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15 February 2006

Dr John Veale  
Head of Payments Policy  
Reserve Bank of Australia  
GPO Box 3947  
SYDNEY NSW 2001

Dear John,

### **Draft Standards for Regulation of the Visa Debit Scheme**

This letter is in response to a media release issued by the Reserve Bank of Australia (RBA) on 20 December 2005. In that media release, the RBA noted that it would finalise its consideration of both the draft standards for the EFTPOS system and those for the Visa Debit Scheme prior to March 2006. The release invited any further comments on the draft standards for the Visa Debit Scheme.

Visa International made two substantial submissions on the proposed standards for the Visa Debit Scheme on 29 April 2005. We have summarised the points made in those submissions at the end of this document; we maintain that they are valid and reiterate them. This letter deals with two issues that have arisen since those submissions were made.

### **Inclusion of Mastercard Debit in the regulatory regime**

The first issue concerns a comment made in the RBA's 20 December 2005 media release, as follows:

#### ***MasterCard Debit***

*MasterCard has recently launched a debit card product in Australia. Following discussions with the Bank, MasterCard has indicated that it will voluntarily conform with Standards dealing with interchange fees and the 'honour all cards' rule should such standards be imposed upon the Visa Debit system.*

We do not believe that this approach is acceptable in principle or that it will prove workable in practice.

First, as we have consistently stated in our submissions, any regulatory regime must be competitively neutral. To have one scheme formally regulated while another is given the option of voluntary compliance is clearly unbalanced and unfair. As a simple matter of regulatory best practice, for one product to be regulated and another, that is similar in character, not to be regulated, must be wrong.

Arguably, a precedent for this has been established in relation to the exemption of three party closed-loop schemes under the credit card standards, even where they have adopted the characteristics of the regulated, four-party open-loop schemes. As the RBA is well aware, Visa strongly objects to this anomaly and it has been the subject of considerable public comment. The imbalance would be even more concerning if such an approach were taken in relation to MasterCard Debit.

Second, in practical terms while Visa will be bound by the strict letter of the standards, MasterCard will have the option of interpreting what its voluntary commitment means and to seek competitive advantage from that opportunity. The RBA may not be in a position to determine if MasterCard is complying with its undertaking or may not be able to detect a breach for an extended period of time.

Furthermore, if MasterCard were to breach its undertaking, the RBA would have no immediate enforcement mechanism. The only sanction would be to amend the standards in order to capture future conduct. It would make more sense to move to that situation now to avoid any future problems of enforcement.

Third, Visa reiterates its view that debit cost data should be used to establish the cost benchmark for scheme debit interchange. The justification is put at length in our earlier submissions. If this approach is adopted it will be essential to have MasterCard included in the regulatory scheme to facilitate the creation of a common cost benchmark, similar to that recently adopted for the calculation of credit card interchange.

Finally, we note that the Bank's media release states that MasterCard will voluntarily comply with Standards relating to interchange and the "honour all cards" rule. While we object to this course, the proposed Visa Debit standards also remove the "no surcharge" rule for Visa Debit. We would expect MasterCard to be subject to a similar limitation, were it imposed on Visa Debit in Australia.

In order to bring MasterCard within the standards, we simply propose that the words "Visa Debit" be replaced with "Scheme Debit" and appropriate definitions identifying the Visa and MasterCard Debit schemes be added to the Standards.

### **Electronic Identification**

The draft Standard No. 5 (paragraph 11) specifies Visa Debit cards must be identifiable as such, both visually and electronically. Further to our comments in our 29 April 2005 submission (paragraph 3.3.4), we have undertaken some initial investigation of the proposed "Electronic Identification" requirement.

Identification of Visa Debit transactions occurs electronically within VisaNet during off-line overnight clearing and settlement to ascertain the relevant fees and charges to be applied. Visa Debit transactions are not specifically identified on-line during authorization processing and our preliminary investigations indicate that a significant amount of work is required to develop support for electronic identification at the point of sale by merchants, acquirers and Visa. These changes will involve significant costs and time for all parties, particularly to acquiring banks and merchants who deploy point of sale terminals.

