Debit & Credit Card Schemes In Australia

estpac's Initial Response To A Study By The Reserve Bank Of Australia And The Australian Competition And Consumer Commission

November 2000

Australia's First Bank

TABLE OF CONTENTS

EXECUTIVE SUMMARY **3**

ATMS 5

CREDIT CARDS 5

DEBIT CARDS 7

1. GENERAL OBSERVATIONS ABOUT THE STUDY **8**

1.1 A BROADER PERSPECTIVE ON PAYMENT SYSTEMS REFORM 8

1.2 OBJECTIVES TOO NARROW TO ACHIEVE DESIRABLE PUBLIC POLICY OUTCOMES 9

1.3 STUDY HAS NOT MET ALL ITS OBJECTIVES 10

1.4 THE NEED FOR A FACILITATOR 11

2. PRINCIPLES THAT SHOULD GOVERN REFORM **13**

3. ATMS **17**

3.1 EXISTENCE OF SUBSTITUTES TO FOREIGN ATMS 17

3.2 INTERCHANGE PRICES 18

3.3 COMPETITION WITHIN THE DISCRETE MARKET FOR ATM SERVICES, INCLUDING ACCESS CONSIDERATIONS 18

3.4 ALTERNATIVE MODELS OF ATM ACCESS BY CARDHOLDERS 19

3.5 IMPEDIMENTS TO CHANGE 20

3.6 ROLE FOR GOVERNMENT 20

4. CREDIT CARDS **21**

4.1 INTERCHANGE FEES 21

4.2 ECONOMICS OF ISSUING AND ACQUIRING BUSINESSES 25

4.3 ACCESS TO CREDIT CARD NETWORKS 28

5. DEBIT CARDS **30**

5.1 DEBIT CARD INTERCHANGE ARRANGEMENTS 30

5.2 VISA DEBIT CARD 32

5.3 ACCESS TO DEBIT CARD NETWORKS 33

5.4 ROLE FOR GOVERNMENT 34

EXECUTIVE SUMMARY

Banks have made an important contribution to dynamic efficiency in consumer payment systems over the past 25 years. They have been responsible for extensive innovation, resulting in a wide range of low cost and flexible consumer payments instruments. These have been of significant benefit to the Australian community. Arguments about the merits of existing interchange and access arrangements for credit and debit card schemes need to be considered in the context.

This does not mean that some criticisms of the schemes are not valid, or that changes are not needed. Indeed, Westpac strongly supports the need for reform. The Study makes a number of constructive suggestions with regard to debit cards and ATM interchange. It is, however, deficient in a number of respects, particularly (but not only) in relation to credit card reform. Thus, while the Study is a step forward, in Westpac's view it provides an incomplete framework for reform.

Westpac recommends the involvement of a facilitator (we suggest the Payment Systems Board ("PSB")) to aid reform which will otherwise be very difficult due to:

- the nature of the web of bilateral contracts that govern ATM and debit relationships that create practical difficulties in finding a new equilibrium shared by all participants;
- the inter-relationship between credit and debit card schemes;
- the global nature of Visa and MasterCard; and
- a need for effective communication of the overall benefit of reforms for the community, as consequential pricing changes will impact stakeholders, including cardholders, differently with winners and losers.

The PSB in its Year 2000 Annual Report acknowledges it has a role to play here. In a different context the Annual Report acknowledges on page 9 that "a single payment provider cannot reform a payments system; it must convince other providers of the need to change and to make the investment that would bring it about. The result too often, is movement at the pace of the slowest".

Westpac endorses the need for payment system networks to be efficient and equitable in meeting the needs of the Australian community. To this end, it suggests a number of principles that should govern reform of credit and debit card schemes and their on-going operations.

Those principles are:

1. An efficient payment system should be acknowledged to exist where pricing of different payment instruments is transparent, so that there are clear price signals to which consumers, merchants, card issuers, card acquirers and other interested parties can respond;

2. Reform of debit and credit card schemes should be pursued jointly, given the substitutability of the cards for each other for both merchants and cardholders;

3. Costs and profit associated with the acquiring and issuing of credit and debit cards should continue to be recovered through a combination of merchant fees and fees levied directly on cardholders. Additionally, interchange fees are an appropriate mechanism to enable card issuers to recover costs and share some of the benefits derived by merchants;

4. To avoid pricing distortions that may favour one payment instrument over another and to ensure competitive neutrality among providers, there should be no prescriptive application of costing or pricing models for interchange;

5. Any interchange model adopted should be designed to ensure that the interchange fee:

- recovers all direct and indirect costs, including the cost of capital where appropriate, incurred by credit and debit card issuers where the benefits flow to merchants; and

- encourages investment in innovation.

6. Card issuers should be free to price their products in an unfettered manner to cardholders through annual fees, interest rates or other fees levied directly on them. Such fees should be set by issuers unilaterally and be subject to market forces;

7. Card issuers should use interchange fees to recover from acquirers, compensation for the benefits which acquirers can offer their merchant customers accepting credit and debit cards compared with other payment instruments. Such fees may have regard to externalities where these exist and would not otherwise be captured;

8. Card acquirers should be free to recover all their costs through the merchant service fee. Such fees should be set by acquirers in negotiations with merchants, and thus be subject to market forces;

9. There should be freedom of entry to all areas of the payments system, access being on appropriate commercial terms and subject to the preservation of confidence in, and stability of, the system;

10. Appropriate transitional arrangements should be agreed between the industry and the authorities that provide for reform to be agreed and implemented over a reasonable time frame; and

11. Acceptance of these principles, and implementation of reform to give effect to them, should be seen as creating credit and debit card arrangements that will meet the Australian community's future needs for efficient consumer transactions in a way which ensures the on-going stability of the payments system.

ATMs

Westpac agrees that charges for cardholder access to other institutions' ATMs (third party access) are high relative to costs. That said, many cardholders have shown themselves to value convenience over price, as they do have the ability to obtain cash without fees through many of the 300,000 EFTPoS terminals nationwide.

There are two models of access to third party ATMs by cardholders:

- The first involves an interchange fee charged from the ATM owner ("acquirer") to the cardholder's bank ("issuer"). The issuer sets a "foreign ATM fee" which enables it to recover its costs as issuer, as well as the interchange fee;

- The alternative "direct charging" model causes the ATM owner to levy a fee at point of interaction and pass this fee back to the issuer. The cardholder has the option during the transaction of stopping it if they do not wish to pay the fee.

The latter option provides greater transparency and the ability for cardholders to respond to the 'price signal'. It also opens the location, range of services and pricing of those services for each ATM to market forces. Researching cardholder preferences is required to confirm this is the preferred option.

In the absence of facilitation by the PSB there is a significant likelihood of both models co-existing in the market with consequent risk of duplicated fees to some cardholders.

There are a number of impediments to change:

- Prices for access to third party machines ("foreign ATMs") are set through a series of bilateral arrangements. This is not conducive to open dialogue across all ATM owners that will facilitate a co-ordinated move to a new business model;

- The speed of implementation will be affected by the need for system changes across the industry.

Credit cards

Westpac accepts that there is a need for some change to existing credit card schemes. Given the substitutability of credit and debit cards for each other, both for merchants and cardholders, any changes need to relate to both schemes and be made concurrently.

There appear to be two primary philosophies about the setting of credit card interchange fees:

- One approach relates to balancing the overall performance of the issuing business with the overall performance of the acquiring business. This has regard for both costs and benefits incurred by merchants, acquirers and issuers;

- The other method is simply to consider interchange as that set of costs of the card issuer that directly benefit the merchant and which therefore need to be reimbursed to the issuer by the merchant. This approach might best be described as "issuer cost reimbursement".

Westpac has significant concerns about some of the assumptions and findings in the Study:

- The finding that the credit loss element of the interchange reimbursement is already being recovered by high interest rates and that 'double dipping' is therefore involved, is erroneous;
- It is inappropriate to conclude that loyalty points are not a 'resource cost' and should therefore be ignored in any cost model. The cost of these is a legitimate marketing cost; and
- The Study doesn't differentiate between consumer cards and commercial cards. Commercial cards operate like a charge card without interest on balances.

An agreed interchange model should enable issuers to recover all direct and indirect costs, including the cost of capital, and facilitate investment innovation.

The effect of the "no surcharging" rule is lessened in the Australian market by the fact that merchants can discount for cash. In any event, Visa and MasterCard are unlikely to agree to have one rule on surcharging for Australia and one for the rest of the world.

[Paragraph containing commercially sensitive information omitted]

Underpricing of interchange greatly risks a worse efficiency and access outcome. Higher prices to cardholders would see the higher cost closed system card products, such as Amex and Diners, gaining market share.

The Study's analysis of access to credit card networks does not conclusively demonstrate that there are non-commercial barriers to entry. A committed entrant with the necessary capital and capability to compete can enter the Australian market. However, lack of positive credit reporting may discourage entrants.

