REFORM OF THE EFTPOS AND VISA DEBIT SYSTEMS IN AUSTRALIA

A CONSULTATION DOCUMENT – FEBRUARY 2005

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Executive Summary

This Consultation Document sets out the Reserve Bank's draft standards for the EFTPOS and Visa Debit payment systems and the Bank's core reasoning underlying these proposed standards. The Bank is seeking submissions on the draft standards and its reasoning by 29 April 2005. Submissions will be published on the Bank's website.

Decisions on the final form of any standards, which will take into account submissions received, will not be taken by the Payments System Board until after the current Federal Court case, challenging designation of the EFTPOS system, has been decided. If warranted, the Bank will conduct further consultation after the determination of this case.

Three standards are proposed with the aim of improving competition and efficiency in the Australian payments system. The first two deal with interchange fees in the EFTPOS and Visa Debit systems, while the third deals with the 'honour all cards' rule in the Visa system and the so called 'no-surcharge' rule in the Visa Debit system.

In the Bank's opinion, current interchange fee arrangements in the EFTPOS and Visa Debit systems are not conducive to the efficient operation of the Australian payments system. In reaching this opinion, the Bank has considered not just the individual payment systems in isolation, but also the payments system as a whole. It has also considered how the system is likely to evolve over time, particularly given the current incentives facing merchants, financial institutions and cardholders.

The existing interchange fees in the EFTPOS and Visa Debit systems are subject to limited competition and appear not to have been set with the efficiency of the payments system in mind. In the EFTPOS system, fees are paid by the cardholder's bank to the merchant's bank, while in the Visa Debit system the reverse is the case. Moreover, the fee applying to Visa Debit transactions is the same as that applying to Visa credit card transactions, despite issuers of Visa Debit cards not providing the interest-free credit that is a feature of most credit cards.

An important effect of these interchange fees is that cardholders face higher prices for EFTPOS transactions than for credit card and Visa Debit transactions. This is despite the EFTPOS system having lower resource costs. This misalignment of relative prices and costs does not promote efficient payment choices by cardholders.

The high relative price of EFTPOS has contributed to the growth of the credit card system at the expense of the EFTPOS system. Further, should regulatory certainty be given to the current interchange fee arrangements, there would be a strong incentive for financial institutions to promote scheme-based debit systems, such as Visa Debit, at the expense of EFTPOS. To the extent that interchange fees mean that the higher-cost payment systems grow at the expense of the lower-cost EFTPOS system, merchants' payment costs rise and, thus, so too does the overall level of goods and services prices in Australia.

The proposed standards seek to bring relative prices and costs into closer alignment by narrowing the current differential in the interchange fees in the EFTPOS and Visa Debit systems. If the proposed standards were implemented, the maximum interchange fee in the EFTPOS system is likely to be around 5 cents paid to the merchant's bank. This compares with the current average fee of around 20 cents. In the Visa Debit system, the interchange fee paid to the cardholder's bank would fall from an average of around 40 cents to a maximum of around 15 cents. The combined effect of these proposed changes would be to reduce the gap between the interchange fees from around 60 cents at present to a maximum of around 20 cents.

Narrowing this gap would be expected to change the relative pricing of these two payment methods and/or the degree to which the two methods are promoted by financial institutions. The Bank's view is that, in time, such changes would affect the relative use of payment methods, including credit cards.

The Bank recognises that, if these standards were implemented, the benchmark interchange fees in the EFTPOS, Visa Debit and credit card systems would each be based on different eligible costs. To a significant extent this is the result of the interchange fees in the various schemes being so far apart initially and the Bank's desire to take an evolutionary, rather than revolutionary, approach to reform.

The Bank has already announced its intention to review the standards for the credit card schemes in 2007. At that time the Bank intends to review interchange fees in all card payment systems to assess whether the public interest would be promoted by moving the various arrangements for setting interchange fees to a more consistent basis.

In proposing these reforms it is not the Bank's intention to encourage the use of EFTPOS simply because of its lower relative costs. Rather it is the Bank's view that the efficiency of the overall payments system would be improved by cardholders being free to choose whatever payment instrument offers them the best value based on effective prices that more closely reflect relative costs than is now the case.

The third standard addresses the current requirement that merchants accepting Visa credit cards also accept Visa Debit cards. In the Bank's opinion this restriction limits normal competitive forces and impairs efficiency by requiring that merchants accept a payment instrument at a price which may be above the value that they receive from doing so. The proposed standard also formally applies the no-surcharge standard to the Visa Debit scheme. The Bank expects that similar arrangements would apply to other scheme-based debit arrangements that might be introduced in Australia.

The Bank has also considered access arrangements in the EFTPOS system. While the draft regime being developed by Australian Payments Clearing Association (APCA) represents an improvement on existing arrangements, the Bank has recently written to APCA raising a number of issues with the proposal. If these issues are not addressed satisfactorily, and in a timely manner, the Bank will consider issuing a draft access regime for public comment.

1. Background to Reforms

1.1 Introduction

The Reserve Bank is seeking comments on its proposed reforms to the EFTPOS and Visa Debit payment systems.

This document sets out the proposed reforms. It also sets out the core reasoning underlying the Bank's proposals, the consultation undertaken to date, and the Bank's analysis of a number of alternative options.[1]

The document is structured as follows. The first section provides relevant background to the reform process, including a discussion of: the EFTPOS and Visa Debit systems; the extent of the Bank's powers; the factors identified by the Bank as impairing the efficiency of the Australian payments system; and a summary of the reform process to date. The second section discusses interchange fees in the EFTPOS and Visa Debit systems and proposes standards for the calculation of these fees. The third section discusses the acceptance rules for Visa Debit and proposes a standard that would prevent a merchant being required to accept Visa Debit cards as a condition of accepting Visa credit cards (*and vice versa*).

The Bank invites interested parties to make submissions on these proposals by 29 April 2005. Submissions will be published on the Bank's website. An opportunity will be provided to those making submissions to discuss them with the Bank.

The release of draft standards now, rather than after the completion of the current case in the Federal Court challenging designation of the EFTPOS system, reflects a desire by the Bank to reduce the current level of uncertainty as to the Bank's proposed policy with respect to debit cards. A number of institutions have recently noted in consultations that the current level of regulatory uncertainty is one factor making it difficult to move forward with business plans. The Payments System Board will, however, not take any final decisions concerning the proposed standards until after the Federal Court case has been completed. If warranted, the Bank will also provide for a further period for consultation after the court case has been concluded.

