

VISA INTERNATIONAL SERVICE ASSOCIATION



VISA DEBIT CARD SCHEME IN AUSTRALIA
COMMENT ON
RESERVE BANK OF AUSTRALIA CONCERNS

MARCH 26, 2004

Introduction

Visa International will comment in this submission on each of the four areas that Reserve Bank of Australia (RBA) has expressed as being of concern to it in the context of the Visa “debit card scheme” operated in Australia by Visa International through its member financial institutions. Those concerns, as set out by the RBA in its media release of 23 February 2004, and a summary of Visa International’s response to them, are set out below.

Visa Debit – ATM/EFTPOS

Before turning to the RBA’s expressed concerns, however, it is worth noting the ways in which Visa debit cards are different from ATM/EFTPOS debit cards and, consequently, warrant different treatment.

First, Visa debit offers a significantly wider range of functionalities than the banks’ ATM/EFTPOS cards. For example, Visa debit cards can be used to pay bills over the telephone and to make transactions over the Internet.

Secondly, Visa debit cards have far wider acceptance than ATM/EFTPOS cards. Even within Australia, the Visa debit card is accepted at locations such as restaurants that do not generally accept ATM/EFTPOS cards. In addition, and for some consumers importantly, the Visa debit card can be used internationally while most bank-issued ATM/EFTPOS cards cannot.

Thirdly, issuance of Visa debit products in Australia has to date been undertaken by smaller financial institutions including credit unions and building societies. While volumes arising from the product are small relative to the volumes arising from EFTPOS and credit cards, it has enabled such institutions to compete with much larger competitors by enabling them to offer a product which has different benefits to the EFTPOS product typically promoted by the big four banks.

Inappropriate regulation of the product may have an unintended adverse impact on these smaller financial institutions, lessening competition and consumer choice within Australia.

Fourthly, Visa debit transactions can under a range of circumstances be “charged back” by the issuer to the acquirer involved in a transaction at the request of the cardholder. This facility is of particular value to cardholders where the merchant fails to deliver the relevant goods or services – for example, as a result of the merchant’s insolvency. Where an ATM/EFTPOS card is used in such a transaction, the cardholder is exposed to risk of bearing any loss.

Interchange Fees on Visa Debit Card Transactions

The RBA observes that the interchange fees charged between financial institutions for the processing of Visa debit transactions are the same as for Visa credit card transactions.

The RBA is aware that Visa International does not consider that interchange fees are fees charged for “processing” transactions. Instead, interchange is a mechanism for balancing the costs and revenues of the issuing and acquiring sides of the payment network. Its purpose is to encourage as many merchants as possible to accept VISA-branded cards, to encourage as many consumers as possible to use such cards and to encourage as many financial institutions as possible to participate and invest in the VISA payment network. This objective does not require that fees for credit card transactions and for debit card transactions need be different, although Visa International acknowledges that they are, in fact, different in some countries outside Australia.

Notwithstanding the above and recognizing that the RBA has established a regulated interchange regime for credit cards in Australia, Visa International proposes establishment of a regulated cost-based benchmark for calculation of interchange rates for Visa debit card transactions in Australia.

Details of this proposal appear below under “Visa Debit Cost-Based Benchmark”. In doing so, Visa International proceeds on the basis that the RBA is seeking only a reduction in the weighted average Australian domestic interchange rate for its Visa debit product.

In summary, consistent with the principles in the existing regulations for credit card transactions, the cost-based benchmark for Visa debit card transactions would be calculated in the same manner as for credit card transactions. It would be based on costs incurred by debit card issuers. As there is no “interest free period” generally allowed for debit card transactions, however, the component referring to the interest free period would either be omitted or set at zero.

Visa Debit Cost-Based Benchmark

Visa International has made extensive submissions to the RBA in the past regarding the need for interchange fees that balance the costs and revenues of the issuing and acquiring sides of the payment network and, more generally, regarding the concepts of network economics that support its approach to interchange rate setting¹. Visa International does not resile from the position expressed by it in those submissions and the proposal set out below should not be read as an abrogation of the position it has previously expressed and continues to hold.

¹ See Visa International’s response to the RBA’s Consultation Document in March 2002, and subsequent submissions by Visa International to the RBA regarding interchange.

Notwithstanding the above and recognizing that the RBA has established a regulated interchange regime for credit cards in Australia, Visa International proposes the arrangements for debit card interchange set out below. (As noted, some of the terms used would have the same/parallel meaning as in the existing regulations.)