Westpac does not believe that the current membership restrictions of Bankcard are a hurdle to a serious player with the resources necessary to maintain confidence in the Bankcard system.

Westpac is not opposed to different access criteria, but wishes to understand the nature of the gap between existing access criteria and those criteria the authorities consider appropriate having regard to the specific risks faced by participants and the need to preserve stability and confidence in payment systems.

Westpac accepts the need to review existing arrangements, subject to the following:

- Costs and profits associated with the acquiring and issuing of credit cards should continue to be recovered through a combination of merchant fees and fees levied directly on cardholders. Interchange fees are an appropriate mechanism to enable card issuers to recover costs and share some of the benefits derived by merchants;

- Card issuers should be free to price their products in an unfettered manner to cardholders through fees levied directly on them. Such fees should be set by issuers unilaterally and be subject to market forces;

- Card issuers should use interchange fees to recover from acquirers, compensation for the benefits which acquirers can offer their merchant customers by accepting credit and debit cards compared with other payment instruments. Such fees may have regard to externalities where these exist and would not otherwise be captured; and

- Card acquirers should be able to set merchant service fees, subject to market forces, to recover all their costs.

Debit cards

The existing business model for provision of debit card services needs to be reformed. The "issuer pays acquirer" (negative) interchange model in Australian debit card services is resulting in inappropriate behaviour by all participants. A positive issuer cost reimbursement fee ("acquirer pays issuer") would close the gap between debit and credit card pricing to merchants.

However, achieving this will prove difficult:

- For major retailers, debit card rebates are an important source of revenue. They retain a strong negotiating position and could deny access to cards issued by institutions that refuse to pay for their transactions; and

- Acquirers have a privileged position with merchants and no incentive to accept positive interchange fees, as this would similarly reduce their revenue.

The PSB should seek reform of debit card arrangements by:

- Facilitating negotiations between major retailers and debit card acquirers and issuers, to discourage efforts by the first two groups to exercise market power;

- Ensuring that interchange fees involving large retailers are changed concurrently, so that institutions reducing interchange fees are not at a disadvantage relative to others in being able to offer rebates to retailers;

- Encouraging the finance industry and retailers to link this reform with that of credit card interchange fees so as to achieve an acceptable net outcome; and

- Encouraging phased implementation so as to preserve a level playing field at all times.

The Visa branded debit card accounts for about 10.5% of all Visa card transactions. The interchange applying to this product flows from acquirer to issuer as Westpac would wish EFTPoS debit card interchange to flow. However, the quantum of interchange is excessive given that the transaction is processed as a credit transaction without credit risk or the need to fund immediate settlement. It needs special focus from the authorities, reducing costs to retailers and facilitating other reforms which retailers might otherwise resist.

1. General observations about the Study

1.1 A broader perspective on payment systems reform

The Study examines existing credit and debit card arrangements, particularly interchange fees and possible limitations on access, having regard for the efficiency and stability of this part of the payments system. Its focus, inevitably, is on whether these arrangements are an appropriate framework for the future, given the passage of time since many of them were put in place and changes that have occurred in technology and customer behaviour.

Whatever the merits of existing arrangements, Westpac is concerned that the Study has downplayed the significant benefits they have delivered to the Australian community over the past 25 years. The remarkable innovation that has occurred over this period has resulted in a wide range of low cost and flexible consumer payments arrangements.

The Study is quick to highlight a perceived dilution of *allocative efficiency* associated with inappropriate pricing signals. It is not so quick to acknowledge the important contribution banks have made to *dynamic efficiency* through the development of many alternative payment instruments. This has been of enormous benefit to the Australian community.

It is worth noting some of the payments system initiatives banks have taken:

- ATMs – “own bank” and later “foreign bank” access
- EFTPOS
- Direct credit
- Direct debit
- Credit cards
- “On-line” banking
- Banking by telephone
- B-pay

These various payment options have entailed considerable investment by banks, and costs that have been passed on in varying degree to users. It is easy to criticise situations where the beneficiaries do not bear the costs in direct proportion to the benefits they receive. But it is, in fact, difficult to align these at any given point in time. It is easy to identify costs, but far more difficult to quantify and allocate benefits, the more so when it may take time for these to become apparent.

Sponsors of new payments instruments or arrangements have to bear the cost of developing them until such time as the benefits are appreciated and consumers are willing to pay for them. When they do seek to recover these costs, however, they are often subject to intense criticism as to the level of fees imposed. It is often a “no win” situation for banks.

This is well illustrated by the financial history of credit cards at Westpac. Based on reasonably reliable data, the cumulative after tax operating losses of Westpac’s credit card businesses (issuing and acquiring) from 1981 until 1990 totalled nearly $100 million. It was not until 1997 that cumulative profits after tax became positive. The 19 year profit history of the Westpac cards business if discounted at the bank’s current cost of capital, is still negative.

All this is not to say, however, that some of the criticisms are not valid, or that changes are not needed. But concerns do need to be kept in perspective, with an equal awareness of the benefits that different payment instruments deliver to the Australian community.

1.2 Westpac finds the objectives of the Study too narrow to achieve desirable public policy outcomes

The Study had four stated objectives:

- To obtain information on interchange fees paid by financial institutions;
- To clarify the basis on which interchange fees are set, looking particularly at the role of costs;
- To assess whether current interchange fees are encouraging efficient provision of debit and credit card services; and
- To obtain information on current restrictions on credit card scheme membership.

Westpac believes the Study is a step forward in helping understand the issues. However, the analysis and conclusions are deficient in identifying the reforms that would best meet public policy objectives. To a significant degree, this appears to be because the objectives are too narrow in scope. Westpac proposes that the public policy objectives should be to:

- Produce the most economically efficient payments systems;
- Ensure public and business confidence in the stability and certainty of payments systems;
- Increase transparency of pricing of various card payment services to users so that they can better respond to price signals;
- Promote competition in the market for card payment systems consistent with the overall stability of the financial system; and
- Ensure that Australia is able to participate competitively in the emerging “on line” global economy by having consumer payments systems that positively support participation by Australian businesses in these opportunities.

Westpac understands the authorities do not wish to regulate pricing of card systems, either to merchants or consumers, and that they favour letting market forces determine pricing. This is consistent with the view, on page 5, that retail charges and fees are not the focus of the Study.

Contrary to this statement, the Study’s focus on “wholesale pricing structures in credit card and debit card scheme” means that it is directly and intimately concerned with how retail charges and fees are calculated, and their level. The very notion of cost models, and focus on margins, implies interfering with prices currently determined by market forces.

This criticism of the Study takes on added force insofar as it contains views which are subjective, such as the conclusion that the costs of loyalty programs should be excluded from any cost models. It is surprising that the Study comments on the acceptability of

recognising different costs; such comments indicate an incomplete understanding of the commercial dynamics of the marketplace.

The Study says it "is mindful that its findings on credit card schemes may have implications for the competitive position of credit cards vis-à-vis store cards and charge cards". However, nowhere does it assess or discuss these implications.

Westpac believes that, given the relationships between alternative payment instruments, efficient consumer payment systems are most likely to be achieved where the relativities of all payment instruments used by consumers to pay merchants are analysed in terms of consumer acceptance, as well as pricing.

1.3 Study has not met all its objectives

In Westpac's view, the Study has some significant limitations.

1.3.1 Inconclusive about an appropriate basis for interchange fees

Westpac would suggest that the Study has not met its objective of clarifying the basis on which interchange fees are or should be set. It is not clear which of the two completely different philosophical approaches to the establishment of interchange is most appropriate. The two approaches are outlined on pages 29-30 of the Study.

Additionally, the Study does not improve understanding of the process by which interchange fees are set (in contrast to how they are priced) and consequences for change. Interchange fees are set, in the case of ATM access charges and debit card access, on a bilateral basis between participants.

This raises very real trade practices constraints affecting existing commercial and legal relationships between participants. The bilateral contracts typically have no foundation for a review of pricing in a way that is consistent across the industry. In addition, the networked nature of the market imposes hurdles to any change in pricing between counter parties to these contracts.

1.3.2. Inconclusive about whether current fees encourage efficient provision of services

There are two limitations to the Study that stand in the way of meeting this objective.

1.3.2.1 Data Limitations

Data limitations in the Study hinder the Study's ability to meet fully the objective of assessing whether current interchange fees are encouraging the efficient provision of debit and credit card services. The data on which many of the conclusions are based is deficient in a number of respects, which point is alluded to in various places in the Study.