1 The Bank has released a number of publications dealing with aspects of these issues. They can be found on the Bank's website, www.rba.gov.au. The principal publications are:
Payments System Board Annual Reports, 1999-2004;
Australian Competition and Consumer Commission and Reserve Bank of Australia, Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access, October 2000;
Reserve Bank of Australia, Reform of Credit Card Schemes in Australia, I: A Consultation Document, December 2001;
Reserve Bank of Australia, Reform of Credit Card Schemes in Australia, II: Commissioned Report, December 2001;
Reserve Bank of Australia, Reform of Credit Card Schemes in Australia, IV: Final Reforms and Regulation Impact Statement, August 2002;
Submissions to the ACCC in Response to the Draft Determination, Including the Pre-Decision Conference, August-December 2003;
Submission by the Reserve Bank of Australia to the Australian Competition Tribunal, April 2004;
Reasons for the Decision to Designate the EFTPOS Payment System, 14 October 2004.

1.2 Debit Card Payment Systems

There are two debit card payment systems operating widely in Australia – the EFTPOS system and the Visa Debit system. With over 27 million debit cards on issue, these cards were used to make more than 1 billion transactions in 2004, with an average value of $68. Of these two systems, the EFTPOS system is the larger by a considerable margin, with total spending through the system around 6 times that in the Visa Debit system.

The two debit card systems operate alongside a number of other retail payment systems including credit and charge cards, direct credits, direct debits, BPAY, cheques and cash. In all, debit cards accounted for around 28 per cent of all non-cash transactions in 2004 (but only around 1 per cent of the value of these transactions). By way of comparison, credit and charge cards accounted for 29 per cent of non-cash transactions (and 2 per cent of their value).

1.2.1 The EFTPOS system

The EFTPOS system allows cardholders to make payments at merchants accepting EFTPOS cards. In some cases, merchants also allow cardholders to withdraw cash using the EFTPOS system. To initiate a transaction, the cardholder swipes his or her card through a terminal at the point of sale and enters a personal identification number (PIN) into the terminal. The details of the transaction and PIN are forwarded to the cardholder's financial institution for authorisation. Once authorised, the transaction is debited electronically to the cardholder's account at that institution. The EFTPOS cards issued by financial institutions can generally be linked to a number of different accounts or linked to the same account in different ways. For example, it is common for the card used for EFTPOS transactions to be used to withdraw cash at an Automatic Teller Machine (ATM) and to be used to make credit card or Visa Debit transactions.

The EFTPOS system is built as a series of bilateral links between institutions that issue the cards (issuers) and institutions that provide payment services to merchants (acquirers). The first cards were issued in the 1980s. Initially these cards could only be used to make a purchase at merchants who used the same bank as the cardholder. However, as the system expanded, links between financial institutions were established and cardholders gained access to an increasing number of merchants. By the 1990s, merchants were able to accept cards from all issuers and, by 2004, there were around 465,000 EFTPOS terminals in Australia.

Currently, there are 11 institutions offering EFTPOS acquiring services to merchants and one merchant acting as its own acquirer (known as a merchant principal). In contrast, there are more than 150 banks, building societies and credit unions issuing debit cards that can be used in the EFTPOS system. These issuers typically charge the cardholder a fixed monthly fee for operating the underlying account, although this fee is sometimes waived for relationship or other reasons. Over recent years, these accounts have offered a certain number of transactions per month for no additional charge, with a per-transaction fee being levied once this number is exceeded. In 2004, this fee (at the largest banks) averaged around 40 cents for an EFTPOS transaction. Data supplied to the Reserve Bank in mid 2004 indicate that, for these banks, around 25 per cent of EFTPOS transactions incurred such fees, earning the five major banks around $70 million in revenue in 2004. More recently, a number of banks have modified their fee structures and now offer an account with an unlimited number of free electronic transactions for a fixed monthly fee.

1.2.2 The Visa Debit system

Like the EFTPOS system, the Visa Debit system allows cardholders to make payments by electronically debiting an account at an authorised deposit-taking institution. Unlike the EFTPOS system, however, transactions are processed and authorised through the Visa system (in the same way as are credit card transactions). Australian Visa Debit cards can be used wherever Visa credit cards can be used and, indeed, cannot be visually distinguished from Visa credit cards. If a merchant accepts Visa credit cards, Visa's 'honour all cards' rule requires the merchant to accept Visa Debit cards as well.

In addition to the different infrastructure, the Visa Debit system differs from the EFTPOS system in other ways. One is that the cardholder usually authorises the transaction by signing a receipt at the point of sale rather than by entering a PIN. A second is that the card can be used to pay for goods and services in situations where the cardholder and merchant are not in the same location; examples include payments over the internet or telephone. A third is that the cardholder is not able to obtain 'cash out' at merchants. A fourth is that the card can be used internationally. And finally, Visa Debit transactions attract the same protections as other Visa transactions, with so-called 'chargebacks' for customers whose cards are used fraudulently or where goods and services are not delivered as promised.

Visa Debit cards are issued as multi-function cards that can be used to make transactions through both the Visa Debit and EFTPOS systems. At an electronic terminal in Australia the cardholder can press either the 'credit' button, or the 'cheque' or 'savings' button. Pressing the 'credit' button results in the transaction being processed through the Visa network, while pressing the 'cheque' or 'savings' button results in the transaction being processed through the EFTPOS network. Regardless of which button is selected, the transaction is a debit transaction on the same account.

The first Visa Debit cards were introduced in 1982 by building societies and credit unions. The introduction of these cards was partly in response to regulations that prevented non-bank financial institutions from issuing credit cards. While these controls have since been abolished, credit unions and building societies remain significant issuers of Visa Debit cards.

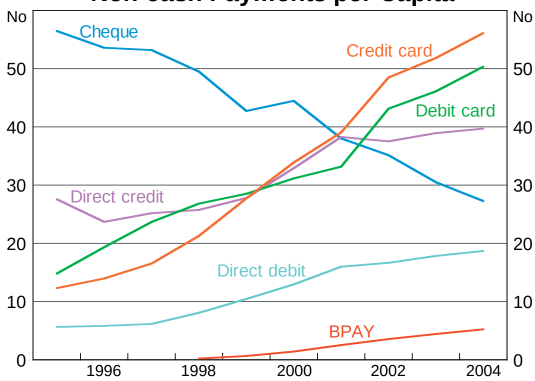
Institutions offering Visa Debit cards have typically not charged per-transaction fees for Visa Debit transactions.

