



31 March 2004

Dr John Veale
Head of Payments Policy
Reserve Bank of Australia
65 Martin Place
SYDNEY NSW 2000

Dear Dr Veale

DESIGNATION OF VISA DEBIT

I refer to the Bank's letter dated 23 February inviting comments on the designation of the Visa debit system. Building Societies currently issuing Visa debit are concerned at the impact that changes to the interchange rates will have on the viability of the Visa debit product.

Considerable material has been prepared by the financial services industry, merchants and interested parties in regard to card-based payments as a result of designation of the credit card schemes and industry self-reform of EFTPOS. Credit card designation and EFTPOS reform appear to have set some precedents and certainly have raised some important issues related to card-based payments. Our intent in this letter is not to reiterate or expand on that material in respect to Visa Debit. Rather we would like to summarise the primary commercial issues of Visa Debit as they impact the Building Societies. We believe that the designation process will then afford us the opportunity to expand on those issues to the degree that they need further detail or where our perspective and that of the RBA may differ.

We make one observation on the timing of reform. The delaying tactics employed by the merchants on EFTPOS reform has left resentment among card issuers now suffering from a substantial fall in income from reduced credit cards and Visa debit interchange fees. Yet, the offsetting reduction in EFTPOS interchange fees is now unlikely to be achieved within 12 months of the credit card reforms. Any further move by the RBA on Visa debit prior to EFTPOS reform will place a totally disproportionate share of the burden of reform on card issuing institutions such as Building Societies.

Visa Debit is an important payment product to the Building Societies and their customers. Societies attract and serve a consumer market segment that is price sensitive and prefers to maintain a relationship with a financial institution that can provide low cost loans and transaction accounts¹. In order to do this, the Building Societies offer a range of payment products (ATM/EFTPOS cards, Visa Debit, credit cards) by which their customers have a range of payment options.

¹ Building societies are low cost operations measured in terms of Net Interest Income and Fees & Commissions by APRA. Refer to APRA, Insight 3rd Quarter 2003, [<http://www.apra.gov.au/Insight/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=6649>], tables B3 and B4 and RBA Cart Pack, [http://www.rba.gov.au/ChartPack/bank_income_profitability.pdf]. The building society industry has the same net interest income as the 4 major banks.

The mix of products offered varies from building society to building society but among the larger societies includes a Visa debit card and a debit or savings card. The mix of products offered to meet different consumer needs and preferences produce a revenue and cost structure that make them, collectively, commercially viable for a building society.

Visa Debit uniquely services a market niche by providing customers with all the functionality of a credit card without the "overspend" that can occur with credit cards². It provides access to a customer's transaction account for purchases and cash withdrawals and also provides (unlike EFTPOS but similar to credit cards) the ability to use the card for cardholder-not-present (MOTO and Internet) and international transactions. It is a unique payment product in terms of functionality, sharing attributes of credit cards without account or annual fees levied on the cardholder. It is an important product offering to our customers.

Recent changes to credit card interchange fees have had a significant impact on Building Societies with major societies issuing their own credit card or issuing a credit card via an alliance partner. Societies have also been impacted by the flow on effect for Visa debit with income cut by 50%

The financial services industry has applied for authorisation of a change in EFTPOS interchange to \$0 under a voluntary scheme. The ACCC issued its final determination; and that determination will be heard in the near future by the Australian Competition Tribunal. Assuming the reduction in interchange fees prevails, the Building Societies should see an offset to the losses from credit/Visa debit changes because they are net issuers of ATM/EFTPOS cards. However, there is pressure for those cost savings to be passed back to customers to the extent that they are charged to customer as part of their fees instead of rectifying the reduction in income from other reforms.

The final outcome for Visa Debit interchange in the designation process is uncertain. The RBA has signalled that it believes the Visa Debit interchange fees (currently at about 53 basis points) is too high and not supported by transparent economic and commercial logic. Building Societies fear that the interchange fees will decline further placing the viability of a Visa debit in considerable doubt.