- In collecting the data, there was limited guidance as to the basis for calculating the information required. In particular, no rules were set as to scope of indirect costs such as overheads. As examples of indirect costs, Westpac includes an allocation for the direct cost of receiving monthly credit card payments through its branch network, and includes the cost of funds to its acquiring business of the 24 hour delay between merchant settlement and recovery of funds from issuers;

[Paragraph containing commercially sensitive information omitted]

- The Study acknowledges on page 38 (for ATM services) and page 46 (for credit card issuing and acquiring) that the participants were generally unable to supply information about the capital employed in these activities. The cost of capital and rate of return are a vital consideration in determining the economics of activities such as these;

- The data as presented is an averaging of the costs of different types of transactions, and as such does not highlight the different costs associated with different processing methods. An electronic card transaction has vastly different economics to an “on line” transaction or a transaction processed by “old fashioned” paper vouchers and operator-assisted authorisation. The mix of transaction types will vary greatly between participants; and

- The Study does not differentiate between commercial cards and consumer cards which have quite different economics. Commercial cards are charge cards relying on interchange to recover the cost of providing the interest free period.

Westpac acknowledges that a detailed and thorough interchange Study has not been done for each of the three credit card schemes, in some cases for many years. It believes the appropriate way forward is now to have expert accountants do such studies in a rigorous manner with consistent data.

1.3.2.2 Limitations about findings on access

Whilst the Study has provided some information on restrictions to access, the issues are not rigorously analysed. As a consequence, the conclusions on access do not conclusively demonstrate that there are non-commercial barriers to entry or that scheme rules on access are really an impediment to committed entrants with the resources necessary for long term success which is essential to the preservation of system stability. Nor do they take account of other barriers, such as the lack of positive credit reporting which, because of Australian privacy legislation, stands in the way of more competition in card issuing. This particular barrier is understood to have delayed entry of US-based card specialists, such as Capital One and MBNA.

In the case of acquiring, potential entrants such as telecommunication service providers, specialist switches or terminal equipment manufacturers may be dissuaded by putting existing commercial relationships at risk.

More should have been done to explore the very real operating and financial risks faced by participants (such as a participant failing to settle) so as to provide the foundations for alternative criteria for participation in card payment systems. Westpac is not opposed to different access criteria, but wishes to understand the nature of the gap between existing access criteria and those criteria the authorities consider appropriate, having regard to the specific risks faced by participants and the need to preserve stability and confidence in payment systems.

1.4 The need for a facilitator

Westpac believes that reform will be very difficult without the intervention of a facilitator, as this is a high stakes game for all participants.

- Existing arrangements are governed by bilateral contracts between participants. Reform requires all the participants in the industry to accept change. However, in the case of debit cards and to a lesser extent “other bank” ATMs, the bilateral nature of contracts creates practical difficulties in moving all participants to a new equilibium;

- Based on the findings of the Study, reform to both credit and debit card schemes concurrently will probably result in “give and take” between financial institutions and major retailers. Current regulatory action in credit card interchange pricing does not provide for banks to gain any offsetting benefits from reform of debit card arrangements;

- The global nature of Visa and MasterCard, with rule changes requiring special resolution by their Boards of Directors, means any rule changes for the Australian market may need to be achieved by legislation or regulation; and

- A likely consequence of reform will be changes in pricing to the various participants. Some will see themselves as winners and others as losers. An official facilitator should be able to provide guidance as to the most appropriate way of communicating the “benefits” of the reforms to the Australian community.

The PSB Year 2000 Annual Report acknowledges that whilst the onus is on participants to move quickly to introduce more efficient arrangements, there are barriers to movement, and therefore there is a role for the PSB to help facilitate change without resorting to use of its reserve powers. Westpac is highly supportive of such a role for the PSB. Indeed, without playing this role Westpac fears the PSB will unnecessarily need to resort to exercising its reserve powers.

2. Principles that should govern reform

Westpac endorses the need for payments system networks to be efficient and equitable in meeting the needs of the Australian community. To this end, it suggests a number of principles that should govern reform of credit and debit card schemes and their on-going operation.

2.1 An efficient payment system should be acknowledged to exist where pricing of different payment instruments is transparent, so that there are clear price signals to which consumers, merchants, card issuers, card acquirers and other interested parties can respond.

It is generally accepted that the ability of consumers and suppliers to respond to transparent pricing will ensure that resources are allocated to their most productive use – *allocative efficiency*.

2.2 Reform of debit and credit card schemes should be pursued jointly, given the substitutability of the cards for each other for both merchants and cardholders.

Where the arrangements accord with the above principles, pricing arrangements within the industry should be developed within a co-regulatory framework facilitated by PSB. Various bilateral agreements cannot readily be renegotiated without being facilitated by the PSB because of competitive disadvantages that will arise where negotiations are not concurrent. PSB involvement will also be required to the extent that the rules of international organisations are an impediment to outcomes it believes are desirable.

Such an approach is consistent with the approach outlined in the PSB Year 2000 Annual Report.

2.3 Costs and profit associated with the acquiring and issuing of credit and debit cards should continue to be recovered through a combination of merchant fees and fees levied directly on cardholders. Additionally, interchange fees are an appropriate mechanism to enable card issuers to recover costs and share some of the benefits derived by merchants

This is consistent with the view in the Study that "… a pricing system based on interchange fees still seems to be the most practical arrangement for the credit card network …" (page 79). The issue is the level of interchange fees relative to fees charged directly to merchants and cardholders.

It is quite possible that the interchange fee received by debit card issuers will be positive where merchants do receive a benefit relative to alternative payments instruments (eg. cash). To the extent that issuers incur costs associated with debit transactions, while the merchant receives a benefit, it is appropriate that issuers should receive some payment from merchants, via acquirers.

In the case of credit cards, where the costs to issuers and benefits to merchants are greater, the positive interchange fee paid to issuers is likely to be greater.

2.4 To avoid pricing distortions that may favour one payment instrument over another and to ensure competitive neutrality among providers, there should be no prescriptive application of costing or pricing models for interchange

Such models should allow for a range of acceptable interchange prices, reflecting the diversity of cost structures within the industry, with transparent prices to cardholders and merchants allowing market forces to determine any other fees imposed. Prescribed models may, in fact, drive providers out of business. If prices are set too low, in the absence of cross subsidisation, issuers could only remain in business at a loss, creating payments system instability. The withdrawal of issuers may also encourage the growth of closed payments systems such as American Express and Diners Club with higher cost to merchants and hence lower overall economic efficiency.

It is important to avoid a situation where the authorities decide one payments instrument (eg. direct debits) is more “efficient” than another (eg. credit cards) and use cost models to influence pricing accordingly. A number of factors other than price (eg. convenience and control) influence consumer behaviour. If the authorities were to try to “pick winners”, this could inhibit competition and lead to a significant distortion in market forces.

2.5 Any interchange model adopted should be designed to ensure that the interchange fee.

- **recovers all direct and indirect costs, including the cost of capital where appropriate, incurred by credit and debit card issuers where the benefits flow to merchants; and**

- **encourages investment in innovation.**

Direct costs should include marketing costs, such as loyalty points, which are a justifiable marketing cost and benefit the merchant by facilitating spending by consumers. The costs of innovation need to be recognised explicitly as these are likely to rise in coming years with investment in new technology. If these were not included in any definition of acceptable costs, *dynamic efficiency* would be compromised.

Another aspect of innovation which cost models need to take into account is sub-segmentation of activities, where different institutions choose to provide different services. As different activities incur different costs, these need to be costed appropriately to avoid distortions. For example, introduction of smart cards may provide added benefits to merchants substituting for cash. If interchange cost models are static they may result in inappropriate pricing signals, discouraging innovation.

The risk of the authorities basing decisions about acceptable cost recovery and profitability on a cost model is that such models are inherently static. They do not allow for changing market conditions and the interplay of market forces.

2.6 Card issuers should be free to price their products in an unfettered manner to cardholders through annual fees, interest rates or other fees levied directly on them. Such fees should be set by issuers unilaterally and be subject to market forces.

Direct recovery is consistent with transparent pricing, and with customers having the ability to adjust their behaviour in response to prices set by the card issuer. Such an approach leaves the level of such fees to be determined through market forces. The Study notes that

the "balancing of private benefits and costs provides one of the essential market disciplines" (page 24).

2.7 Card issuers should use interchange fees to recover from acquirers, compensation for the benefits which acquirers can offer their merchant customers accepting credit and debit cards compared with other payment instruments. Such fees may have regard to externalities where these exist and would not otherwise be captured.

Merchants receive benefits from credit card issuance through such factors as their impact on customer spending levels, the ability to offer customers credit with little or no credit risk, the prompt availability of funds after transactions are completed and efficiency of payment processing compared to other instruments. They also receive benefits from debit card issuance through such factors as immediate settlement of funds, guarantee of payment and delivery of transaction information. Credit and debit card transactions each entail costs for merchants, but so do alternative payments instruments.