1.3 The Payments System

As mentioned above, the two Australian debit card systems operate within the wider context of the Australian payments system. Graph 1 shows the trends in use of the most significant non-cash payment systems over recent years.

Over this period, the use of electronic payment methods has grown particularly strongly at the expense of more traditional, paper-based cheques. While all the electronic methods have been growing strongly, there have been changing patterns of use within this category. Until the late 1990s, debit cards were used more frequently than credit cards. However, the mid

Graph 1
Non-cash Payments per Capita



Sources: ABS; APCA; RBA

to late 1990s saw very rapid growth in credit card use and the number of credit card transactions has exceeded the number of debit card transactions each year since 2000. This change coincided with the introduction and heavy promotion of credit card reward schemes which served to lower the effective price of credit card use to the cardholder, but not to the community as a whole.

In most situations, cardholders have a variety of payment options from which to choose. A number of factors influence this choice including convenience, security and ubiquity of acceptance. It is generally more convenient, for example, to use card-based payments than cheques at the point of sale due to the shorter transaction time for card-based payments. Similarly, cash is generally the fastest payment method for small transactions, and so is commonly favoured for quick, low-value purchases in locations with high turnover.

Another important factor influencing the choice of payment instrument is price. The reduced use of cheques, for example, has coincided with higher charges for writing cheques. Similarly, the shift away from bank branches to ATMs for cash withdrawals has been influenced by the higher charges for branch withdrawals. These price effects are evident in other countries as well. For example, in the United States, scheme-based debit cards, such as Visa Debit and MasterCard Money, gained market share at the expense of PIN-based debit cards because they offered a very similar service at a lower price to the cardholder.[2]

The effective price is also frequently mentioned as a factor influencing choice in surveys of cardholders. For example, a survey of New Zealand consumers found that 56 per cent of credit card users listed the interest-free period as a reason to use credit cards while 46 per cent listed other price-related factors such as reward programs and lower transaction costs. Similarly, 61 per cent listed high transaction costs as a reason for not using EFTPOS.[3] A survey commissioned by the Australian Merchant Payments Forum also found that price was important for Australian consumers.[4] Nearly half of credit card users cited loyalty points or other price-related factors as the reason they used a credit card instead of other payment instruments. Of those consumers that were aware of the price they were paying for a particular transaction, the overwhelming majority chose to use a payment instrument that had zero per-transaction fees. Indeed, much of the recent competition between financial institutions has focussed on the price charged for use of transaction accounts. This clearly suggests that these financial institutions believe that consumers will be attracted to their institution based on the price they charge for transactions.

2 L Nyberg and G Guiborg (2003), D Humphrey, M Kim and B Vale (2001).
3 Liu, C, C Matthews and D Tripe (2004).
4 A report on the survey results can be found on the Reserve Bank website at http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/Reforms/Eftpos/SubmissionsOnEFTPOSInterchangeFees/ampf_09112004_2.pdf.

Both the Australian and international evidence strongly supports the view that price is an important factor influencing payment choices.

1.3.1 Interchange fees

Payment systems sometimes require the payment of fees between the institutions in the system. These fees – known as interchange fees – are an important factor influencing the prices that cardholders and merchants face for using the system.

Where interchange fees exist around the world they typically flow from the merchant's financial institution to the cardholder's financial institution. The EFTPOS system in Australia is an exception. In this case, the fee flows in the reverse direction: that is, from the cardholder's financial institution to the merchant's financial institution. The fee is flat and averages around 20 cents per transaction. Most of the interchange fees for the major banks are clustered around this average, while smaller financial institutions typically pay interchange fees some 5 to 10 cents higher. The interchange fees are identical in both directions (that is, they are the same when Bank Y's customer uses a card at Bank Z's merchant and when Bank Z's customer uses a card at Bank Y's merchant).

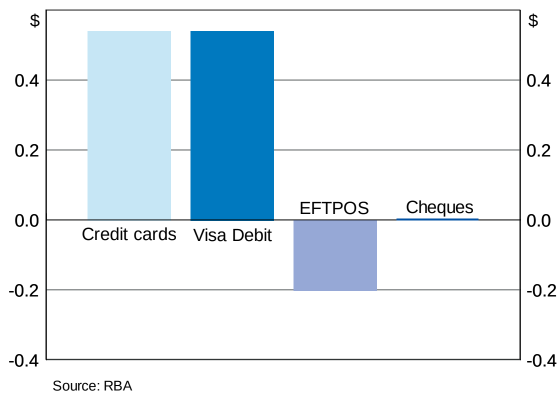
Most interchange fees in the EFTPOS system were negotiated when initial network connections were formed and have varied little since that time.

In the Visa Debit and credit card systems, interchange fees flow in the opposite direction; that is, from the merchant's financial institution to the cardholder's financial institution. Unlike in the EFTPOS system, the fee is a percentage of the amount spent, and is the same as the fee in the Visa credit card system. This fee currently averages around 0.55 per cent across all transactions, 0.4 of a percentage point lower, on average, than it was prior to the Bank's reforms to the credit card systems.

As an illustration of the various fees, Graph 2 shows the interchange fees that would typically apply on a payment of $100 in different payment systems.

Graph 2

Interchange on a $100 Transaction



A consequence of these interchange fees is that they increase the net costs of the institution paying the fees, and reduce the net costs of the institution receiving them. As such, institutions receiving interchange fees may be able to charge customers a price lower than the underlying cost to them of providing the payment service. And institutions paying interchange fees may need to charge their customers a price above that suggested by the underlying costs of providing the service. In this way, interchange fees can alter the usually direct link between costs and prices on both sides of a payment system.

1.4 The Reserve Bank's Payments System Powers

The Reserve Bank has various powers to address questions of efficiency, competition and the stability of payment systems. These powers are set out in a number of Acts including the *Reserve Bank Act 1959* and the *Payment Systems (Regulation) Act 1998*.

