card-based payment products, they are ready to prepare for a voluntary review that respects the following principles:

- Visa Debit is a unique card product that requires its own assessment of interchange fees but an assessment that is consistent with other card-based payment products
- A review of Visa Debit interchange should not be conducted in isolation of the overall review of interchange arrangements of all card products, including credit cards and EFTPOS
- A review of Visa Debit interchange fees must be based on an interchange cost methodology that is supported by sound economic principles and consistently applied across all card-based payment products
- A review of Visa Debit must take into account the potential impact on all constituents, including the smaller institutions that issue this product and cardholders
- A transition period is required to avoid unnecessary and undue economic hardship to the financial institutions and, in many cases, the customers that are their owners.

As a next step, Visa Debit issuers would be pleased to arrange direct discussion meetings with the RBA to review the content of this document and agree to a review process and timescale that is acceptable to all parties.

[4] AAPBS, Bendigo Bank, CUSCAL and St George.

2. Background and Objective

Over the last 18 to 24 months, various regulatory agencies in Australia have been conducting inquiries into aspects of card-based payment products in Australia.

One of the primary areas of focus is credit card interchange fees. Credit cards are a payment product that offers cardholders both a convenient manner to “buy now and pay later” and the ability to extend repayment under an extended credit facility that is an integral part of the credit card payment product functionality[5].

A credit card issuer has two principal sources of revenue: the cardholder and the merchant. In the instance of “on-us” transactions[6], the issuer has a direct relationship with both the cardholder and the merchant and receives revenue directly from both sources. In the instance of “not-on-us” transactions[7] the issuer has a direct relationship only with the cardholder. The credit card interchange fee is the wholesale price paid by the Acquirer (the financial institution that acquires a credit card transaction from a merchant) to the issuer (the financial institution that issues the credit card used at that merchant). The fee recovers a portion of the issuers’ costs incurred in providing credit card services. Typically the Acquirer recovers the interchange fee paid to the issuer from the Merchant Fee that the Acquirer charges to the merchant.

The history and major milestones of the recent regulatory inquiries into card-based payment products are well known to those who have an interest in those inquiries and include such matters as:

- The ACCC inquiry into interchange fees
- The lawsuit against the National Australia Bank
- The *Joint Study*
- The intent of the card association[8] members to seek authorisation under the *Trade Practices Act 1974* of credit card interchange fees
- The designation of the domestic credit card networks by the RBA.

Because these events are well known and publicly documented, this paper will not elaborate on them further.

On 12 April 2001 the RBA announced that it would designate the domestic credit card network[9]. The announced scope included interchange fees, access and surcharging.

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[5] Subject to a minimum monthly payment. Credit cards also provide a third functionality: the ability to obtain cash from an ATM machine as a cash advance. The amount of the advance is posted to the cardholder’s statement.

[6] An on-us transaction is a transaction for which the same financial institution is both the issuer and the Acquirer.

[7] A not-on-us transaction is a transaction for which the issuer and Acquirer are separate financial institutions.

[8] Bankcard, MasterCard and Visa.

The first step in the designation process has been for the RBA to obtain comments from various parties regarding the designation process itself and the substantive issues with which the RBA is concerned. That process is occurring now and the RBA is expected to issue a consultative document in the October 2001 timeframe.

The Visa Debit Card was not included in the RBA credit card scheme designation but the regulators have expressed an acute concern in regards to Visa Debit interchange fees.

In the *Joint Study*, the RBA stated:

> *" there is no case for simply extending credit card interchange fees to debit card transactions … issuers are being over-compensated for what is, to all intents, a debit card transaction".*[10]

On 25 June 2001 Ian Macfarlane, RBA Governor sent a letter to the Visa Debit issuers stating that they should:

> *" put more efficient and defensible arrangements in place*" in order to *"obviate a regulatory response under the Payment Systems (Regulation) Act 1998 to deal specifically with the Visa Debit Card scheme"*

As a first step in response to those concerns, this document provides information on the Visa Debit Card product in Australia and the perspective of the Visa Debit issuers that authored this report on an appropriate way forward that is consistent with the regulators' concerns and the need to effect any changes in a manner that is commercially sound and within the context of sound economic principles.

Specifically, this paper (1) provides factual background on the introduction, growth, current market positioning, usage and cost structure of the Visa Debit product; (2) describes the current interchange fee arrangements in Australia and in other markets; (3) highlights key issues to be taken into consideration when reviewing Visa Debit interchange arrangements; and (4) provides initial suggestions of a way forward that would be consistent with potential changes and reform to other card-based payment products.

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[9] The term "network" is logically assumed to refer to the economic network of issuers and Acquirers and not the more narrow meaning of the hardware, software and communications links that comprise the switching, clearing and settlement (ie operational) network.

[10] *Joint Study*, p70

3. Description of Visa Debit in Australia

3.1 History of the introduction of Visa Debit in Australia

The Visa Debit Card (also referred to as the Visa Payment Card) was introduced into Australia in 1982. Building societies[11] and credit unions were early adopters of the Visa Debit Card.

The Visa Debit Card enabled the smaller institutions in the retail banking sector to:

- Overcome barriers to their participation in the payments system (e.g., issuing credit cards; market power in negotiating bilateral EFTPOS arrangements)
- Provide their members and customers with an efficient payment card without the reliance on a credit facility – many members and customers either did not qualify for, or did not want, credit.