The Study accepts the validity of interchange fees to capture externalities (pages 24-27). There may be a need to capture externalities that exist generally as well as in new market segments such as the internet and B2B commerce. Externalities are unlikely to be significant in the case of debit cards.

2.8 Card acquirers should be free to recover all their costs through the merchant service fee. Such fees should be set by acquirers in negotiations with merchants, and thus be subject to market forces.

The cardholder initiates the transactions, whether this involves credit or debit cards, and this creates both a cost and a benefit for the merchant. No interchange fee or netting out against the fee reimbursing issuers for their costs is appropriate in these circumstances.

2.9 There should be freedom of entry to all areas of the payments system, access being on appropriate commercial terms and subject to the preservation of confidence in, and stability of, the system.

The focus of the Wallis Report on "appropriate commercial terms" for more liberal payments system access (page 398) is reflected in the Explanatory Memorandum for the Payments Systems (Regulation) Bill 1998. To ensure that new distortions are not introduced, careful analysis is required so that perceived barriers to entry are not removed when they are, in fact, necessary for prudential or commercial reasons.

2.10 Appropriate transitional arrangements should be agreed between the industry and the authorities that provide for reform to be agreed and implemented over a reasonable time frame.

This is necessary as the resolution of bilateral arrangements involving debit cards and ATMs, and the revision of existing external arrangements which are beyond the direct control of banks (eg. involving MasterCard and Visa), may take considerable time and may require legislative or regulatory intervention. As well, card issuers, acquirers and merchants will need sufficient notice to prepare for the changes, given the time required for system enhancements, training, etc.

2.11 Acceptance of these principles, and implementation of reform to give effect to them, should be seen as creating credit and debit card arrangements that will meet the Australian community's future needs for efficient consumer transactions in a way which ensures the on-going stability of the payments system.

Any new set of arrangements should be prospective and clarify that they do not involve any admissions in relation to past conduct. This is necessary to ensure the co-operation of banks in securing meaningful reform of credit and debt card schemes. Any suggestion of proceedings in relation to the past can only impede the reform process.

3. ATMs

Westpac agrees with the findings of the Study that foreign ATM access charges are high relative to costs, and has made this observation in prior correspondence with the Reserve Bank. Westpac also agrees with improving transparency in charges to cardholders.

There are, however, very real impediments to migrating the current business model based on interchange to an alternative model based on direct charging at point of interaction. The impediments are discussed later in this section.

3.1 Existence of substitutes to foreign ATMs

The Study has not fully considered the various substitutes for access by cardholders to cash and the relative costs to consumers of these substitutes. Westpac acknowledges that retail fees and charges were not the focus of the Study.

In Westpac's view it is not possible to come to a holistic view of debit and credit card reforms without an end to end perspective on the market. There are four main ways in which customers can access cash from their accounts:

- over the counter cash at an "own bank" branch;
- at an "own bank" ATM;
- at a third party owned (foreign) ATM; and
- via EFTPoS.

In addition to accessing cash, consumers also access account information. (Account information is not available at EFTPoS but is available via Telephone Banking or 'on line'.) The Study is deficient in not giving statistics of the volume of these various types of transactions across the industry so that a more fully informed debate could occur about substitutes.

The highest cost of accessing cash is "over the counter" after a customer has used up all their free "over the counter" transactions. The least costly in many cases is cash back at retail point of sale. It is surprising to Westpac that the Study and other commentators have not highlighted much more the essentially "fee free" access customers have to cash at point of sale. This type of access benefits all participants – it helps retailers manage their cash float so as to minimise risk of theft and trips to the bank, while it offers fee free access to cash at many of the 300,000 EFTPoS terminals throughout Australia. Westpac debit cardholders make over 20 million withdrawals of cash every year using EFTPoS, totalling over $1 billion.

Westpac obviously encourages its account holders to use Westpac branded ATMs wherever possible, and encourages third party account holders to use Westpac ATMs. Westpac introduced access to ATMs owned by other financial institutions as a way of providing convenient alternative choices to its account holders, albeit at a price premium, and in turn sought to attract use by the account holders of competitors as a way of enhancing its return on the considerable investment it has made in a fleet of 1500 ATMs across Australia.

It is important to keep the ATM interchange fee in perspective. Cardholders do have cheaper options than using foreign ATMs. The fact that they continue to use the latter, and pay the price of doing so, indicates they value convenience over price.

Westpac nevertheless recognises that, despite the option of "fee free" cash at point of sale, there is community concern about the cost of access to cash at ATMs owned by a bank other than the cardholder's own bank. In Westpac's experience this concern is usually most vigorously expressed by account holders of competitors with relatively few ATMs. Given that many account holders bank with an institution that owns relatively few ATMs, the cost to these consumers will be higher than if they were to bank with an institution that owns a large fleet of ATMs. ***[Sentence containing commercially sensitive information omitted]***

[Paragraph containing commercially sensitive information omitted]

3.2 Interchange prices

While the price of third party ATM transactions is high relative to cost, these are transactions priced at the margin against readily available alternative lower cost sources of cash. The cardholder is looking for convenience and is clearly prepared to pay for it.

Westpac sees nothing in free market economics that says it should not seek to recover costs plus an appropriate margin from consumers who are not price sensitive and choose to use foreign ATMs when other, low cost ways of accessing their accounts are readily available.

Westpac has invested $60 million in ATM equipment and associated switching equipment over the last 7 years, and believes that it should operate in a market where it can price its services to generate an acceptable return to shareholders on this fixed capital and associated operating risk.

That said, Westpac can see arguments in moving to a "direct charging" methodology as outlined below.

3.3 Competition within the discrete market for ATM services, including access considerations

The graph at page 13 of the Study does not highlight the introduction of so-called "white label" ATMs, typically owned by cash courier companies and by private owners. These ATMs are "hosted" into the network by participants who take a margin for this function, and then pass back to the "white label" owner a substantial portion of the existing interchange fee. The increasing predominance of these rebates is becoming an increasing impediment to future reduction of bilateral interchange fees.

Westpac has no information as to the number of ATMs in the market that are not owned by financial institutions, but estimates that they now account for between 5% and 10% of all machines, and are gaining market share quite rapidly. Westpac is aware of investment schemes being promoted for private ownership of ATMs. This is clear evidence that the market is growing.

Existence of these white label ATMs is reducing “transparency” as users are unable to easily see who owns the machine and whether a fee will be payable.

The above comments suggest that the observation in paragraph 3 on page 40 of the Study about access constraints faced by new ATM owners is not true in practice. Nor does the observation about access constraints faced by small card issuers in paragraph 2 seem correct in practice as small issuers are hosted by special purpose gateways such as First Data Resources Australia (“FDRA”) or Cashcard Australia.

Westpac has direct ATM interchange links with the other three major banks, through FDRA, Visa and MasterCard. FDRA acts as a gateway to all other ATM participants in the Australian market and most other domestic card issuing financial institutions. Thus issuers can either negotiate with Westpac directly for access if they have sufficient volume, or they can negotiate for access via FDRA or Cashcard. Westpac does not deny access to these small issuers as it is clearly in Westpac’s interest to acquire ATM transactions from their cardholders. These smaller issuers do however clearly bear a higher cost of access due to their small scale and need to use a gateway.

3.4 Alternative models of ATM access by cardholders

Westpac sees two models of access to ATMs by account holders:

- The first is via an interchange fee which is charged from the ATM owner (“acquirer”) to the cardholder’s bank (‘issuer”). The issuer sets a “foreign ATM fee” which enables it to recover its costs as issuer, as well as the interchange fee.

- The alternative “direct charging” model causes the ATM owner to levy a fee at the point of interaction. The cardholder has the option of cancelling the transaction prior to completion if he or she does not wish to pay the fee.

The first interchange model operates in Australia today.

3.4.1 Transparency of charges to cardholders

Westpac favours greater transparency, but not in circumstances where excessive technology costs are likely to produce marginal benefits. Westpac is concerned that a public policy approach which requires the real time disclosure of fees payable by cardholders (having regard to each cardholder’s free transaction status) will impose enormous system costs that will need to be passed on to users. The cost will obviously be even greater for third party ATMs than for a bank’s own ATMs.

The benefit of the “direct charging” method outlined in the Study is that the cardholder clearly sees the fee imposed by the ATM owner and can decide to abort the transaction and not incur the fee before the transaction is concluded. In contrast, in the existing interchange model, the cardholder needs to know what the fees are that are charged by his or her financial institution for a third party ATM transaction as typically there is no shelter to a cardholder from third party ATM fees via a free transaction limit. This is due to the fact that the issuing institution always incurs a charge from the owner of the ATM used by the cardholder which it reasonably wishes to recover from the account holder.

The focus of public policy on issues of efficiency clearly favours a direct charging methodology because of the direct price signals involved and the ability of cardholders to

respond to them. Consumer research is appropriate to test scenarios with users, and hence to confirm which of the 2 models is preferred, particularly as there is some evidence of consumer resistance in other markets where this change has occurred.