These powers are exercised by the Payments System Board of the Reserve Bank. According to the *Reserve Bank Act 1959*:

It is the duty of the Payments System Board to ensure, within the limits of its powers, that:

(a) the Bank's payments system policy is directed to the greatest advantage of the people of Australia; and

(b) the powers of the Bank under the Payment Systems (Regulation) Act 1998 and the Payment Systems and Netting Act 1998 are exercised in a way that, in the Board's opinion, will best contribute to:

(i) controlling risk in the financial system; and

(ii) promoting the efficiency of the payments system; and

(iii) promoting competition in the market for payment services, consistent with the overall stability of the financial system…

The *Payment Systems (Regulation) Act 1998* gives the Reserve Bank the authority to 'designate' a payment system if it considers that doing so is in the public interest. Having designated a system, the Bank may then set an access regime, determine standards, give enforceable directions and arbitrate on disputes (where the parties agree to arbitration). In introducing the legislation, the Government made it clear that the development of an access regime or the setting of standards should be undertaken, as far as possible, in conjunction and consultation with the private sector.

1.5 The Public Interest Test

In determining whether a particular action is in the public interest, the *Payment Systems (Regulation) Act 1998* states that:

…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 Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so.

In applying the public interest test, the Bank has considered how best to assess efficiency and competition in the Australian payments system. After considering a number of theoretical approaches, it is the Bank's opinion that this assessment is best done by using a number of practical benchmarks.

In particular, an efficient and competitive payment system is one in which:

- the relative prices charged by financial institutions to consumers who use payment instruments reflect the relative costs of providing those instruments (except where the private benefits or costs do not match the society-wide benefits or costs) as well as demand conditions;
- merchants are free to set prices for customers that promote the competitiveness of their business;
- prices of payment services are transparent;
- any restrictions on entry of institutions to a payment system are the minimum necessary for the safe operation of the system; and
- competition within each payment system and between payment systems is open and effective.

In assessing the current system against these benchmarks, the Bank considered whether it was necessary to define strictly the market in which particular payment systems, including debit cards, operate. The Bank determined that market definition, of the kind customarily undertaken under the *Trade Practices Act 1974,* would not assist its analysis and was not necessary before forming an opinion about competition and efficiency in Australia's debit card payment systems.

The Bank recognises that payment instruments are substitutable in many circumstances, but also recognises that in other circumstances the same payment instruments may not be good substitutes for one another (for example, where a consumer does not have cash funds available in his or her account and wishes to purchase on credit).

The Bank also considered whether it was necessary to obtain formal estimates of the extent of substitutability between different payment instruments. It concluded that it was not necessary to do so given the strong evidence that credit and debit cards are highly substitutable for many people. In many cases, a single card offers both credit and debit facilities, with the cardholder simply pressing 'credit' or 'savings/cheque' at the point of sale to use one system or the other. For cardholders with funds in their account, a key factor influencing which method they choose is the relative price of the two methods. In particular, the Bank noted that financial institutions often promote the use of credit cards over both EFTPOS and ATM withdrawals on the basis that using a credit card saves the cardholder transaction fees. The Bank also noted that obtaining reliable estimates of elasticities using existing techniques and data is very difficult. Overall the Bank's opinion is that the above benchmarks provide a sufficient basis for judging the efficiency and competitiveness of the current system.

In this context, the Bank noted a number of aspects of the overall Australian payments system that fall short of these benchmarks.

Prices and costs

The first is that the relative prices of various payment instruments are not closely aligned with the relative costs of providing those payment instruments. In effect, users of the payment system with the lowest cost often face the highest price.

For many people, the effective price for using the EFTPOS system is higher than that for using the credit card system. This is despite the EFTPOS system having the lower resource costs. Given the strong substitution possibilities between these systems, the effect of this is likely to be that the EFTPOS system is underused.

Similarly, users of the EFTPOS system face either the same or a higher price than users of the Visa Debit system, despite the Visa Debit system having higher costs.

To a significant extent these divergences between relative prices and costs are the result of the different interchange fee arrangements in the EFTPOS, Visa Debit and credit card systems. Moreover, these interchange fees are not subject to the normal forces of competition that operate in most other markets.

It is also important to recognise that interchange fees affect not only the prices that cardholders face, but also the charges faced by merchants for accepting various payment instruments. Under current arrangements, credit cards are much more expensive for merchants to accept than EFTPOS payments. Moreover, merchants are charged the same fee for accepting Visa Debit cards as they are for accepting credit cards, despite the fact that the user of a Visa Debit card is not offered any free credit by the financial institution that issued the card.

In effect, the distorted price signals to the cardholder, which have encouraged the use of the more expensive payment options, have come at the expense of higher merchant costs. In turn, these higher costs flow through into higher prices for goods and services.

Accordingly, the Bank's opinion is that bringing the relative prices and costs for these payment systems into closer alignment would promote the efficiency of the overall system. Encouraging more efficient payment choices by cardholders should reduce merchants' overall costs, and thus put downward pressure on the overall level of prices for goods and services.

In forming its views, the Bank has taken a medium-term perspective and considered not only the individual payment systems in isolation, but also the payments system as a whole. In particular, it has considered how the system is likely to evolve if the existing incentives facing financial institutions remain unchanged. Given the often strong competition on the issuing side, the Bank's assessment is that a continuation of current arrangements could see, over time, financial institutions encourage customers wishing to use a debit card to use the Visa Debit system (or similar scheme-based systems with similar interchange fees) rather than the EFTPOS system.

One effect of such a change would be an increase in merchants' overall payments costs, given that merchant costs for accepting Visa Debit are significantly higher than for accepting EFTPOS. This, in turn, would put upward pressure on the general prices of goods and services.

In forming its views, the Bank has recognised that a payment system in which all payments were made with the lowest cost payment instrument would, in all probability, not be efficient. In many cases, payment systems with higher resource costs deliver greater benefits to their users than low-cost systems. From an efficiency perspective what is important is that the price signals are correct, that cardholders are free to use the payment systems that best suit their needs, and that merchants are free to accept those payment systems that deliver them value. If the high-cost system is underpriced, then the system will be overused with cardholders using payment services whose cost of provision to society exceeds the benefit they obtain.

Restrictions on merchants

The second aspect of current arrangements that falls short of the benchmarks is that merchants are not able to freely choose which payment instruments they accept. In particular, under current arrangements a merchant who accepts Visa credit cards must also accept Visa Debit cards. Moreover, merchants are charged the same fee on both cards despite the fact that on a Visa Debit card there is no provision of interest-free credit.