We consider that the RBA together with the industry undertake a proper assessment of signature debit interchange during the designation process.

The framework to determine interchange fees for all card based payment products should be uniformly and consistently applied. This does not mean that the interchange fees would be the same because product specific interchange fees would be driven by different cost structures of the different institutions and card-based payment products. In addition, following the credit card interchange standard, interchange fees for Visa Debit could be different for different transaction types (e.g. one rate for card present transactions and another for cardholder not present transactions) such that the weighted average of the fees does not exceed measured average interchange costs.

² A reoccurring theme in various Reserve Bank speeches and statements is the increase in household debt. While largely attributed to housing, credit card debt is acknowledged by the Bank as a significant source of growth in household debt. Worse in the mind of the Bank is that credit card debt is expected to be largely consumer expenditure brought forward and not investment expenditure.

In its credit card Consultation Document the RBA said "The Reserve Bank acknowledges that interchange fees can have a role in credit card schemes, as a means of enabling issuers to recover costs of providing specific payment services that are of benefit to merchants." (page vii). The model applied to pricing credit cards applies equally to Visa debit. Visa debit card issuers also need to keep their system compliant with all the changes expected for credit cards. Recent examples include internet authentication methods (VbV), Triple DES encryption, Mail order/ Telephone order authentication (CVV2), regular 6-monthly Visa system enhancements, etc. This is in addition to the normal costs associated with card scheme membership. Expenses on Visa debit require the current interchange fee levels to ensure the on-going viability of the product.

The Building Societies have reviewed their payments business in the light of different possible outcomes for Visa Debit interchange fees. If the interchange rate for Visa debit were to drop much below the credit card interchange levels, the product would not be viable for Building Societies to offer customers as part of their payment product mix. A positive interchange fee close to the credit card interchange fee would allow societies to retain a commercially viable product. While not having rigorously applied cost data to the credit card cost model, Societies intuitively consider the costs would support near credit card interchange levels. Societies would be prepared to provide data to assist populate the credit card model.

There is also the question of whether a customer chooses the credit button or the cheque/savings button. This choice does not exist with a comparable credit card although similar functionality exists. It is our contention that the ability for merchant's to surcharge and the fact that many are taking up this option addresses policy concerns. All transactions where the credit button is pushed should attract Visa debit interchange rates. It is noteworthy that the customer has the option; the alternative is for a credit card when there will be no choice of button **and at a higher cost to the merchant.**

Building Societies support the continuation of the honour all card rule. Removal of the rule would lead to confusion among Visa debit cardholders as their card could be used at most but not all merchants. Visa debit would quickly disappear as cardholders replaced their Visa debit cards by a universal credit card. Again the answer is for merchants to surcharge **and still benefit by the advantages of a credit card type payment at a rate marginally below credit card interchange rates..**

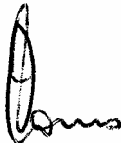
If Visa Debit does not remain a viable product, the Building Societies would revise the mix of their products to meet the payment needs of their customers including cardholder-not-present transactions and international purchases. A logical change would be to replace Visa Debit cards with credit cards **or introduce new fees on society members to recover lost income.** We do not perceive this as a particularly desirable outcome for:

1. Building Societies because its customers typically prefer a transaction account card rather than a credit card;
2. Australia because credit card transactions would displace Visa Debit transactions, resulting in higher payments system costs because credit card interchange likely would be higher than Visa Debit interchange under a consistent interchange framework: or
3. merchants because they would pay a higher merchant service fee.

Dr John Veale
Reserve Bank of Australia
31 March 2004

We trust the information above helps you understand the primary issues and concerns of the Building Societies in respect to Visa Debit interchange fees and the designation process. Within that framework, we will be looking forward to working with you to provide additional clarity and facts to these issues and concerns.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'John Toms', with a stylized flourish at the end.

JOHN TOMS
CHIEF EXECUTIVE OFFICER