As the Financial System Inquiry found,

> *"Historically, building societies and credit unions have been innovative in the provision of financial services..."*[12]

The smaller institutions had to be innovative to meet their members' and customers' needs in the face of the significant market power held by the largest institutions.

In addition, non-bank institutions in the 1970s and 1980s were locked into a complex federal and state legislative framework with complex and incompatible legislation. This restrictive legislative framework was not reformed until 1992 with the introduction of the Financial Institutions Scheme.

Banks launched Bankcard in 1974 and credit unions sought access to the Bankcard scheme in 1976[13]. By 1978, negotiations had broken down. Credit unions argued that the Bankcard agreement was anti-competitive:

> *"The banks responded in August 1979: credit unions were free to start their own payments system; no one was stopping them. All they had to do was finance it – a massive undertaking."*[14]

Credit unions and building societies turned to the Visa Debit Card as the solution to providing their members and customers with a payment card with very wide acceptance and that suited their members' and customers' needs.

Bendigo Bank, then a building society, and credit unions issued the first Australian Visa Debit Cards in 1982.

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[11] St George Bank was a building society until 1992. Bendigo Bank was a building society until 1995.
[12] *Financial System Inquiry Final Report*, March 1997, p307.
[13] *People Before Profit: The Credit Union Movement in Australia*, G Lewis, Wakefield Press, 1996, p281.
[14] *People Before Profit*, p282.

In December 1983, CUSCAL's predecessor body became a principal member of the Visa International Card system. Credit unions in New South Wales, Queensland, Victoria, South Australia, Western Australia and the ACT gained access to a dual Redicard-Visa network. (Redicard was the credit union ATM card.) Work began on linking Redicard and VISA with a national ATM network and national EFT switch.

> "The VISA Card arrangement already highlighted the absurdity of denying credit unions access to the domestic payments system when Australian credit unions were accepted on an equal footing with banks in an international system."[15]

Credit unions gained access to the national EFTPOS network in late 1985, reaching an agreement with Westpac and the Commonwealth Bank on accepting Redicard at EFTPOS terminals.

The Visa Debit Card was an important means for building societies and credit unions to overcome the competitive and regulatory obstacles they faced in the 1970s and 1980s. Although the retail banking market has changed considerably since then, the benefits of the Visa Debit Card to cardholders and merchants are as relevant today as in 1982. In fact, as technology has delivered new access channels for merchants such as the Internet, the value of the product has grown.

[15] *People Before Profit*, p304.

3.2 Growth of Visa Debit in Australia

The number of Visa Debit Cards has increased over time to achieve a total of approximately 2.7m cards on issue in late 2000. This growth has not been inconsistent with the overall growth in card-based payment products generally.

Table 1: GROWTH IN VISA DEBIT CARDS IN AUSTRALIA[16]

Period	Number of Visa Debit Cards ('000s)	Growth %
December 2000	2,731	+11.6%
December 1999	2,448	+15.5%
December 1998	2,120	+10.5%
December 1997	1,918	+20.3%
December 1996	1,595	+15.3%
December 1995	1,383	+21.3%
December 1994	1,140	+23.8%
December 1993	921	+22.8%
December 1992	750	-

Visa Debit remains a fairly marginal card product in Australia as it only represents approximately 6% of the dollar spend conducted on debit and credit cards combined.

Table 2: BREAKDOWN OF $ SPEND BY CARD TYPE[17]

Period	Visa Debit ($m)	%	EFTPOS ($m)	%	Credit Cards ($m)	%
1999	$5,239	6%	$31,654	37%	$47,892	57%
2000	$6,149	6%	$34,767	34%	$62,305	60%

[16] Source: Visa quarterly report.
[17] Source: Visa quarterly report and RBA bulletin. Analysis excludes charge cards and proprietary store cards.

3.3 Comparison of Visa Debit products

Visa currently has at least three different debit card products on issue globally[18]. Each of the products offers different functionality to the Cardholder. Table 3 provides a summary of some key differences between the three products.

Table 3: VISA DEBIT PRODUCTS AVAILABLE GLOBALLY			
Characteristic	**Visa Debit[19]**	**Electron**	**Interlink**
Authorisation	Online	Online	Online
Account Posting	Off-line	Off-line	Online
Signature / PIN	Signature	Signature	PIN
Used at	POS, MOTO, Internet[20]	POS	POS
Embossed	Yes	No	Yes
Geographic reach	Global / Australia	Global / not Australia	US predominantly
Processing	Credit card network	Debit card network	Debit card network

[18] Visa Debit Cards appear to be designed, as needed, for local markets at the time they are introduced. The table is therefore illustrative and not exhaustive.

[19] Visa Debit in the UK is called Visa Delta: signature based; on-line authorisation; embossed.

[20] MOTO and Internet transactions are cardholder-not-present transactions.