The Bank is concerned that this restriction inhibits normal competitive forces and increases the overall costs to merchants of accepting Visa Debit. As noted above, these higher costs flow through into the general level of prices of goods and services.

Restrictions on entry

The third aspect where current arrangements fall short of the above benchmarks is that of entry into the EFTPOS system.

In most markets, competition and efficiency are enhanced by having low barriers to entry. A concern for the Bank has been the potential for entry barriers in the EFTPOS system, particularly on the acquiring side, to effectively limit competition. Currently, direct entry to the system by an acquirer can require negotiations with around ten institutions on both technical matters and pricing. The failure to reach agreement with any one of these institutions – which are typically competitors – means that the potential entrant could have considerable difficulty in offering a marketable or competitive acquiring service. Even if an incumbent agrees to a direct connection, it can take considerable time before it agrees to schedule the necessary testing for establishment of the link. The alternative entry route is through a gateway, although here the costs can be quite high.

The difficulty of entry can limit effective competition on the acquiring side and can impair efficiency by making it difficult for new lower-cost entrants to enter the system and offer acquiring services to merchants at a lower price.

1.6 History of Reform in the Card Payment Systems

Soon after the Payments System Board was established, it undertook an extensive study of debit and credit card schemes in Australia. The findings of this study, which was conducted jointly with the Australian Competition and Consumer Commission (ACCC), were published in October 2000 in *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (the 'Joint Study').

A central theme of the Joint Study was that in a number of areas the price signals faced by consumers of payment services did not reflect the underlying costs of providing those services. The Study concluded (page v) that the '*structure of incentives has encouraged the growth of* *the credit card network at the expense of other payment instruments, particularly debit cards and direct debits, that consume fewer resources. As a result, Australia has a higher cost retail payments system than necessary, and much of this higher cost is borne by consumers who do not use credit cards.*'

Given the conclusion that the efficiency of the payment system would be improved if consumers faced prices for payment services that more closely reflected underlying costs, and restrictions on effective competition were removed, the Bank set about encouraging industry efforts at reform.

The initial roadmap envisioned parallel work on the major card payment systems in Australia with the introduction of final reforms in all systems at roughly similar times. As it eventuated, progress in some payment systems has been more protracted than in others. Given the complicated nature of the task, the difficulty of achieving industry coordination, and the extensive legal proceedings, the process has run over a number of years and reform across individual payment systems has become decoupled.

Credit cards

In the area of credit cards, the reforms have addressed:

- the setting of interchange fees;
- the so-called 'no surcharge' rule that prevented merchants from passing on the cost of accepting credit cards; and
- restrictions in the schemes' membership requirements that were stronger than those needed to protect the integrity of the schemes.

After an extensive period of consultation, the Bank established two standards. The first of these came into effect on 1 January 2003 and made it possible for merchants accepting MasterCard and Visa cards to pass on the cost of acceptance to customers that use the cards. The Bank also obtained undertakings from American Express and Diners Club to eliminate prohibitions on such charges (Bankcard had no such prohibitions). The second standard came into force in October 2003. This standard requires that the weighted-average interchange fee in each of the Bankcard, MasterCard and Visa schemes not exceed a cost-based benchmark based on its issuers' eligible costs. This standard has seen the average interchange fee in these schemes fall from around 0.95 per cent to around 0.55 per cent. This fall has been passed through to merchants in the form of lower merchant service fees, and is estimated to have saved merchants around $500 million in 2004.

The Bank also established an access regime which came into force in February 2004. Under the regime, potential entrants could seek authorisation by the Australian Prudential Regulation Authority (APRA) as specialist credit card issuers and/or acquirers. Card schemes are now not permitted to discriminate against potential entrants on the basis of whether they are a specialised credit card institution or a traditional authorised deposit-taking institution, or on the basis of whether the potential entrant will be an issuer of credit cards only, an acquirer of credit card transactions only, or both.

EFTPOS

At the time the credit card reform process was proceeding, the Bank hoped that a voluntary industry process would deliver changes to the debit card system on a timetable roughly similar to that of credit cards. To assist in this process, the Bank convened a series of meetings of industry participants, beginning in early 2002, to explore the options for reform.

Industry views on reform were quite diverse and strongly held; for this reason, the Bank encouraged the industry to seek public input into the reform process. In July 2002, an industry group released a paper outlining three basic options for reform: retention of current arrangements (with small modifications); adoption of collectively determined interchange fees calculated on a cost-based approach; and the elimination of interchange fees either through their abolition or by setting them to zero.[5]

Following publication of the paper, the group met with interested parties to discuss the options. Significant differences in commercial interests remained both within the industry group and among other interested parties. Despite the lack of unanimity, in February 2003, a group of banks, building societies and credit unions submitted an application to the ACCC for authorisation of a proposal to reduce interchange fees to zero.[6] The ACCC initially proposed to deny the application due to concerns about access arrangements. In response, at the request of the applicants for authorisation, the Australian Payments Clearing Association (APCA) committed to develop an access regime and the Bank indicated that, were these efforts to fail, it would consider designating the EFTPOS system to achieve access reform. In light of this, the ACCC authorised the application in December 2003.[7]

Following the authorisation, a group of retailers successfully appealed to the Australian Competition Tribunal (ACT), with the Tribunal overturning the ACCC's decision on 25 May 2004. The Bank has carefully considered the evidence before, and the findings of, the ACT. The Bank's views in response are set out in Section 2.3 below.

Following the ACT's decision, the Bank invited submissions from interested parties on whether it would be in the public interest for it to designate the EFTPOS system. In all 23 submissions were received, with arguments being presented both for and against designation. Parties making submissions were invited to discuss them with the Bank. After reviewing these submissions, together with submissions previously made to the ACCC and the ACT and the decisions by those bodies, the Board concluded that designation was in the public interest. In September 2004, the Bank designated the EFTPOS system.

On the issue of access, APCA is still drafting a regime. As the draft currently stands, prospective entrants will be offered greater certainty as to the cost of connection and the time such connection will take. While the proposed arrangements offer an improvement on those currently in place, the Bank has recently written to APCA raising some concerns with the proposal. These concerns relate to whether the regime provides sufficient certainty on the cost and timing of entry and whether volume requirements are necessary for new entrants. If these

5 EFTPOS Industry Working Group (2002).
6 ANZ Banking Group and others (2003).
7 Australian Competition and Consumer Commission (2003).

concerns are not addressed satisfactorily, and in a timely manner, the Bank will consider issuing a draft access regime for public comment.