Proposal

Visa International proposes setting interchange for domestic transactions² on Visa debit cards³ by using a cost-based methodology similar to that mandated for interchange on domestic transactions on Visa credit cards under Standard No. 1: The Setting of Wholesale (“Interchange”) Fees (the “Standard”).

The following terms would apply:

1. The cost categories at the outset (see 3. and 4. below for later arrangements) for deriving a cost-based benchmark for Visa debit transactions would mirror those established for credit cards under the Standard, with the exception of the cost of the “interest free period” (or, if the RBA prefers consistent categories of eligible costs, that component could be set at zero). Consequently, they would be:
 - (i) issuers’ costs incurred principally in processing debit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;
 - (ii) issuers’ costs incurred principally in respect of fraud and fraud prevention in connection with debit card transactions;
 - (iii) issuers’ costs incurred principally in providing authorization of debit card transactions,(referred to collectively as “initially eligible debit costs”).

² A “domestic transaction” is a transaction in Australia between the holder of a debit card issued in Australia and a merchant in Australia that accepts debit cards involving the purchase of goods or services using the debit card.

³ A “debit card” is a card issued in Australia under the Visa International rules that can be used for purchasing goods or services by debiting the transaction amount to a cardholder’s deposit.

2. The initially eligible debit costs could be determined by undertaking a study as soon as reasonably possible of the costs of a representative sample⁴ of debit card issuers that issued debit cards that were used in transactions in Australia (“nominated debit participants”) in the 2002/03 financial year.

However, in order to avoid both undue delay in implementing the new interchange arrangements⁵ and the high cost of carrying out a study at relatively short notice, Visa International proposes determining the cost-based benchmark by extracting the initially eligible debit costs from the study conducted by Bayshore Consulting Inc. in December 2001 of five debit issuers.

We would expect that we could arrange for Bayshore Consulting to review their earlier cost study without delay and on the basis of that study and necessarily estimating some costs to account for differences in methodology, to determine a cost-based benchmark for debit cards.

Visa International proposes an implementation date for these new arrangements that would see the new interchange rates being introduced to coincide with the beginning of the next financial year for the majority of its members in Australia, namely 1 October 2004.

3. The cost-based benchmark for debit card interchange would be re-calculated for commencement of a revised rate on 31 October 2006 and thereafter at intervals of not more than three years. In order to encourage issuers of Visa debit cards to adopt PIN-based authorizations,

⁴ Visa International will need to propose a method of determining a representative sample of debit card issuers. The composition of the sample would likely change over time. At present, there are approximately 110 Visa members in Australia issuing from around 5,000 cards to over 110,000 cards, so sampling requires careful consideration.

⁵ The time of Visa International’s cost consultants is typically booked out several months into the future, so it could be some months before a cost study could be commenced. It would, of course, be likely to take several weeks to complete.

the “fraud” component of the initially eligible debit costs would be adjusted. Consequently, the ongoing cost categories would be:

- (i) issuers’ costs incurred principally in processing debit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;
- (ii) issuers’ costs incurred principally in respect of fraud and fraud prevention on the basis of:
 - where and to the extent that the relevant nominated debit participant’s debit card transactions are authorized by PIN, the actual such costs; and
 - where, and to the extent that, the relevant nominated debit participant’s debit card transactions are authorized by the cardholder’s signature, by an estimation of such costs (for example, based on fraud experience in that issuer’s EFTPOS transactions) as if its transactions had been authorized by PIN and not by signature; and
- (iii) issuers’ costs incurred principally in providing authorization of debit card transactions (including the costs of migrating from a signature-based to a PIN-based authorization system), (referred to collectively as “ongoing eligible debit costs”).

4. The ongoing eligible debit costs would be based on a cost study conducted in relation to the nominated debit participants at that time for the 2005/06 financial year. This would align the debit cost study to the timing of the next credit cost study, which should reduce the cost of the study that would be borne solely by nominated debit participants. The methodology would be the same as for credit card cost studies required by the Standard and its independent expert appointed for the purposes of the Standard would undertake the same work for debit card cost studies as for credit card cost studies.

Thereafter, cost studies in relation to nominated debit participants would ordinarily be conducted at the same time as studies for Visa credit card nominated Scheme participants. The cost-based benchmark for debit cards would ordinarily be adjusted in accordance with timing of adjustments required by the Standard for the credit card cost-based benchmark. (“Ordinarily” assumes that eligible costs would be determined every three years as set out in the Standard.)