3.4 Positioning of Visa Debit in Australia

A Visa Debit Card offers the payment features typically associated with debit cards with the acceptance attributes typically associated with an internationally accepted credit card:

TABLE 4: COMPARISON OF TYPICAL CARD FEATURES			
Characteristic	**EFTPOS**	**Visa Debit**	**Credit Card**
Acceptance locations[21]	POS	POS, MOTO, Internet; paper based merchants	
Global POS acceptance	No	Yes	
Global cash accessibility	No	Yes	
Cardholder verification	PIN	Signature	
Charge-back rights	Minimal	Yes	
Cardholder transaction fees	Yes	No	
Credit line[22]	No		Yes
Deferred payment	No		Many
Extended credit	No		Yes
Rewards/loyalty programs	Embryonic[23]		Many
Add-on features	No		Some[24]
Annual cardholder fees	No		Yes

The conclusion from the above table is that the Visa Debit product is different from EFTPOS and is different from Visa Credit; it is a unique product that shares similarities with both a debit and a credit card.

Compared to the major banks, building societies, credit unions and regional banks have historically been presented with unique challenges to offer competitive and commercially viable card-based payment products:

- Credit cards could not be offered by credit unions and building societies until recently
- The smaller financial institutions did not enjoy market power parity in the cumbersome process of negotiating bilateral EFTPOS agreements; they were essentially price takers.

[21] MOTO and Internet transactions are cardholder-not-present transactions; cardholder verification is frequently not done or is accomplished using methods other than a signature.
[22] Overdraft facilities provided on a transaction account are not an integral functionality of a debit card.
[23] Includes two loyalty programmes directly related to a debit card: Commonwealth Bank's Ezy Banking and Bendigo Bank.
[24] Such as insurance and product warranty.

The delayed entry into the credit card issuing market and unique demographics of many of these smaller financial institutions has resulted in a lower penetration of card (cards on issue) and lower transaction volumes per card compared to the major banks:

- A proportion of their customers typically do not want a credit card
- A proportion of their customers typically do not qualify for credit cards.

The introduction of Visa Debit enabled the building societies, credit unions and regional banks to provide their customers:

- With a debit card product that is commercially viable compared to the cumbersome process of bilaterally negotiating EFTPOS agreements
- With a card-based payment product that can be used globally
- With the ability to use a debit card payment product for mail order/telephone order (MOTO) and Internet transactions that typically cannot be made with a PIN based debit card
- Access to a global payment method for those who otherwise do not qualify for (or want) a line of credit.

At the time it was made available in Australia, Visa Debit allowed the smaller financial institutions to offer a competitive card-based payment product on viable commercial terms that met the needs of a large portion of their customer bases. This was one reason that they were able to compete effectively with the larger banks.

The Visa Debit product has continued to be popular despite the increased availability of credit card and EFTPOS payment products across the industry. For many customers, the Visa Debit product is superior to other alternatives as it provides global payment acceptance without having to establish a line of credit.

3.5 Usage of Visa Debit Versus EFTPOS and Visa Credit

Just as the Visa Debit Cards offer a unique combination of functionality to the cardholder, Visa Debit Cards demonstrate unique metrics in actual use, confirming the distinctive nature of Visa Debit when compared with EFTPOS and Visa Credit.

The primary difference is that key metrics such as the average transaction value of purchases, and the number of cash transactions per card related to Visa Debit Card are approximately mid-way between the metrics associated with EFTPOS and Visa Credit:

Table 5: COMPARISON OF CARD PRODUCT USAGE[25]

	EFTPOS[26]	VISA Debit	VISA Credit[27]
# of Cards on Issue		2.8 million	6.3 million
# of Accounts	18.5 million	TBD	TBD
Purchase Transactions			
Average Transaction Value	$ 58	**$ 74**	$ 94
Transactions per Card per Year	33.4	32.9	60.7
$ Turnover per Card per Year	$ 1,931	**$ 2,436**	$ 5,708
Cash Advance / Withdrawal Transactions			
Average Transaction Value	$ 175	$ 262	$ 231
Transactions per Card per Year	27.6	**13.9**	2.9
$ Turnover per Card per Year	$ 4,808	**$ 3,648**	$ 668

25 Source: RBA bulletin and Visa quarterly report: all metrics are annualised data based on Q1 2001.

26 EFTPOS metrics are calculated on a per account basis.

27 Only refers to the Visa Classic Credit product, ie. excludes Visa Gold and Visa Commercial products.

3.6 Transaction Processing

The processing characteristics for a Visa Debit Card transaction are similar as for a Visa credit card transaction:

Table 6: COMPARISON OF THE PROCESSING OF VISA DEBIT VS EFTPOS TRANSACTIONS

Activity	Visa Debit Process	EFTPOS Process
Authorisation	- Press "credit" button on POS keypads - Switched via domestic Visa credit card network - BIN number used to identify transaction as Visa Debit (flows into separate processing stream at issuer) - Primary account number used to check funds availability - Batch processing of transactions to cardholder account (up to 2 days after transaction date)	- Press "debit" button on POS keypads - Switched via EFTPOS bilateral network - On-line posting to cardholder transaction account
Settlement	- Net settlement reports generated by VisaNet	- Direct between financial institutions under bilateral and gateway agreements

The provision of the Visa Debit and EFTPOS products on one piece of plastic and subsequent transaction processing is a decision by the issuer of how they can best provide the operational aspects of the two products. The transaction processing characteristics will have an impact on interchange costs but are not the sole determinant of interchange fees.