3.4.2 Impact on competition in the market for ATM services

Introduction of direct charging takes away certainty of income from interchange and opens the location, range of services and pricing of those services for each ATM to market forces. In response, ATM owners can be expected to bid for attractive spaces and develop additional services such as ticketing and phone card recharging that will attract usage. Westpac would expect that quite a large increase in fleet size might eventuate which will ultimately find a new equilibrium where new investment will continue until marginal returns are unable to support further investment.

3.4.3 Costs incurred by issuers not recognised in the Study

As noted above, there are costs incurred by the issuer in a third party transaction which do not appear to be considered by the Study. In Westpac's case, a $1.25 charge is levied on cash withdrawals made by its account holders at third party ATMs. A significant portion of the mark up between the interchange cost of about $1 per transaction and the $1.25 charge is consumed by the costs it incurs as issuer.

3.5 Impediments to change

The existing interchange model is governed by a series of bilateral arrangements which set prices for access. Whilst this legal structure protects participants from any trade practices legal risks, it does not facilitate open dialogue across all owners of ATMs so that the industry can move in a co-ordinated manner to the different business model.

An additional impediment, which will affect the speed with which any decision for change can be implemented, will be the required investment in system development.

Westpac sees merit in a "direct charging" methodology and is prepared to enter into bilateral negotiations with counterparties to test the prospect of moving some participants to this model.

3.6 Role for Government

To test the willingness of ATM owners to move more quickly to a "direct charging" approach, Westpac believes the Government, ideally through the PSB, should poll owners or convene, with ACCC sanction, a meeting of owners to explore the issues in moving to this model, including the commissioning of consumer research. In the absence of such regulatory facilitation, change is likely to be slow as illustrated by the earlier quotation from page 9 of the PSB Year 2000 Annual Report.

The PSB may also wish to discourage the emergence of two models, as has occurred in the UK. Having two business models operating at the same time is confusing for account holders, and risks emergence of "double dipping" as some institutions without ATM fleets seek to retain existing third party ATM charges despite not incurring interchange with some players.

4. Credit cards

Westpac accepts that there is a need for some change to existing credit card schemes. Given the substitutability of credit and debit cards for each other, both for merchants and cardholders, any changes need to relate to both schemes and be made concurrently. The current joint bank review of interchange sanctioned by the ACCC addresses only credit card interchange. Westpac is concerned about the potential consequences of a less than comprehensive scope of review.

4.1 Interchange fees

It is true that credit card interchange fees have not been reviewed regularly in Australia. However, as acknowledged in the Study, this does not invalidate the use of interchange fees: "While a pricing system based on interchange fees still seems to be the most practicable arrangement for the credit card network ……" (page 70).

The central issue to be considered, therefore, is how interchange fees are set and their level.

There appear to be two primary philosophies about the setting of credit card interchange fees which are outlined on page 30 of the Study:

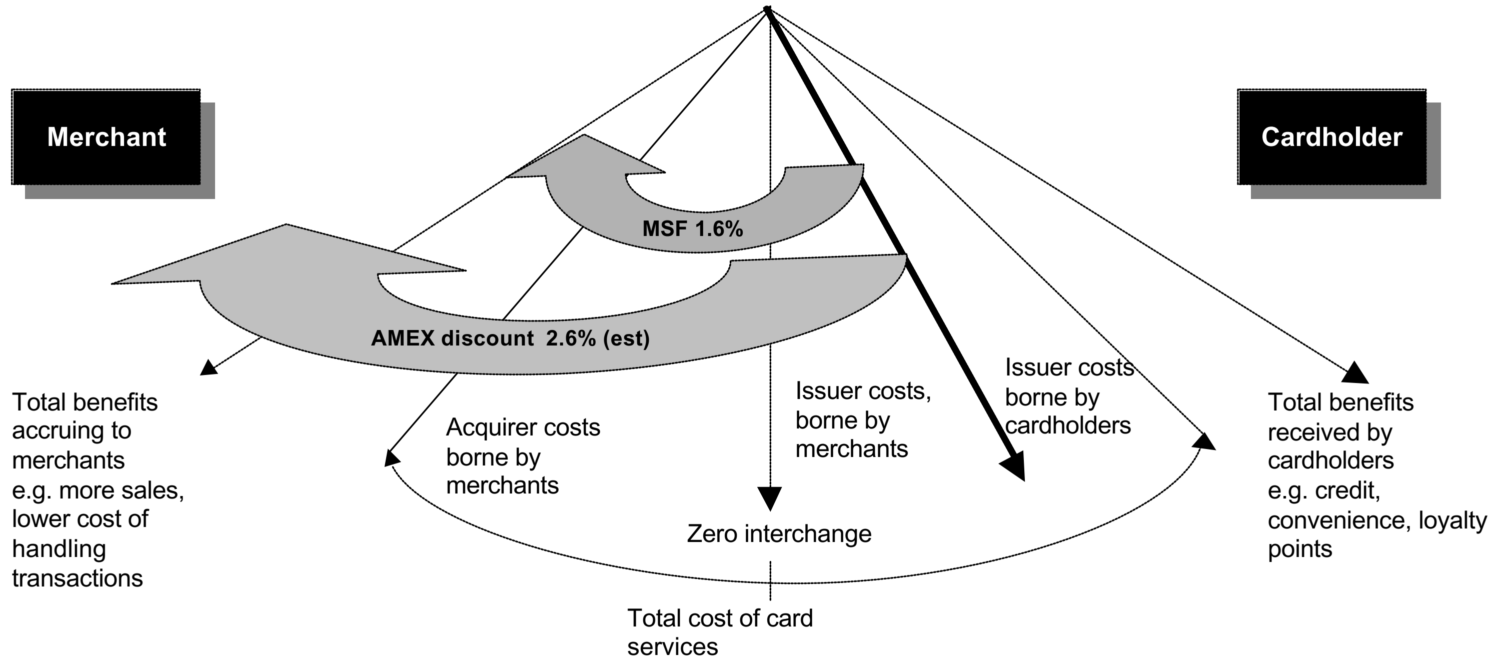
- One approach relates to balancing the overall performance of the issuing business with the overall performance of the acquiring business. This has regard for both costs and benefits incurred by merchants, acquirers and issuers so that cardholders don't pay for benefits derived by merchants; and

- The other method is simply to consider interchange as that set of costs of the card issuer that directly benefit the merchant and which therefore need to be reimbursed to the issuer by the merchant. This reimbursement occurs via the merchant's acquiring bank. This approach is described in this note as "issuer cost reimbursement".

The diagram below may aid an understanding of differing approaches to interchange and the discrete business activities of issuing and acquiring:

Card interchange pricing pendulum

Illustrative



	Acquirer costs	(Interchange)	Other issuing costs
Cost apportionment:			
Examples of cost	• Terminals • Merchant support • Sales/marketing	• Payment g'tee (authorisation, fraud, credit losses) • Immediate settlement	• Interest cost • Marketing/loyalty • Servicing • Embossing • Application approvals

The Study does not fully explore the nature of benefits to both merchants and cardholders. There clearly are externalities that benefit merchants such as access to a larger pool of cardholders, and arguably the benefits from increased sales driven by the availability of credit. It can therefore be argued that a proportion of those benefits should be incorporated in the interchange fee, for without the credit card scheme, merchant sales revenues would be less.

The analogy in the diagram is that the pendulum is set at a point between the issuer and the acquirer such that there is a fair distribution of the value of benefits in favour of the issuer. A consequence is that cardholder fees are kept relatively low, encouraging consumers to hold and use credit cards.

Merchants will continue to accept credit cards provided their merchant service fees (including any interchange component) are not above their perception of additional value generated. If interchange rates are set too high, merchants will refuse to accept credit cards, as it often the case with American Express or Diners Club which have high merchant discounts.

The alternative issuer cost reimbursement approach to interchange is solely focussed on that set of costs incurred by issuers that can be directly attributed to benefits received by merchants and which are to be reimbursed to issuers, based on the principle of accepting credit cards as a substitute for store credit. The pendulum in this case is set at a point designed to recover specific issuer costs from the merchant, that the merchant no longer incurs by ceasing to offer store credit in favour of credit card acceptance eg interest on the debtors' ledger, credit and fraud losses.

It is not apparent whether in fact there is an 'either/or' situation around these philosophies. For example an issuer cost reimbursement model could include the marketing costs of issuers that drive the growth in credit and hence in merchant revenues.

The Study addresses the issuer cost reimbursement model in some depth. Westpac has significant concerns about some of the findings and assumptions drawn.