If it were necessary or desirable for either the credit card cost-based benchmark or the debit card cost-based benchmark to be determined at a shorter interval, they may fall out of step with each other. Nevertheless, studies and consequent adjustments would be made at intervals no longer than three years.)

5. Visa International would provide to the RBA the cost-based benchmark and the data on eligible costs used by the independent expert to calculate the cost-based benchmark for debit cards and certify annually in writing that debit card interchange fees in Australia over the prior twelve months ending 31 October adhered to that benchmark (similarly to compliance under the Standard).
6. The costs of nominated debit participants may be higher than “equivalent” costs for nominated Scheme participants, particularly at the outset, due to lack of scale and other operational issues.

The cost-based benchmark for debit cards at any time would, nevertheless, be capped at the cost-based benchmark for credit cards at that time calculated in accordance with the Standard.

7. Visa International would publish the interchange fee rates for Visa debit card transactions in Australia on its website (in the same manner as it publishes its interchange fee rates for credit cards, as required by the Standard).

Visual Distinction Between Visa Credit and Debit Cards

The RBA notes that debit cards cannot be distinguished at the point of sale from Visa credit cards.

Visa International agrees that this is typically the case in Australia, although Australian merchants would sometimes be presented with debit cards issued outside Australia that are, in fact, visually distinguishable on their face as debit cards. This arises from a preference in some countries for visual distinction for various local reasons, possibly including local regulatory requirements, or may arise simply from a preference of the relevant card issuer. Visa International does not believe that visual distinction of its debit cards of itself has any material effect on efficiency and competition in the payments system in Australia.

Consistent with this view, Visa Asia Pacific does not have any rules currently requiring a member in Australia that chooses to issue a VISA-branded card as a debit card to visually distinguish such cards from VISA-branded credit cards carrying the same acceptance logo (that is, the familiar “blue, white and gold bands design” – the “Visa Flag”⁶ - that is used by its members in Australia).

Nevertheless, in order to address the RBA’s concern, Visa Asia Pacific is prepared if necessary to seek the necessary approvals to require Visa

⁶ In some countries, members issue Visa “Electron” cards, usually as debit cards. This branding is quite separate from the Visa Flag brand. Visa Asia Pacific has no current plans to promote issuance of Visa Electron in Australia and does not propose to do so in order to achieve visually distinctive cards for a variety of reasons including the high cost of establishing and promoting a new brand/acceptance mark in Australia.

International's members in Australia to add an identifier to their Visa Flag card to clearly distinguish "debit" cards from its other payment cards.

This would enable merchants that wish to surcharge them to identify Australian Visa Flag cards at point-of-sale.

Due to the time required to re-design cards and the costs involved in card re-issuance – that is, to avoid an unnecessary cost burden on its members, particularly given that its smaller members (for example, credit unions) tend presently to issue cards as debit cards - Visa International proposes phasing in this requirement as cards are issued or re-issued in the course of their normal replacement cycle on and from 1 October 2004.

Visa International's 'Honor All Cards' Rule

The RBA makes the point that the 'honor all cards' rule enforced by Visa International requires that merchants accepting Visa credit cards must also accept Visa debit cards.

The 'honor all cards' rule is not unique to Visa or to four-party payment card schemes generally. All major payment card brands – including MasterCard, American Express and Diners Club – have a similar rule that they apply to their participating merchants. The rule also is not unique to Australia. It is applied internationally by major payment card brands throughout the world. The main goal of Visa's rule is to ensure that holders of VISA-branded cards can be confident that their card will be accepted at any merchant that displays the same acceptance logo anywhere in the world, including in Australia. The rule helps give four-party payment networks the ubiquity that is so vital to their existence and growth and to the convenience and security of their cardholders and merchants.

The 'honor all cards' rule is, therefore, a fundamental rule of Visa International's payment system.

A copy of Visa International's extensive submissions to the RBA explaining the reasons for this and discussing the effect of the 'honor all cards' rule on the efficiency of, and competition in, the payment system, from which confidential information has been deleted, are for convenience attached to this paper – see Appendix A: *Visa's Response to the RBA on Debit Issues*, January 2004 and Appendix B: *Economic Analysis of Visa's Honour All Cards Rule*, 12 December 2003.

These submissions responded to lines of argument raised verbally by the RBA during discussions with Visa Asia Pacific and which seem to have been sparked by views expressed by retailers.