The BIN number provides a unique identification for the issuer and the transaction flows through a different processing stream during the clearing process when it is switched to the issuer. In this sense, Visa Debit transactions can be separately identified from credit card transactions.

The identification of interchange transactions for the determination of interchange fees is part of the clearing and settlement process performed through Visa's systems. Changes might be required to Visa's systems if a separate interchange arrangement was to be established for Visa Debit transactions. The specific nature of these changes, the time period required to make the changes, the cost of the changes and the commercial arrangements to fund the changes are not known at this time. Additionally, card aquirers would need to make system changes in order to charge lower fees to merchants for Visa Debit purchases.

3.7 Summary Cost Elements by Card Type

Each primary form of payment product (eg, cash, cheques, credit card, debit card and so forth) offers the merchant a unique set of attributes in terms of impact on the merchant's costs and behaviour of the consumer (type and level of purchases). From the merchants' perspective, the Visa Debit Card offers a number of attributes, including[28]:

- Near immediate availability of good funds
- No credit losses or credit collections costs
- Minimal counterfeit losses
- Reduced cash handling costs.

Typically each type of payment product has a different inherent cost structure. Differences in cost structures exist amongst card-based payment products. The types of cost differences between debit and credit cards are illustrated (but not exhausted) in the table below. In addition, the table further demonstrates the unique nature of the Visa Debit Card that shares a set of cost characteristics with Visa Credit and another set of cost characteristics with EFTPOS.

<table>
<tr><th colspan="4">Table 7: INDICATIVE COMPARISON OF COST ELEMENTS BY CARD TYPE</th></tr>
<tr><th>Cost Element</th><th>EFTPOS</th><th>Visa Debit</th><th>Visa Credit</th></tr>
<tr><td>Card association charges[29]</td><td>Nil</td><td colspan="2">Authorisation fee: 2.5-5 cts per txn
Settlement fee: 2.5 cts per txn
Assessment: 0.03% of purchase $</td></tr>
<tr><td>Fraud and other Related Losses[30]</td><td>Lower</td><td colspan="2">Higher and comparable for Visa Debit and Credit</td></tr>
<tr><td>Charge-backs[31]</td><td>Lower</td><td colspan="2">Higher and comparable for Visa Debit and Credit</td></tr>
<tr><td>Transaction processing</td><td>TBD</td><td colspan="2">Comparable for Visa Debit and Credit</td></tr>
<tr><td>Statementing</td><td>Lower</td><td colspan="2">Higher</td></tr>
<tr><td>Funding period</td><td colspan="2">Lower</td><td>Higher</td></tr>
<tr><td>Credit losses</td><td colspan="2">Nil</td><td>Yes</td></tr>
<tr><td>Transaction account shared costs (common costs)</td><td colspan="2">Yes</td><td>Nil</td></tr>
</table>

To the degree that future interchange fee arrangements are driven primarily by efficient pricing and underlying costs, it is likely that the efficient pricing envelopes amongst these three product types may be different.

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28 This does not include the fact that Visa Debit Card can be used for "cardholder-not-present" transactions (eg, MOTO and Internet) for which a PIN-based debit card cannot typically be used.

29 Expressed and charged in USD by Visa.

30 Other losses may incorporate costs incurred when a card-not-present transaction is used to withdraw funds beyond the available funds of the transaction account. This may also occur when a stand-in authorisation is performed due to a temporary network failure.

31 Estimate, no detailed charge-back cost data was available.

4. Visa Debit Interchange Arrangements

4.1 Current interchange fees in Australia

As indicated in the tables below, the current weighted average interchange fee[32] for Visa Debit is comparable to the credit card interchange fee and dissimilar (in level and direction) to the EFTPOS interchange fee.

Table 8: CURRENT INTERCHANGE CHARGES	
Card Product	**Interchange as a % of Transaction Value**
EFTPOS	(0.36)%[33]
Visa Debit	0.95%[34]
Credit Card	0.95%[35]

TABLE 9: INTERCHANGE FEES (EXCLUSIVE OF GST)			
Interchange Category	**EFTPOS**	**Visa Debit**	**Credit Card**
Domestic Standard	NA	1.20%	1.20%
Domestic Electronic	-$0.20[36]	0.80%	0.80%
International Standard	NA	1.6% – 1.64%	1.6% – 1.64%
International Electronic	NA	1.1% - 1.16%	1.1% - 1.16%

Visa members currently set an interchange rate that is not specific to Visa Debit or Visa Credit but applies across both products. The interchange fees for Visa Debit were set almost 20 years ago. No institutional knowledge currently exists as to how the Visa interchange fees were specifically determined or the methodology that was used. In addition, there is no institutional knowledge of what role Visa played in the original determination of the Visa Debit interchange fees in Australia, nor is there any indication

32 A weighted average of the paper (1.20%) and electronic (0.80%) rate.
33 Based on a per transaction fee of $0.20 and an average transaction value of $55. The fee is shown in brackets () because the interchange fee is paid by the issuer to the Acquirer.
34 Estimate.
35 *Joint Study*, p43.
36 Reserve Bank Study; Table 6.1. The fee is paid from the issuer to the Acquirer.

that the Visa Debit issuers have sought counsel on this issue from Visa since that time. It is unlikely to serve any purpose going forward to try and establish the historical record.