Visa Debit

Initially, the Bank also pursued voluntary reform of the Visa Debit system with Visa and the institutions that issue the cards. Much of the discussion took place between Visa and the Bank, with Visa making a number of submissions on voluntary reforms it was prepared to implement and arguments in defence of its current arrangements. Although some progress was made, discussions were complicated by the fact that issuing institutions could not discuss what would amount to the collective setting of interchange fees and the process was not transparent. Furthermore, there remained a number of areas where the Bank and Visa could not reach agreement.

The Payments System Board ultimately reached the conclusion that designation of the Visa Debit system was in the public interest. This decision was influenced in part by the fact that designation would allow for a transparent and inclusive consultation on possible reforms – a situation that had been difficult to achieve previously. In February 2004, the Payments System Board designated the Visa Debit system.

2. Interchange Fees

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

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

2.1 Potential Justifications for Interchange Fees

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

2.1.1 Maximisation of social welfare

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

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

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

2.1.2 Viability of the payment system

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

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

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

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

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

Table 1: Costs and Benefits – An Example

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

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

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

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

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

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

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

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

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

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

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

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

2.1.3 Start-up phase – reimbursement of investment

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

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

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

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

2.1.4 'User pays'

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

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

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

2.2 Competition and Interchange Fees

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

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

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

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

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

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

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

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

2.3 The Detriment from Current Interchange Fees

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

2.3.1 Prices and costs

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

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

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

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

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

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

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

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

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

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

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

2.3.2 Interchange fees affect prices and promotion

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

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

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

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

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10 Reserve Bank of Australia *Bulletin*, July 2004.
11 Dove Consulting (2002).
12 Fisher F, (2000).
13 Nilson Report, Issue 809, p6.

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

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

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

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

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

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

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

2.3.4 Further considerations

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

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

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

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

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

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

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

14 Assuming an average transaction size of $80.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

16 Australian Competition Tribunal (2004).

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

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

2.4 Consultation

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

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

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

2.4.1 EFTPOS

(i) No standards for interchange fees

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

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

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

(ii) Zero interchange for EFTPOS

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

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

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

(iii) Consistency with the credit card interchange standard

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

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

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

2.4.2 Visa Debit

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

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

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

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

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

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

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

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

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

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

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

2.5 Possible Regulatory Responses

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

(i) No change

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

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

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

(iii) Apply the credit card standard to all systems

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

(iv) Narrow the differential

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

2.6 Discussion of Options

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.7 Draft Standards for Interchange Fees

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

2.7.1 EFTPOS

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

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

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

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

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

Standard No. 3

The Setting of Interchange Fees in the EFTPOS Payment System

Objective

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

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Interchange Fees

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

Methodology

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

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

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

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

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

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

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

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

Initial and subsequent benchmarks

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

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

Transparency

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

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

2.7.2 *Visa Debit*

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

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

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

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

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

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

Standard No. 4

The Setting of Interchange Fees in the Visa Debit Payment System

Objective

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

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

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

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

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

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

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

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

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

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

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

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

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

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

Interchange Fees

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

Methodology

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

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

Initial and subsequent benchmarks

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

Transparency

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

3. The 'Honour All Cards' Rule

Merchants that accept Visa credit cards are also required to accept Visa Debit cards under Visa's so-called 'honour all cards' rule. MasterCard has a similar rule but, at this time, does not issue a debit product in Australia. This rule has received heightened scrutiny in recent years and, in addition to the Bank's investigations, has been the subject of legal proceedings in the United States and an investigation by the European Union.

This section considers the 'honour all cards' rule in the Visa Debit system. The analysis could apply equally to similar products issued by other card schemes which applied such rules in Australia.

3.1 The Rationale for an 'Honour All Cards' Rule

There are two relevant aspects to the 'honour all cards' rule.

The first is that the rule requires merchants to accept Visa cards regardless of which bank or financial institution issued the card. This might be best thought of as an honour all issuers rule.

The second is that the rule requires merchants to accept all products issued under the Visa brand. This might be best thought of as an honour all products rule.

The main rationale provided to the Bank by Visa for the honour all cards rule largely relates to the honour all issuers aspect of the rule. Indeed, because Visa initially issued only credit cards, the 'honour all cards' rule related to issuers and there was no honour all products dimension. Over the years, however, Visa has expanded the types of products it offers under its brand. In particular, it now offers credit cards, debit cards and pre-paid cards (in overseas markets). Consequently, over time, the rule has gained an honour all products aspect in addition to the original honour all issuers dimension.

3.1.1 Honour all issuers

There is a general acceptance that the honour all issuers aspect of the rule is in the public interest. By insisting that merchants must accept Visa-branded cards regardless of the issuer, Visa is maximising the network value to cardholders and issuers. If merchants were allowed to selectively refuse cards issued by particular institutions, the value of the Visa brand and card system could be reduced. Selective refusal could generate a need for bilateral negotiation between issuers and acquirers and, potentially, merchants. This would raise the costs of participating in the system and generally impair efficiency. Cardholders could also be directly disadvantaged by not knowing whether cards issued by their financial institution would be accepted at any given merchant.

3.1.2 Honour all products

Visa has made two related arguments as to why the honour all products rule is also in the public interest.

First, it argues that the rule provides a cost effective way to offer multiple card products. For example, there is little additional cost to Visa of ensuring merchant acceptance of Visa Debit cards because it is a condition of merchants accepting Visa credit cards. Additionally, because the two products only differ in the nature of the customer account they access, there is no need for acquirer systems or the Visa network to be structured to accommodate any differences.

Second, Visa argues that the 'honour all cards' rule encourages the development of new products. That is, with a ready-made acceptance network, it is easier for issuers to experiment with new products. Visa argues that such experimentation is in the public interest.

3.2 Concerns with the 'Honour All Cards' Rule

The Bank's concerns with the 'honour all cards' rule are focused on its honour all products aspect. The Bank accepts that the honour all issuers aspect of the rule provides efficiency gains and enhances the value of the Visa credit card network in a way that benefits the public. In contrast, the Bank does not view the extension of the 'honour all cards' rule across product types to be in the public interest. By 'tying' acceptance of one card product to another, normal competitive forces are diminished.