- We have already addressed the data limitation of the study in para 1.3.2.1 above. Much more rigorous data than appears in the Study is required to support conclusions about interchange. Decisions based on erroneous conclusions may result in an outcome that is both economically inefficient and a source of potential payment system instability; and

- Westpac takes issue with the findings of the Study that the credit loss element of the payment guarantee within issuer cost reimbursement is already being recovered by high interest rates and that 'double dipping' is therefore involved.

  Under an issuer cost reimbursement model of interchange, the costs of providing payment guarantees, including credit losses that the merchant would bear if they provided store credit, are to be recovered through the interchange fee.

  The level of interest rates charged to cardholders is a function of costs associated with the provision of transaction services, consumer credit, and other benefits including loyalty points. Interest rates are determined by market forces.

To conclude that the interchange fee should not include reimbursement for credit losses because they are recovered by seemingly high interest rates is erroneous and risks destroying the integrity of the model of issuer cost reimbursement by preventing recovery of those costs that the merchant would bear if they offered store credit.

- Once agreement has been reached on the costs incurred by issuers that should be reimbursed by an interchange fee, there is the question of how these should be calculated for different types of transactions. With the growing penetration of credit cards into different markets, a range of interchange rates for differing categories of transactions is required eg. from interchange on electronically authorised transactions with card present through to internet transactions with card not present.

A wider range of interchange categories is now appropriate in the Australian market, to reflect different cost dynamics of different types and levels of service provided by issuers. For example, some issuers may choose to provide a guarantee of payment where the card is not present, the cost of which should be included in any interchange fee. In other cases where a guarantee is not provided, the interchange fee would be correspondingly less. Another example is the different costs of authorisation between “on line” authorisation and old fashioned operator-assisted authorisation for transactions above floor limits. Additionally interchange rates for commercial cards (“charge cards”) may be different to consumer cards.

The Study suggests on page 59 that “a formal cost recovery methodology would produce an interchange fee in Australia well below current levels. Such a view is based on incorrect assumptions, discussed above, about such factors as loyalty points, double dipping on credit losses and indirect costs, including the cost of capital. Indeed Westpac can see arguments to include some marketing costs that benefit merchants by facilitating credit-induced sales.

Adding the costs of loyalty programs of 46 cents per transaction as an item to be reimbursed by merchants in table 5.1 of the Study, would increase the aggregate cost recovery from merchants to $1.35 per transaction against current average interchange fees of 95 cents. It can be argued that Merchants should contribute to these marketing costs as they facilitate spending by consumers. This analysis also disregards whether merchants should contribute some of the 30 cents per transaction that the Study finds to be an acceptable rate of return on capital.

Westpac accepts that behaviour in some segments of the market, such as bill payment, and arguably purchase of staples, is substituting credit card transactions for cash, cheque or debit card transactions. These segments may derive less benefit from these marketing programs and therefore should bear less of their costs. They may however, derive benefit from lower payment processing costs and more prompt payment by consumers.

Westpac is reluctant to form a view as to the most appropriate method of calculating interchange ahead of the current review sanctioned by the ACCC. Westpac does, however, accept the need for an up to date review of interchange for each card scheme and the establishment of more categories of interchange.

4.2 Economics of issuing and acquiring businesses

There is a need to understand the benefits received by merchants and cardholders, and how acquirers and issuers should best price services in relation to these benefits. The Study does not adequately address this issue.

4.2.1 Issues specific to cardholders and issuing

It is simplistic to suggest, as the Study does, that there is an over-use of credit cards because they are under-priced. Acceptance of Westpac's views in the debit card section of this response will do much to redress this relative imbalance, with a positive interchange fee for debit card issuers leading to some substitution of debit card transactions for credit card transactions. This underlines the reason why credit and debit card interchange arrangements must be considered concurrently.

Westpac is concerned at the lack of understanding in the Study of the issues associated with the cost of loyalty programs.

- Firstly, it is wrong to argue, as retailers have done, that the interchange fee is used to pay for loyalty points. It is important to look more deeply at the economics of the credit card issuing business. As noted above, the interchange fee relates to costs of card issuers that directly benefit the merchants and which therefore need to be reimbursed to issuers by the merchant's acquiring bank. Marketing costs such as loyalty programs are not presently reimbursed to issuers. That is not to exclude the possibility of merchants contributing to the marketing costs of issuers where a benefit to the merchant can be proven, as may be the case, for example, in increasing merchant revenue due to availability of credit on a general purpose credit card; and

- Secondly, it is inappropriate for the Study to conclude on page 44 that loyalty points are not a "resource cost" and should therefore be ignored. Loyalty programs are an inducement for consumers to apply for and use a particular card, and are thus a legitimate marketing cost.

  Cards offered with loyalty programs cost cardholders more in interest rates and fees than cards whose use does not generate loyalty points, such as the recent introduction of a low rate no frills (ie. no loyalty points) card by St George Bank. The fact that a variety of cards compete successfully in the same market reflects that cardholders have differing views about the benefits of cards with and without loyalty points. Market forces are working successfully.

The reality is that any squeeze on one revenue stream will result in issuers developing alternative revenue streams. A realistic response to inappropriate reduction in interchange would be for issuers to increase annual fees or introduce transaction fees on credit cards. This could result in bank-issued credit cards becoming more expensive to the consumer relative to competing closed systems such as American Express and Diners Club, and hence loss of market share would occur in favour of these much more expensive and exclusive closed payment systems.

Commercial cards operate as a charge card without interest income on balances, and with cardholders taking advantage of the full interest free period. A different set of economics apply to these cards which must be reflected in interchange rates and the commercial terms in which they are offered in competition with American Express and Diners Club.

4.2.1.1 Financial Performance – Credit Card Issuing

The Study suggests on page 46 that only one bank was able to calculate the return on capital from the cards business. Westpac's overall rate of return on its "end to end" cards business in 1999 was 11%, and on the issuing business was 7%. These returns are below the Bank's hurdle rate on capital, and below reported returns on shareholders' equity of 18%.

[Paragraph containing commercially sensitive information omitted]

As earlier noted, loyalty costs of 46 cents per transaction have been omitted from table 5.1 of the Study. On page 44, the Study concludes that the mark up over cost in issuing is 39%, adding back the inappropriate elimination of loyalty costs would produce a mark up over costs of only 12.5%.

The Study suggests that a mark up over costs of 30 cents per transaction would provide a competitive rate of return on capital. Were loyalty costs of 46 cents per transaction to be added back to the costs on table 5.1, overall cost per transaction would be $2.39 and the margin earned against average revenue per transaction of $2.69 would be exactly 30 cents. Westpac therefore concludes that a more inclusive definition of costs in fact produces exactly the indicative rate of return that the Study finds acceptable.

4.2.2 Issues specific to merchants and acquiring

Merchants derive benefits from their decision to accept debit and/or credit cards. As discussed earlier, they may gain additional sales volume by offering the convenience of accepting a general purpose credit card. They also gain benefits of accepting payment in an electronic form without the costs associated with holding and processing cash or cheques.

4.2.2.1 Surcharging

All payment instruments incur costs for merchants. If there is to be a surcharge for credit card use, then price signals should also be required for using each of the other instruments, including cash. This is clearly impractical. To single out credit cards is unfair, when acceptance of cheques, debit cards and retailer store cards all incur costs to the merchant. Westpac is unaware of Australian data for these costs to the merchant, but US data gathered by the US Food Marketing Institute in 1998 shows:

Cost per $100 revenue starting with least costly payment instrument:

On Line debit	0.70
Cheques	0.95
Cash transactions	1.87
Visa	2.34
MasterCard	2.37
Off Line debit (see note)	2.43
Amex	2.79

Note: Off Line debit is a service where the transaction is approved without authorisation by the issuer. Visa debit cards in Australia are largely "off line" debit cards. Losses on this product are typically much higher than in the case of on line debit due to non payment by cardholders. These higher losses are reflected in the costs above.

Specific data is required for the Australian market: for example, the interchange rates for Visa and MasterCard are up to 0.80% lower in Australia than in the USA.

The effect of this rule is lessened in the Australian market by the fact that merchants can discount for cash.

In any event, MasterCard and Visa are unlikely to agree to have one rule on surcharging for Australia and one for the rest of the world. If the Government and regulators are determined to allow surcharging on credit cards then the only practical solution is to legislate, given the practical restrictions on convincing the card schemes to change their rules.

Westpac cautions the Government from proceeding with such action until a detailed study has been undertaken of the cost to merchants of alternative payment instruments, and consideration has been given to excessive surcharges at point of sale. There can be no certainty that consumers will be better off if surcharging for different payment instruments is legislatively enabled.