4.2 Interchange arrangements in other markets

The treatment of Visa Debit interchange fees varies around the world. In some markets, Visa Debit interchange fees are set at the same level as Visa Credit (e.g., Canada), and in others there is a different interchange fee for Visa Debit compared to Visa Credit (e.g., UK). There are marked differences in the structure and features, and therefore the underlying costs, of the Visa Debit product across different markets. Because there is no one accepted international standard for setting payment systems interchange fees, local market considerations and industry structure are major determinants of the way in which interchange has been established.

The data in Table 10 is provided for illustrative purposes and not as the basis for suggesting the appropriate Visa Debit interchange fees in Australia. The comparison of interchange fees with other known markets shows that interchange is positive for debit and credit card products (except for Australia). It is also worth noting that to the collective authors' knowledge EFTPOS in Australia is the only card product in the world that attracts negative interchange. This comparison of interchange fees with other markets therefore suggests that a detailed review of the interchange fees for debit products in Australia (Visa Debit and EFTPOS) is warranted.

Table 10: ILLUSTRATIVE INTERCHANGE FEES			
Country	**Interchange Fees**	**ATV**	**Effective Ad Valorem Fee**
Australia			
Visa Debit standard	1.20%	$74[37]	1.20%
Visa Debit electronic	0.80%	$74	0.80%
EFTPOS	-AU$0.20	$55	(0.36)%
Visa Credit	0.80% - 1.20%	$94	0.80% - 1.20%
UK[38]			
Visa Debit	£0.092	£31	0.30%
Switch (EFTPOS)	£0.038	£31	0.12%
Visa Credit	1.10%	£48	1.10%
Canada			
Visa Debit	1.75% - $0.25	-	-
Visa Credit	1.75% - $0.25	-	-
US			
Offline debit[39]	US$ 0.40	US$ 41	0.98%
Online[39]	0.45% plus US$ 0.03 (max US$ 0.20)	US$ 41	0.52%
Online supermarket[39]	US$ 0.15	US$ 41	0.37%
France			
Cartes Bancaires[40]	0.7FF plus 0.21% plus fraud component[41], [42]	315FF[43]	0.40% - 0.50%

[37] Source: Visa quarterly reports.
[38] Source: Cruickshank report.
[39] Source: Lafferty newswire.
[40] French interchange arrangements represent a blended rate between debit and credit transactions. Credit cards, however, represent approximately only 3% of all cards.
[41] Source: Cruickshank report.
[42] The Fraud Component (TICO) is calculated bilaterally based on each bank's actual fraud incurred from transactions acquired by other institutions.
[43] Source: Lafferty Newswire.

5. Considerations for Setting Visa Debit Interchange

5.1 Regulatory background

In general, the regulatory framework for this paper was described in the introductory section on Background and Objectives. In particular, there are five specific items that frame the Visa Debit interchange issue:

- The *Joint Study* in which Visa Debit issuers were described as being "*over-compensated*"
- The communication from the ACCC to the Australian banks (dated March 2000) that indicated that the ACCC believed that the process for setting credit card interchange fees was a breach of the *Trade Practices Act 1974*
- The letter from the RBA Governor to the Visa Debit issuers that states "*a more efficient and defensible*" interchange arrangement is needed
- The ABA submission to the RBA that summarises the required key attributes that were identified by the ACCC for a credit card interchange methodology
  - Cost based, transparent and efficient
  - Includes only those costs that are related to the payments network services
  - Differential interchange fees (by transaction type)
  - Forward looking
  - Data integrity (validation)
  - Regular reviews of the interchange fee.
- The methodology proposed in the ABA submission for the setting of an efficient pricing envelope based on avoidable costs.

5.2 Efficient Pricing Principles

In the current regulatory environment, sound economic principles centre on the concept of efficient pricing. As is well documented in various submissions there are three types of efficiency as summarised below.

- Allocative Efficiency: Achieved when prices are set so that they are consistent with the value of resources consumed in the creation and delivery of a good or service
- Productive Efficiency: Achieved when production takes place at the lowest cost
- Dynamic Efficiency: Achieved when incentives exist (e.g., adequate compensation for risk assumed in innovating and adopting new technology) for resources to move over time to their highest and best use.

Efficient pricing is founded on the concept of allocative efficiency – prices that are set consistent with the resources consumed (costs) to ensure the long-term viable delivery and support of the product.

5.3 Application of Efficient Pricing

The efficient pricing envelope described in the ABA submission is the only interchange framework methodology to date that appears to meet efficient pricing principles. Visa Debit issuers do not exclusively endorse that framework and would consider other efficient pricing interchange frameworks if they met efficient pricing principles and were consistently applied to all card-based payment products.

The ABA submission provides an approach for the determination of a pricing envelope that defines the upper and lower bounds for interchange fees that would meet efficient pricing principles. The approach is not intended *per se* to provide the specific methodology for the precise determination of an interchange fee but allows each card association to determine an interchange fee reflecting their respective cost structure and commercial market requirements. Interchange fees thus determined, if within the pricing envelope, would meet the economic pricing principle for efficient prices.