In consultation, merchants have repeatedly told the Bank that they would rather not accept the Visa Debit card on its current terms, yet they are forced to accept it as a condition of accepting Visa credit cards. A consequence of the forced acceptance is that competitive forces cannot bear upon the price of, or acceptance of, the product. In particular, merchants pay the same fees for Visa Debit as they do for Visa credit cards. This is despite Visa Debit not offering interest-free credit.

There is also the clear practical concern that competition between payment systems is being distorted by the rule. In most respects Visa Debit and EFTPOS are competing payment systems. In particular, for domestic point-of-sale transactions, which represent the largest segment of card-based transactions, they are effectively interchangeable – all that is required is the press of a different button at the terminal. Visa Debit, however, has a competitive advantage over EFTPOS because merchants are forced to accept the card when they make the decision to accept Visa credit cards and must pay a higher price to do so than with EFTPOS. Moreover, the higher interchange fee is used to encourage issuers to issue and promote Visa Debit in preference to EFTPOS. This raises concerns that, over time, the efficiency of the payments system will be impaired through the operation of the 'honour all cards' rule as it currently stands.

These concerns are reinforced by the experience of the United States. As discussed in Section 2, the combination of higher interchange fees and the 'honour all cards' rule has enabled Visa Debit and the similar MasterCard product to significantly increase their market shares in the US at the expense of alternative debit products. A significant spur to this was the higher revenue issuing banks could earn by issuing scheme-based debit cards over other debit cards.

These arguments were central to recently concluded litigation between US retailers, led by Wal-Mart, and the credit card companies. In this case, a number of US retailers sued Visa and MasterCard under US anti-trust laws to force Visa and MasterCard to remove the tying provisions between their debit and credit card products. The litigation was settled when Visa and MasterCard agreed to: pay $US 3 billion to the retailers; reduce their debit card interchange fees; and untie the two products. Debit cards issued in the United States by Visa and MasterCard are now separately identified and subject to separate acceptance decisions by US merchants.

Finally, as discussed above, available cost data suggest that the Visa Debit system requires more resources to process a transaction than the EFTPOS system. These cost differences are not currently reflected in prices to consumers. The Bank's proposed regulation of interchange fees is aimed at reducing this discrepancy. Nonetheless, even with reduced interchange fees, the 'honour all cards' rule means that merchants will be unable to respond freely. Efficiency of the overall Australian payments system is likely to be enhanced if cardholders and merchants are in a position to freely evaluate the benefits provided by Visa Debit against the costs and make acceptance decisions based upon that evaluation. The honour all products rule significantly restricts this possibility.

3.3 Consultation and Summary of Submissions

The Bank invited submissions from interested parties at the end of January 2004 on whether it was in the public interest to designate the Visa Debit system. These submissions are available on the Bank's website. The Bank has also been engaged in ongoing discussions with Visa and Visa Debit issuers over the product.

As discussed above, Visa argues that there are a number of reasons why the 'honour all cards' rule is in the public interest. In addition, Visa's consultant, NECG, has detailed what it sees as the benefits for efficiency and competition of the 'honour all cards' rule. According to its analysis, the rule reduces consumer transaction costs and enhances efficiency by increasing the ability of a scheme to offer a wide choice of card products.

The issuers of Visa Debit and Visa also argue that the rule should be retained because Visa Debit is mainly issued by small financial institutions as a way of competing with the credit card issuance of the large banks. These smaller institutions would be disproportionately affected if merchants decided not to accept Visa Debit cards. They also argue that removing the rule would allow the large acquirers who do not issue Visa Debit to refuse to acquire Visa Debit transactions – thereby unfairly limiting competition.

MasterCard argues that retention of the rule is essential if it is to introduce a product to compete with Visa Debit on equal terms.

A number of industry participants suggested that the distinction between a debit product and a credit product will be increasingly difficult to make. For example, they raised the question of how a Visa card attached to a mortgage account should be classified. Also, it was argued, consumers may be confused if there are multiple variants of the Visa product available and significant expenditure would be required to educate consumers and merchants about the differences.

Some of those arguing for retention of the honour all products rule concede that, if something must be done, the no-surcharge rule could be formally removed, giving merchants the ability to charge a different amount for accepting Visa Debit than for accepting Visa credit cards. This possibility is raised because the no-surcharge rule has not been formally removed for the Visa Debit system – previous Bank standards applied only to the credit card systems, although *de facto* they also applied to Visa Debit as it is currently not possible to distinguish credit and debit cards. If Visa Debit cards were to become separately identifiable, as is canvassed in this document, the Bank proposes that the no-surcharge rule in the Visa Debit system be formally removed for the same reasons as applied in the case of credit cards. A number of submissions argue that most of the benefits of untying could be obtained by such an action without some of the perceived costs of a full untying.

The merchants, on the other hand, argue that the honour all products rule should be removed. They argue that Visa Debit offers them no benefits over and above those they receive from EFTPOS, yet it costs them considerably more. Given this, they would like the freedom to decline acceptance, and/or negotiate over the terms of acceptance. They point to examples from the UK and the recent Wal-Mart settlement in the United States to support the view that there is no detriment from abolition of the rule and, in particular, that consumers are not confused. Finally, the merchants argue that a pre-requisite for the abolition of the 'honour all cards' rule to have any effect is the separate identification of Visa Debit cards, both at the merchant/customer level and the issuer/acquirer level. There was little opposition amongst financial institutions to the proposal for separate identification on its own.

3.4 Possible Regulatory Responses

Through consultation three distinct options have emerged. First, there is the option of doing nothing. Second, some Visa Debit issuers have suggested that the honour all cards rule be retained but that separate product identification be required, thereby, allowing for differential charging by merchants. Third, there is the option of removing the honour all products aspect from the 'honour all cards' rule and making associated changes to ensure the effectiveness of this change.

Regardless of the option chosen, the Bank proposes to require that the no-surcharge rule be removed. This proposed change is essentially a housekeeping matter to ensure that Visa Debit cards are treated identically in this respect to other card payment products in Australia. A comprehensive discussion of the no-surcharge rule can be found in the consultation document on the credit card standards issued in December 2001.