4.2.2.2 Additional merchant sales volumes attributable to card acceptance

Externalities, where merchants as a whole receive a benefit from additional cardholders and vice-versa, may need to be taken into account in interchange models and by the market in setting merchant service fees. These externalities associated with bringing incremental business by virtue of card acceptance may not be as great as in the past, but their existence in some situations should not be too readily dismissed. The significant growth in retail sales evidenced by the growth in credit card outstanding debt may not have occurred if credit cards did not exist. Credit card debt has increased by $7 billion in the last 3 years which implies significant additional profit to retailers. A further specific example of externalities might be the role credit cards could play in opening up the Business to Business e-commerce market.

The question is how these benefits to merchants should be captured in the overall design of a card system. A possible method would be to recognise that even the most detailed interchange cost model is likely to produce a range of values, and that in striking an interchange rate, regard should be had to these externalities and whether the interchange rate is set at the top end of the range or at the bottom.

Support for this approach lies in the fact that closed system card products such as American Express and Diners Club typically charge merchants 1% more for card acceptance. (American Express refers to this as its "merchant discount" rather than a

merchant service fee.) American Express is known to encourage merchants to accept American Express by "promising" additional sales revenue that would not be achieved if they did not accept Amex cards. At current volumes, this premium fee paid to Amex and Diners Club is estimated to cost Australian merchants $100 million more than prevailing merchant fees on bank issued cards.[1]

Under-pricing of interchange greatly risks a worse efficiency and access outcome. In such circumstances closed system card products could be expected to gain market share. This probably will occur because card issuers will need to increase prices to cardholders, who in turn will find Amex or Diners Club a more attractive product. If these closed payments systems gain market share at the expense of bank issued credit cards it will be at significant efficiency cost to the Australian community.

4.2.3 Financial Performance – Credit Card Acquiring

On page 46, the Study concludes that the mark up over costs in acquiring is 67%. This is on the basis that the costs of interchange are omitted. In calculating mark up on cost there is no reason to omit the costs of interchange. The mark up including interchange as a cost element is in fact 19%, based on weighted average data in the Study without any adjustment for data integrity.

Westpac takes issue with the costs shown and believes that with a consistent set of assumptions about cost allocations that cost per transaction would be higher than the weighted average shown. The averages in the table also hide significant differences in business mix between participants in the Study. For example some participants may have a higher mix of electronic transactions rather than high cost paper transactions, other participants may acquire credit card transactions from major retailers without the cost of terminal equipment and support, others still may acquire a high mix of telephone bill payment transactions with relatively lower transaction processing costs.

There is no trend analysis in the data to show the dynamic nature of this market and the fact that average cost per transaction is steadily reducing with an increasing mix of electronic transactions, and overall increase in transaction volumes. Competition is causing these benefits to be passed onto merchants in lower prices. ***[Sentence containing commercially sensitive information omitted]***

[Paragraph containing commercially sensitive information omitted]

4.3 Access to credit card networks

In considering access to credit cards, Westpac is concerned that confidence is maintained in each specific payment network. The Study's analysis of access, in Westpac's view, does

[1] Table 2.3 shows Amex and Diners Club to have 6.7% market share of cards issued. Due to much higher average spending per card, this translates into about 15% share of turnover on credit and charge cards.

not conclusively demonstrate that there are non-commercial barriers to entry. A committed entrant with the necessary capital and capability to compete can enter the Australian market.

An oversight in the Study is its silence concerning the impact on access of the lack of positive credit reporting as a consequence of Australian privacy legislation. This is believed to have discouraged major foreign card issuers such as Capital One and MBNA from entering the Australian market and may be a more important barrier to entry than the rules of different card schemes. These specialists have recently made significant inroads into the UK market.

Bankcard is a semi-closed card system established by the four major banks as a joint venture in the 1970s. Westpac would like to understand better the Study's perspective of how these rules might stop a significant competitor of the type that would change market dynamics. It doesn't believe that the current membership restrictions of Bankcard are a hurdle to a financially responsible entrant.

CUSCAL, The Credit Union services company, has recently entered the market to enable members to provide acquiring services to their customers. Westpac understands that CUSCAL established a third party acquiring agreement with a major bank to acquire Bankcard transactions in lieu of becoming a full member of Bankcard.

Westpac also understands that Adelaide Bank, Bendigo Bank and Suncorp Metway have elected to offer Cashcard's "merchant acquire" product to their business customers. In this arrangement St George Bank is the acquiring bank "wholesaling" credit card acquiring services to these regional banks via Cashcard.

Current access arrangements to Bankcard may be seen to be restrictive by small competitors. However, this ignores the fact that, to enter as a serious player in the acquiring market with the efficacy required to maintain confidence in the Bankcard payment system, the potential entrant will require an investment of many millions of dollars. Participants such as Telstra, Coles Myer, Keycorp and FDRA, are all latent potential entrants to acquiring, who may be more discouraged by their other commercial interests in supporting current participants than by any restrictions in Bankcard rules.

Westpac believes the current costs of entry to Bankcard are not likely to dissuade a serious entrant.

If access to Bankcard is to be liberalised as a consequence of regulatory intervention, who bears responsibility for any loss of confidence arising from the activities of under-capitalised participants? There is also a question of equity between competing credit card schemes. Westpac believes it would be appropriate to open access to acquiring for American Express and Diners Club, based on a consistent interchange model.

Many of the rules which govern credit card networks are set by global organisations, which are unlikely to agree to one set of rules for Australia and another for the rest of the world. Nevertheless, there is evidence of some flexibility around these rules as evidenced by the entry of GE Capital as a MasterCard issuer. Changing the rules of Visa and MasterCard require special resolutions of members of directors. Consequently, the most practical way to bring such a change about may be to legislate or regulate a specific set of access requirements for the Australian market, which will preserve the confidence of acquirers

around the world that a card issued by an Australian issuer will be honoured in all circumstances.

5. Debit Cards

5.1 Debit Card Interchange arrangements

The direction of debit card interchange payments, from issuer to acquirer[2], reflects three factors:

- the original rationale for EFTPoS ("Electronic Funds Transfer at Point of Sale") - to offer consumers and merchants more cost-effective and convenient electronic transactions;
- the perception of retailers that card issuers would be the main beneficiaries, with EFTPoS reducing the growth of transactions in bank branches and thus their costs; and
- their strong market negotiating position: acceptance by the major retail chains was critical to the successful take-up of EFTPoS by their customers.

Without negative interchange enabling rebates to merchants to fund investment in EFTPoS equipment, it is doubtful whether EFTPoS would have been acceptable to the large retailers and therefore whether it would have been successfully introduced.

Interchange fees for debit cards have not changed since their inception, and more than a decade later it is clear to Westpac that the current arrangements are inappropriate.

- Firstly, large retailers representing the majority of EFTPoS transactions have been well compensated for the cost of the equipment they installed to accept EFTPoS transactions;
- Secondly, it is reasonable to argue that merchants do receive significant benefits relative to alternative payments instruments, such as cash. For example, they benefit from a smaller float, reduced cash handling costs and cash losses, the elimination of costs associated with making bank deposits, fewer cheque losses, the immediate settlement of funds, a guarantee of payment and the delivery of transaction information.

  It is appropriate for a proportion of the benefits received by merchants, and certain of the issuers' costs incurred in generating these benefits, to be recovered by card issuers by way of interchange fees (via acquirers). For example, to be consistent with credit cards the cost of providing a payment guarantee (authorisation and fraud costs) should be borne by the merchant, not the cardholder. (This approach is also consistent with issuers recovering benefits received by cardholders, such as the ability to obtain cash at the checkout, directly by transaction fees.);
- Thirdly, individual acquirers act as the sole gateway for issuers to individual retailers, giving them a privileged monopoly position. Issuers have little market power to exercise in negotiations, with the result that interchange fees can be held above levels that would prevail in a contestable market;

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[2] This direction is represented by the term "negative interchange fees", ie where the outcome is negative to issuers. Positive interchange fees flow acquirer to issuer.

The result has been that EFTPoS transaction fees to consumers have been higher than would prevail under a neutral or positive interchange model. The gap between credit card fees and debit card fees has sent a stronger signal in favour of using credit cards than would otherwise have occurred.

- Banks are seeking to opt out of EFTPoS by issuing Visa debit cards to their customers at significant cost to merchants; and

- Finally, Westpac's own internal analysis suggests that, on a fully costed basis (including interchange), costs per transaction to issuers are at the high end of the range in Table 6.1 of the Study with the result that, for all issuers, transaction fees paid by cardholders fall short of recovering costs.

Westpac therefore believes that the existing negative interchange fee should be replaced by a small positive issuer cost reimbursement fee consistent with credit card interchange principles. There are good reasons to argue why all the acquirer's costs identified in Table 6.2 benefit the merchant and should be reimbursed by the merchant service fee. The issuer's costs also largely benefit the merchant and should therefore mean a positive interchange fee.

However, achieving this will prove difficult.