The pricing envelope is based on the issuers' costs of the "buy now, pay later" functionality of the credit card product; the issuers' costs of the extended credit and ATM cash advance functionality are excluded. The upper bound of the envelope is then determined based on the credit card issuers' avoidable costs – "*what costs would be unavoidable if an issuer were to provide (on a sustainable basis) only credit card payment services*".[44]

From a practical viewpoint, an adjustment is made to account for the fact that the issuer has two sources of revenue – the Acquirer/merchant and the cardholder. Revenues from the cardholder are deducted from the calculated avoidable costs to determine a 'net' avoidable cost. It is this net avoidable cost that credit card interchange fees should not exceed if they are to be considered efficient.

Cardholder fees are deducted from total issuer costs for the "buy now, pay later" functionality because there is no accepted efficient pricing principle upon which to allocate the issuers costs between the cardholder and the Acquirer / merchant. Reduction of total costs by this revenue source satisfies other economic and commercial requirements.

5.4 Alternative Methodologies to Determine Interchange Fees

During the current regulatory process there have been three primary methodologies submitted for determination of specific interchange fees for card-based payment products:

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[44] *Credit Card Networks in Australia: An Appropriate Regulatory Framework*, Australian Bankers' Association, July 2001, p51.

Specific Cost Recovery (SCR)

- The SCR methodology focuses on commercial aspects of pricing
- Seeks to set a wholesale price at least the same as the costs that the merchant would incur if they provided a comparable payment product themselves. For example:
    - Payment guarantee costs – Merchants pay to guarantee a cheque payment, or they bear the cost of counterfeit notes
    - Funding cost – Merchants would have to fund the cost of deferred payment terms offered to their customers
    - Processing costs – Merchants would have to pay for the cost of maintaining their accounts receivable ledger for deferred payment terms offered to customers or the systems costs related to a proprietary store card
- The SCR methodology is transparent. Costs that are included are explicit and the calculation algorithms are clear
- Factors other than calculated interchange costs are taken into consideration. Competitive products, merchant acceptance issues, economic cycles and so forth are all considered prior to determining interchange fees
- Has been consistently and successfully applied across many markets
- Has been successfully defended to regulatory authorities.

Baxter Based

- Based on the theory of network economics; considered theoretically robust
- As certain cost elements increase, calculated interchange costs can significantly exceed commercially viable interchange fees
- The methodology is not transparent. It is difficult to explain to regulators, merchants and consumers
- Requires separation of the 'buy now, pay later' payment functionality from the extended credit function, raising issues related to the most appropriate cost allocation methods
- Cost calculations are only one input into the determination of interchange fees. Market considerations and network balancing are considered prior to determining the market interchange fees
- Has been applied across many markets successfully
- Has been successfully defended to regulatory authorities.

Residual Cost

- Uses regulatory pricing concepts that exist in other industries such as telecommunications
- Effectively sets the profitability of credit card issuing at an industry level
- Relatively easy to calculate and avoids many of the cost allocations of the other methodologies (e.g., separation of payment and extended credit functionality is not required)
- At present, untested in any credit card markets.

It is important to note that the costs calculated using the Specific Cost Recovery and Baxter Type methodologies are only one input in the determination of interchange fees using those methodologies. As noted above under the description of those methodologies, other factors are considered when the actual interchange fee is determined.

5.5 Applicability to Visa Debit Interchange

A consistent efficient pricing framework should be used for all card-based payment products. However, the underlying cost structures of the different card-based payment products will vary. This will result in different underlying interchange costs (and the end points of the efficient pricing envelope). Therefore, a consistent interchange methodology can be applied across all card-based payment products and the inherent differences in costs structures of these products will result in interchange fees appropriate to each card-based payment product.

Table 11 below indicates the primary cost categories associated with providing a transaction account product (Column 1) regardless of the method used to access the account and incrementally providing a Visa Debit Card product (Column 2). Columns 3 and 4 respectively indicate the costs that would be incurred if a financial institution only provided a Visa Debit Card product or a credit card product ("buy now, pay later" functionality).

Table 11 indicates that the cost structure between Visa Debit and the "buy now, pay later" function of a credit card is similar. There are two important differences:

- The level of the costs on a per card or per transaction basis may be different
- Transaction account common costs are shared with the Visa Debit product and not the credit card product.

Table 11: COST COMPONENTS OF DEBIT CARD ISSUING

	1	2	3	4
Cost element	**Transaction Account Common Cost**[45]	**Direct Visa Debit Card Cost**[46]	**Visa Debit Card Stand-Alone Costs**[47]	**Credit Card Stand-Alone Costs**[48]
Application management	Yes	Yes	Yes	Yes
Deposit processing	Yes		Yes	
Payment processing				Yes
Statement production	Yes	Yes	Yes	Yes
Card Issuing		Yes	Yes	Yes
Cardholder authorisations		Yes	Yes	Yes
Transaction/settlement processing		Yes	Yes	Yes
Chargeback processing		Yes	Yes	Yes
Customer service and account maintenance	Yes	Yes	Yes	Yes
Product strategy and development	Yes	Yes	Yes	Yes
Advertising and Promotion	Yes	Yes	Yes	Yes
Association charges		Yes	Yes	Yes
Credit losses and collections				Yes
Fraud and other losses and investigations		Yes	Yes	Yes
Funding costs[49]		Yes	Yes	Yes
Interest expense	Yes		Yes	Some Institutions
Cost of capital	Yes	Yes	Yes	Yes
Centre management	Yes	Yes	Yes	Yes
Corporate overheads	Yes	Yes	Yes	Yes

45 Common costs are costs associated with a transaction account that are incurred regardless of the access product used.

46 Direct Visa Debit Card costs are defined as those costs that are only incurred through activities directly related to issuing a Visa Debit Card.