So far as Visa Asia Pacific is aware, neither the RBA nor the Australian Retailers' Association (or any individual retailer or retailer representative) has put forward public arguments for the abolition of the 'honor all cards' rule in Australia, together with reasons supporting those arguments. Consequently, there may be points that Visa International's existing submissions have not addressed. If such arguments are put forward as part of the RBA's current consultation process, Visa International looks forward to addressing them based on the reasons then advanced.

In the meantime, Visa International notes that since 1992 the European Commission has conducted inquiries into various aspects of Visa International's conduct. On 9 August 2001 it released its findings⁷ on a number of issues,

⁷ Commission decision 9 August 2001 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (Case No. COMP/29.373 – Visa International).

including its findings concerning the competitive and efficiency effects of the 'honor all cards' rule.

In particular, the Commission found⁸ that:

“The fact that under the honour all cards rule, merchants are obliged to accept all valid cards with a certain brand, regardless of the type of card and regardless of the merchant fee, cannot be said to be restrictive of competition.”

While the 'honor all cards' rule was 'bi-furcated' in the United States in 2003 to make a distinction between credit cards and debit cards as part of a settlement between Visa U.S.A. Inc and a group of retailers led by Wal-Mart, the decision to proceed in this way was not in any way an abrogation of the fundamental importance of the rule.

The decision occurred as a result of balancing the risks of continuing with class action litigation that involved a damages claim (US\$100 billion, with a claim that this amount should be trebled) that was so substantial as to place the continuation of the Visa system at risk even if Visa U.S.A. was confident of ultimately prevailing on the merits. The US retailer settlement did not address, or relate to, aspects of competition and efficiency that are relevant under the Payment Systems (Regulation) Act 1998, but proceeded on anti-trust grounds that were significantly different from the regulatory and competition laws applicable in Australia.

There were other more practical differences between claims in the Wal-Mart litigation and the situation in Australia. The Wal-Mart plaintiffs claimed that Visa U.S.A. was trying to use a dominant position in the credit market in the United

⁸ Supra, at paragraph 68.

States in various ways and that the ‘honor all cards’ rule was instrumental in that context. Claims included arguments about monopolization of the debit sector through acquisition of the Interlink “PIN debit” network, arguments that Visa U.S.A. had prevented merchants from steering cardholders to lower cost debit alternatives, arguments that Visa U.S.A. tried to prevent competitive marks being placed on the back of VISA-branded cards and arguments that if there were no ‘honor all cards’ rule there would be increased competition that would lead to an interchange rate of zero. All of these claims – specific to the United States marketplace situation - were factually wrong or unsupportable.

Had the matter proceeded to trial or other resolution on the merits, the theory that Visa U.S.A. had set out to destroy the competitive networks would have been decisively rebutted by evidence from competitors that Visa U.S.A.’s presence in the market actually helped them because of the contribution that it made to consumer acceptance of debit products generally and the system infrastructure. Notwithstanding the Wal-Mart settlement, interchange in the United States continues to be set by Visa U.S.A. at commercial levels and merchant discounts negotiated between acquirers of VISA transactions and merchants.

The position is fundamentally different from that proposed in Australia, with regulated interchange rates for Visa debit transactions. Given the merchants’ allegation in the Wal-Mart litigation that they were injured because the ‘honor all cards’ rule permitted Visa U.S.A. to set debit interchange too high, in the case of regulated interchange rates there is no purpose to be served by interfering with the efficiency and consumer benefits of the rule. In the Australian context, Visa International believes the ‘honor all cards’ rule continues to be of fundamental importance. The rule facilitates both efficiency and competition in the payments system and these effects overwhelm any potential negative impacts. The economic arguments supporting these factors are summarized in Appendix A (together with a discussion of some of the more commercial aspects of them and

the implications for Australia – for smaller financial institutions, such as credit unions in particular) and are fully discussed in Appendix B.

Of particular concern in the context of Australia is that removal of the rule might lead to large acquirers suppressing the acceptance of VISA-branded debit products currently issued largely by smaller financial institutions.

Visa International's 'No Surcharge' Rule

The RBA notes that Visa debit cards are subject to a 'no surcharge' rule.

Visa International believes that the 'no surcharge' rule is important because it prevents merchants from increasing the price of its goods or services to a cardholder, typically in a way that is inadequately monitored, that seek to pay with a VISA-branded card. Visa International considers it is unfair to cardholders for merchants to be able to levy a charge for accepting a Visa card payment, particularly when such a charge is not required to be reflective of costs incurred by a merchant in accepting such cards. Consequently, Visa International remains opposed to surcharging on all its payment cards.

Visa International, Asia Pacific Region

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