- For major retailers, interchange fees are an important source of revenue – Westpac estimates that $60 million flows to major retailers as their share of the negative interchange fee. Removal of these fees will eliminate this revenue. Indeed, adoption of a 7 cents per transaction reimbursement of issuer costs as Westpac would prefer, will result in payments to issuers of about $40 million. It is therefore unlikely that they will voluntarily agree to the removal of interchange fees, much less pay issuers an interchange fee (via acquirers) to recompense them for the net benefits they receive. They retain a strong negotiating position: adverse publicity aside, they could deny access to cards issued by institutions that refuse to pay an interchange fee; and

- Acquirers have no incentive to accept positive interchange fees, as this would similarly reduce their revenue. As noted above, they have a privileged position and could be expected to leverage this to preserve their position. Table 6.1 in the Study suggests that, if the interchange fee were abolished, some acquirers may need to increase their income by raising additional merchant service fees from retailers if they are to recover their costs fully - although the wide range of both acquirers' costs and revenues casts considerable uncertainty over this conclusion.

In the circumstances, it is unrealistic to expect existing bilateral interchange fee arrangements to be revised so as to abolish the fee as it stands, or move towards a system of "positive" interchange fees, without a degree of regulatory intervention.

One solution that may encourage large merchants to accept such an outcome would be to link acceptance of a small positive debit card interchange fee to a lower credit card interchange fee – a package approach.

On the figures in Table 6.1, the costs borne by small merchants would fall if interchange fees were removed – perhaps quite significantly. Similarly, issuers using gateways would experience a significant reduction in total costs per transaction (though the gateway fee, which is negotiated competitively on a bilateral basis, is unlikely to change).

As noted above, Westpac believes that, on a fully costed basis, costs per transaction to issuers are at the high end of the range in Table 6.1, with the result that transaction fees do not fully recover costs. If banks wish to recover these costs the solution is to raise transaction fees for debit card usage, to reflect the benefits their customers receive.
Banks may nevertheless have good commercial reasons for not doing this. For example, they may choose not to pursue full cost-recovery so as to encourage customers to use EFTPoS in lieu of in-branch transactions. Westpac views such decisions as entirely consistent with an efficient payments system.

The wide range of costs indicated for both card acquirers and issuers suggests that responses to the removal of interchange fees on debit card transactions or a shift to positive interchange fees, may vary widely across the industry. As well, different merchants have different service needs: large ones usually own their terminal equipment, most small merchants do not; other participants pay for entry via transaction gateways. Such considerations emphasise the importance of leaving pricing decisions to be made on a commercial basis, allowing market forces to determine the pricing outcome for merchants and acquirers.

For the customer, transparency would be optimised if they were advised of the cost of an EFTPoS transaction prior to the transaction being undertaken. This is, however, impractical, as whether a fee is charged will usually depend on whether the customer is still within their monthly fee-free quota. The software required to give this information in real time at 300,000 point of sale terminals for 18 million Australians who may bank with one of many hundreds of providers of transaction account services is an extraordinarily complex task, and would dramatically increase the cost of EFTPoS transactions. Such an outcome makes little sense when a competitive market response to the introduction of positive interchange could see EFTPoS transaction fees fall to a level below the threshold of consumer concern.

Westpac has recently reduced EFTPoS transaction pricing to consumers and moved towards greater transparency by including, in each customer's monthly statement, details of their use of fee-free and chargeable transactions. (Attach a copy) This provides customers with the information they need to make objective decisions about their transaction activity, albeit at month end.

5.2 Visa Debit Card

The Study's discussion of the Visa branded debit card (page 70) points to a significant anachronism, one with which Westpac has experience as the result of its merger with the Bank of Melbourne. Westpac acquired a portfolio of Visa cardholders who use the card in the way outlined in the Study

Many regional banks, building societies and credit unions are issuing Visa debit cards and encouraging the cardholder to press 'credit' instead of 'cheque' or 'savings' to access their own funds. Pressing 'credit' causes the transaction to be processed with credit card interchange. On a typical transaction this results in a fee of 50 cents flowing from the merchant to the issuer, rather than 15 cents flowing from the issuer to the merchant, if it were an EFTPoS transaction, or 7 cents from merchant to issuer if Westpac's preferred model of reimbursement of issuer costs was accepted.

Westpac estimates that 10.5% of all Visa card transactions are, in fact, Visa debit transactions. This results in about $35 million flowing inappropriately from merchants to

financial institutions. The trend is away from EFTPoS to Visa debit such that this cost can only grow. These costs are presumably passed on to customers of the merchants, and the account holders of the financial institutions encouraging this behaviour are getting the benefit of fee free or low cost banking at the expense of merchants.

Elimination of this practice requires issuers and card schemes to cease this practice voluntarily, and for Visa to process such transactions as debit transactions. Facilitating this change may help overcome retailer resistance to debit card reforms.

5.3 Access to debit card networks

The Study expresses concern about the market power of large acquirers, which can enable them to charge interchange fees above cost and can raise the cost of access for new entrants. It suggests that small issuers have to pay gateway fees or higher negotiated interchange fees.

Certainly, small issuers do typically pay higher transaction fees than large issuers, but to a substantial degree this reflects economies of scale. New or small issuers do not have the transaction volumes to enable them to set up alternative arrangements to secure lower transaction charges.

Access to an acquirer by small issuers, so that their cardholders can undertake transactions with the 'acquired' merchant, typically involves them being sponsored by a larger issuer that has a direct link to the acquirer. In some cases, Cashcard may act as a further gateway between the small issuer and the large issuer. The fee paid by the small issuer reflects the costs incurred by the different switching organisations between them and the merchant.

It has always been open for an issuer of any size to have a direct link with an acquirer. The question is one of cost, of setting up and maintaining the link. Subject to agreeing requirements and complexity of routing/switching ie. current functionality v. new functionality across interchange, the cost of setting up a link may be up to $0.5 - $0.6 million. For this to be cost-effective compared with the cost of large issuer sponsorship, the cardholders of an issuer would need to generate about 6 million transactions a year.

However, there may be other factors involved, and Westpac is aware of cases where smaller banks have established direct links even where this is not strictly cost-effective.

Westpac is conscious of the additional costs that low volume issuers may incur gaining access via a gateway arrangement. In August, therefore, Westpac initiated action as an acquirer to facilitate more cost-effective access for smaller issuers. This involves a direct EFTPoS interchange facility with Australian Settlements Ltd (ASL) on behalf of the building society industry via a third party switch, FDRA. The link establishes a direct commercial relationship between Westpac and ASL. FDRA is not a financial institution and does not therefore sponsor the small issuer. We understand that at least one other major acquirer is looking to implement similar arrangements.

By reducing the need for a sponsorship element, Westpac is lowering the costs borne by small issuers. It can be seen as a market response to bridge the gap between the sponsorship route and the direct electronic link.

Another development that is relevant to the issue of access to the debit card network is that relating to merchant access to the Consumer Electronic Clearing System (CECS). The rules

of the Australian Payments Clearing Association (APCA) have recently been amended to provide merchants which handle large transaction volumes with participation in APCA. This gives them a say on such matters as technical standards, business matters such as the development of infrastructure, as well as the principles that should govern how the consumer payments system should develop.

As noted in section 5.1.1 above, individual acquirers act as the sole gateway for issuers to individual retailers, giving them a privileged position. Issuers (whether large or small) have little countervailing market power to exercise in negotiations, with the result that it is possible that interchange fees may at times be held above levels that would prevail in a contestable market.

Of course, this has analogies in other network and distribution industries. For example, large customers of telecommunication firms, and gas and electricity utilities, have a stronger negotiating position than small customers and can negotiate better terms of access. Similarly, large book distributors can refuse to stock books published by small publishers if they do not agree to their terms.

In Westpac's view, shifting from a negative to positive interchange arrangement, with a small positive interchange, should significantly reduce the fees small issuers are required to pay.

5.4 Role for Government

Westpac strongly disagrees with the existing interchange pricing for debit cards. Government involvement will be necessary to achieve a better outcome – a small positive interchange fee, consistent with credit card interchange principles. Westpac believes that the PSB consistent with the offer in its Year 2000 Annual Report should seek to foster reform of the debit card interchange fee, with the aim of providing transparent pricing for those accepting and providing debit cards, by:

- Facilitating negotiations between major retailers and debit card acquirers and issuers. This will be necessary to discourage efforts by the first two groups to exercise market power by denying access to cards issued by institutions that do not accept their terms;

- Ensuring that interchange fees involving large retailers are changed concurrently, so that institutions reducing interchange fees are not at a disadvantage relative to others in being able to offer rebates to retailers;

- Encouraging the finance industry and retailers to link debit card reform (including Visa debit) with that of credit card interchange fees so as to achieve an acceptable net outcome;

- Encouraging phased implementation so as to preserve a level playing field at all times; and

- Encouraging institutions to undertake a periodic review of interchange under RBA auspices.