47 Stand-alone costs are the costs that would need be incurred to operate a Visa Debit Card product.

48 For the buy now, pay later payment functionality only.

49 The cost to fund the period between settlement with the merchant and either: a) a charge to the cardholder's transaction account (debit product) or b) a payment receipt from the cardholder (credit card).

Under the approach submitted by the ABA for credit card interchange, the efficient pricing envelope would be:

- At the lower bound, the incremental costs (column 2) to offer the Visa Debit product in addition to a transaction account
- At the upper bound, the stand-alone cost (column 3) of offering the customer only the Visa Debit Card product. Under this scenario, the transaction account is established and maintained only to fund Visa Debit transactions.

Based on initial assessments of the underlying costs data, this envelope for the Visa Debit Card is likely to be very broad with a significant spread between the lower bound (the incremental cost of adding the Visa Debit Card to an existing transaction account) and the upper bound (the stand alone cost of providing only Visa Debit Cards with no other transaction account products and services).

In order to provide a more precise direction for the determination of Visa Debit Card interchange fees, the following is suggested as the general approach for the determination of the actual interchange fee:

- Calculate the upper and lower bounds of the pricing envelope to ensure the calculated interchange costs and interchange fees are consistent with efficient pricing principles
- Calculate the common costs of providing transaction account services to consumers
- Determine the fair share of transaction account common costs that should be assigned (shared) to the Visa Debit Card product as opposed to other transaction account access products such as EFPTOS, cheques and so forth (likely to be based on transaction volumes)
- Determine the fair share of Visa Debit Card costs that should be assigned (shared) to other card functions (e.g. EFTPOS) that reside on the same card.
- Combine the transaction account and card costs attributable to the Visa Debit product
- Determine the fair share of transaction account revenue to be deducted from the above calculation

  Cardholder-related revenue might be calculated by quantifying implicit fees that are incurred by cardholders (such as foregone interest on positive transaction account balances), and/or by determining a proportion of explicit fees related to transaction accounts (such as account maintenance fees) that can be accessed via Visa Debit.

While the resulting interchange fee cannot be determined without a careful and thorough study of relevant costs, it would appear with some certainty at this time that the resulting Visa Debit interchange fees:

- Would meet efficient pricing principles
- Would be greater than zero
- Could be different from the Visa Credit interchange fee.

5.6 Commercial Impact of Alternative Arrangements

In order to understand the commercial impact of alternative interchange fee arrangements, it is necessary to have a starting point represented by the Visa Debit issuers' current revenue position. This position encompasses both EFTPOS and VISA Debit payment products[50]:

- Visa Debit: All Visa Debit issuers receive the current Visa Debit interchange fees (standard and electronic) for domestic purchase transactions. These interchange fees are the same as credit card interchange fees
- EFTPOS: All Visa Debit issuers provide EFTPOS functionality and pay the EFTPOS interchange fee to the acquirer for not-on-us transactions. The *Joint Study* estimates that this fee ranges between $0.18 and $0.25 and may include an additional $0.10-$0.15 for a gateway fee in the case of small issuers that do not negotiate direct bilateral arrangements

The table below shows the total net debit card interchange revenue obtained by the Visa Debit issuers that issue the majority of the Visa Debit Cards[51].

Table 12: CURRENT INTERCHANGE REVENUE

	Interchange Revenue ($ Million)[52]	Proportion of Total Profit[53]
Visa Debit	$37.2	9.6%
EFTPOS	($29.3)	(7.6%)
Net impact of debit interchange	$7.9	2.0%

If Visa Debit interchange fees were to be reduced to zero, the impact on the financial institutions would be significant. As indicated in Table 12, the impact would be a loss of revenue of $37.2 million and, all other things remaining constant, a drop in the profits of

50 This document does not speculate on the potential change in credit card interchange fee levels. If they decrease, the impact described above would be greater.
51 AAPBS, Bendigo Bank, CUSCAL and St George Bank.
52 Information provided by a sample of Building Societies, Bendigo Bank, CUSCAL and St George. Data is gross annual interchange revenue and does not include any netting of interchange costs (e.g., fraud costs).
53 Results weighted based on number of Visa Debit Cards on issue. Profit is defined as net profit before tax. It is worth noting the wide range for Visa Debit (between 1.2% and 25%) and for EFTPOS (between [1.5%] and [8.8%]).

the average financial institution of 9.6%. For an individual issuer this could be as high as 25%.

The table also indicates that the Visa Debit issuing institutions included in the table are net issuers of EFTPOS (i.e., the interchange amount they pay in EFTPOS interchange is greater than the interchange amount they receive). If the EFTPOS interchange fee is not efficient (e.g., because it is negative and/or too high), the Visa Debit issuers would be adversely impacted by a reduction to the Visa Debit interchange fees while not benefiting from a warranted change to the EFTPOS interchange fee. A reduction in the credit card interchange fee would further exacerbate the adverse impact.