3.5 The Bank's Preferred Option

In the Bank's view, current arrangements whereby it is not possible to treat Visa Debit cards and Visa credit cards differently are not in the public interest. In its opinion, the efficiency of the system would be promoted by Visa Debit competing against other debit and card products on its merits – something that it currently does not do. Thus, the Bank believes that no change is not in the public interest.

The first option for change is to mandate separate identification of Visa Debit and credit cards. This change would offer the possibility that a merchant could impose different charges on Visa Debit cards and Visa credit cards. If Visa Debit interchange fees are lowered in line with the draft Standard 4 outlined in the previous section, Visa Debit is likely to be cheaper for merchants to accept than Visa credit cards and this may be reflected in any charges levied by the merchant. Similarly, merchants may elect to impose a charge on Visa Debit transactions but not EFTPOS transactions.

The option would require Visa issuers to develop visually distinctive Visa Debit cards so that merchants would be in a position to identify the cards at the point of sale and impose different charges if they chose to do so.

The benefits of this option are, however, limited. It is unlikely that many merchants would take advantage of the ability to differentially charge for Visa Debit cards. Many merchants do not currently charge for accepting credit cards and fewer impose differential charges; as such, it is unlikely that many would differentially charge for Visa Debit cards. Consequently, in the Bank's view the implementation of this option would, at best, have little effect on market dynamics. And, to the extent that there are benefits, they are unlikely to outweigh the costs involved. As such, the Bank does not favour this option.

The second option for change is to require separate identification and modify the 'honour all cards' rule such that a merchant's decision to accept Visa credit cards did not automatically require him or her to accept Visa Debit cards (and *vice versa)*.

By separating the acceptance agreements, Visa Debit would be required to compete with other payment systems on its own merits. If merchants do not see value in accepting the card at the price charged by their financial institution they will be free to decline acceptance. This would move the payments system closer to the benchmarks discussed in Section 1, enhancing the efficiency of the overall system.

Visa argues that there are higher costs involved in maintaining a separate brand for debit cards. Visa also argues that there may be increased customer confusion if Visa Debit cards were distinguished from Visa credit cards. In evaluating these arguments, the Bank noted that separate electronic identification of Visa Debit cards is, as a practical matter, required if differential interchange fees, as discussed in the previous section, are to be implemented. It views physical identification of the cards to be a natural complement to this change. Separate identification is also necessary if merchants are to be able to exercise their ability to accept just Visa credit or Visa Debit cards. Furthermore, recent advertising by Visa promoting the Visa Debit card suggests that Visa perceives some benefit from separate promotion of the product even absent regulatory changes. Ultimately, there has been little objection to the proposal to have separate product identification. On balance, while this approach would involve greater costs to implement than the previous option, it has larger potential benefits.

As noted above, concerns have been raised that, because Visa Debit is predominantly issued by small financial institutions, any restrictions on Visa Debit would harm their competitive position. While the Bank recognises this argument, it does not believe that limiting competition to protect the current issuers is in the long-term interests of the Australian payments system. There is the significant prospect that any regulatory authorisation of the 'honour all cards' rule would contribute to rapid growth in issuance of scheme-based debit cards by larger financial institutions at the expense of EFTPOS. Furthermore, any action by large acquirers to refuse Visa Debit acquiring services to their merchants, as has been suggested might happen, would seem to be likely to raise further regulatory attention. More importantly, it is unlikely to be a profitable strategy for acquirers to follow.

On the basis of this discussion, the Bank's preferred approach is to require the modification of the 'honour all cards' rule to remove its honour all products aspect and make associated changes to support this.

3.6 Draft Standard on Visa Debit Identification and Acceptance Restrictions

This standard deals with two matters. The first is the abolition of the no-surcharge rule for Visa Debit transactions. Although the rule was removed for Visa credit transactions on 1 January 2003, there is still scope for it to apply to Visa Debit transactions. Paragraphs 8 and 9 of the Standard address this using language consistent with that in the standard for credit cards.

The second is the 'honour all cards' rule that requires merchants to accept Visa Debit cards if they accept Visa credit cards. Paragraph 10 would disallow this rule while paragraph 11 would provide for separate identification of Visa Debit cards.

Standard No. 5

The 'honour all cards' rules in the Visa Debit and Visa credit card systems and the 'no surcharge' rule in the Visa Debit system

Objective

The objective of this Standard is to ensure that the rules of the Visa Debit system and the Visa credit card system promote:

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the payment system operated within Australia known as Visa Debit, which was designated as a payment system on 18 February 2004 and to the Visa credit card system operated within Australia known as the Visa system or the Visa network card system which was designated as a payment system on 11 April 2001.
3. In this Standard:

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

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

   'credit transaction' means a transaction in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card;

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

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

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

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

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

‘rules of the Scheme’ means the constitution, rules, by-laws, procedures and instruments of the Visa Debit system and the Visa credit card system as applied in Australia, and any other arrangement relating to the scheme by which participants consider themselves bound;

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

4. Each participant in the Visa Debit system and the Visa credit card system must do all things necessary on its part to ensure compliance with this Standard.
5. If any part of this Standard is invalid, the Standard is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
6. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.
7. This Standard comes into force on [1 July 2006.]

Merchant pricing

8. Neither the rules of the Scheme nor any participant in the Visa Debit system shall prohibit a merchant from charging a Visa Debit cardholder any fee or surcharge for a Visa Debit card transaction.
9. Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a Visa Debit cardholder will be limited to the fees incurred by the merchant in respect of a Visa Debit card transaction.

Honouring cards

10. Neither the rules of the Scheme nor a participant in the Visa Debit system or Visa credit card system may require a merchant to accept Visa Debit cards as a condition of the merchant also accepting Visa credit cards. Likewise, neither the rules of the Scheme nor a participant in the Visa Debit system or Visa credit card system may require a merchant to accept Visa credit cards as a condition of the merchant also accepting Visa Debit cards.

Transparency

11. Visa Debit cards must be identifiable as such, both visually and electronically.

12. The administrator of the Visa Debit system and Visa credit card system must certify in writing to the Reserve Bank by 30 September each year that the Visa Debit system and Visa credit card system and participants in those systems complied with this Standard in the previous financial year.

Glossary of Acronyms

ACCC	Australian Competition and Consumer Commission
ACT	Australian Competition Tribunal
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ATM	Automatic Teller Machine
EFTPOS	Electronic Funds Transfer at Point of Sale
NECG	Network Economics Consulting Group
PIN	Personal Identification Number

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