It would be reasonable to assume that a reduction in Visa Debit interchange fees would be at least partially offset by the introduction of cardholder fees. If this transition were made in an orderly manner, any impact on cards on issue or transaction volumes, while not necessarily desirable, would be consistent with sound economic and commercial principles.

In order to mitigate the commercial impact of changes to the Visa Debit interchange fees, it is prudent, logical and economically sound to:

(1) Review and reform EFTPOS interchange at the same time as Visa Debit.

(2) Provide for an appropriate transition period.

5.7 EFTPOS Interchange and Efficient Pricing Consistency

The strategies of different financial institutions have been adjusted over time to reflect the impact of the different interchange regimes between EFTPOS and Visa Debit. Typically, smaller institutions, which are not large EFTPOS acquirers, have been unable to negotiate attractive bilateral EFTPOS interchange arrangements with the large acquirers. As a result, these smaller institutions have been more inclined to promote the Visa Debit product to their customers because of the attractive economics to the issuers and cardholders. The existence of the Visa Debit product, with its positive interchange fee set at credit card interchange fee levels, allowed these smaller institutions to offer (and continue to offer today) an attractive transaction account access facility despite the inherent disadvantages presented by their lack of market power under the bilateral system of EFTPOS interchange determination.

If the current Visa Debit interchange fees do not conform to efficient pricing principles, a move to a more efficient pricing level does not guarantee greater efficiency in the overall payments system. In theory, if the move to more efficient pricing for a given payment product drives consumers to a more inefficiently priced payment product, the overall efficiency of the total payment network may be reduced. Inconsistent pricing signals to the consumer are still likely to be observed if a close substitute such as EFTPOS continues to be inefficiently priced, even though the Visa Debit product moves to an efficient pricing structure.

It can be argued that the interchange fees for EFTPOS payment transactions may not be efficient, having their origins in bilateral arrangements determined by the commercial considerations of large retailers and large banks. It has not been demonstrated that either the retailers or cardholders pay an efficient price for this payment product.

In order to move closer to the most efficiently priced card-based debit payment system, it is essential that EFTPOS and Visa Debit interchange fee pricing be assessed concurrently so as to remove as many pricing inconsistencies between these substitutable products as possible. The end result would likely be a reduction in the inconsistent cardholder pricing that currently exists (eg. very different cardholder prices for very similar payment functionality) and shift the payment system towards the optimal network size from a social perspective.

In summary, it is important to achieve consistency of efficient pricing across all card-based payment products:

- EFTPOS and Visa Debit interchange fees should be evaluated concurrently
- Any changes to Visa Debit interchange fees should be made in the same timeframe as changes to EFTPOS and credit card interchange. This will minimize distortion of pricing signals resulting from unnecessary differences in the timing of those changes
- An adequate transition period should be provided to allow the change in pricing signals to be adequately absorbed and integrated in the marketplace.

5.8 Public Interest

The Visa Debit Card issuers do not feel it would be a prudent use of resources for the RBA to initiate a formal designation process in regards to Visa Debit interchange because they are prepared for voluntary reform which is consistent with credit card and EFTPOS reform. To that end, the Visa Debit Card interchange reform should be consistent with the public interest test of an access regime as described in Section 12 of the *Payment Systems (Regulation) Act 1998* (the Act).

> " (a) whether imposing the access regime would be in the public interest; and
>
> (b) the interest of the current participants in the system; and
>
> (c) the interests of people who, in the future, may want access to the system; and
>
> (d) any other matters the Reserve Bank considers relevant."

The public interest is defined in Section 8 of the Act:

> "In determining, for the purposes of this Act, if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:
>
> (a) being (in its opinion)
>
> (i) financially safe for use by participants; and
>
> (ii) efficient; and
>
> (iii) competitive; and
>
> (b) not (in its opinion) materially causing or contributing to increased risk to the financial system."

The Visa Debit issuers believe that there will be a significant precedent set in regard to the formal designation process for establishing a reformed credit card interchange methodology and this framework should be mirrored across all card-based payment products, including Visa Debit and EFTPOS.

6. Conclusion

The Visa Debit issuers[54] recognise that a detailed review of Visa Debit interchange arrangements is required, but there is an equally compelling case for a concurrent review of EFTPOS debit interchange arrangements. If appropriate within an efficient pricing interchange framework for card-based payment products, they are ready to prepare for a voluntary review that respects the following principles:

- Visa Debit is a unique card product that requires its own assessment of interchange fees but an assessment that is consistent with other card-based payment products
- A review of Visa Debit interchange should not be conducted in isolation of the overall review of interchange arrangements of all card products, including credit cards and EFTPOS
- A review of Visa Debit interchange fees must be based on an interchange cost methodology that is supported by sound economic principles and consistently applied across all card-based payment products
- A review of Visa Debit must take into account potential impact on all constituents, including the smaller institutions that issue this product and cardholders
- A transition period is required to avoid unnecessary and undue economic hardship to the financial institutions and, in many cases, the customers that are their owners.

As a next step, Visa Debit issuers would be pleased to arrange direct discussion meetings with the RBA to review the content of this document and agree to a review process and timescale that is acceptable to all parties.

[54] AAPBS, Bendigo Bank, CUSCAL and St George.