Acquirers and merchants deploy point-of-sale terminals in Australia. These terminals have been configured in accordance with Visa's regulations as well as criteria specified by the Australia Payments Council of Australia (APCA), because the overwhelming majority of terminals accept EFTPOS, Visa and other card schemes. The terminals follow these standards and practices to ensure a common approach to security, telecommunications, the nature of the consumer experience and fundamental processes relating to settlement.

These standards currently do not define how a device would electronically identify a Visa Debit card. Issues that arise include and are not limited to:

- How the terminal would identify a Visa Debit card transaction.
- How this feature would be enabled/disabled at the terminal.
- What messages would be displayed to the merchant and consumer.
- How the terminal would avoid denial of EFTPOS functionality from Visa Debit cards carrying capability for both types of transactions.
- How foreign Visa Debit cards would be handled.

Given that most Visa Debit cards have dual functionality (they can also operate as EFTPOS cards), it seems that the RBA's intention is to enable a merchant to identify electronically a Visa Debit transaction as distinct from a Visa Debit card.

Our investigations suggest that acquiring banks and large merchant processors do not have the technical ability in place to introduce electronic identification of Visa Debit transactions. Specifically, an acquirer (or merchant processor) would be required to maintain a secure, active list of Visa Debit card ranges at all terminals. Terminals would need to be reprogrammed to consider a combination of account selection (cheque, savings or credit button at the device) and the current list of Visa Debit card ranges. To complicate this matter further, there are no current standards that ensure the process at the point of sale is common across the network. It is our belief that standards would need to be defined in this area prior to the development of such changes.

Emerging prepaid card products and Visa Debit cards without EFTPOS functionality, which will also utilise the same terminal equipment, will need to be assessed as part of this standard setting process, adding a further layer of complexity.

Based on our preliminary understanding of the degree of difficulty involved, we believe the project would take a significant amount of time and resources to define the necessary standards, to modify or replace terminals, payment gateways and acquirer processing environments and to test the system. There would be a further period to propagate and install the code at all terminals nationally.

In addition to changes at physical terminals, changes of this nature will also be required in systems that provide “card not present” acceptance of Visa Debit cards. Specifically, operators and processors of mail and telephone order systems, internet payment gateways and the like will require modification to meet the RBA’s proposed standard. It is our recommendation that if the Bank continues to pursue Paragraph 11 in support of changes to the “honour all cards” rule, a formal technical market assessment should be undertaken, plus development of standards and a lengthy implementation process then carried out.

### **Summary of previous submissions**

The following sections briefly restate the principal arguments Visa has made in its earlier submissions on the proposed regulation of the Visa Debit scheme.

#### *Balancing Role of Interchange*

The use of interchange has been fundamental to the development of credit and debit card markets around the world. It has enabled the card schemes to tailor the net benefits that accrue to both cardholders and merchants in order to promote growth in the overall market. Interchange allows a “balancing” of market conditions on both sides of the network, and in doing

so fosters network externalities to the benefit of cardholders and merchants alike.

By proposing replacement of this market-derived and internationally accepted approach with a cost-based methodology for interchange, the RBA has embarked upon a course that risks introducing distortions that will limit choice, reduce competition, harm products with more features and deter innovation. In particular, an emphasis on reducing merchant service fees is inappropriate as a basis for assessing whether particular reform options will or will not promote social welfare and the objectives set out in the relevant statutes.

### *Differing Methodologies*

As a general matter, Visa views with some concern the RBA's proposal to allow the interchange fee for EFTPOS to flow in a different direction from that for credit and Visa Debit without providing any economic or public benefit basis for that decision. A simply expressed desire for "incremental change" without a sound economic underpinning is an insufficient basis for reform. If there is to be regulation, it should follow good regulatory practice and good regulatory practice requires consistency in the application of principle that is grounded in sound economic analysis.

### *Calculation of the Visa Debit Cost Base*

If a cost-based approach is to be used for setting an interchange benchmark for a system, then it is both logical and important to use the costs for that system as the basis for the benchmark. The approach should be consistent with, and not narrower than, the approach established in the RBA's standard for the regulation of credit card interchange.

In particular, Visa International believes that the eligible costs should be based on those of current Visa Debit (and MasterCard Debit) issuers and then adjusted at the subsequent review, should the base of supply have changed. Basing interchange for Visa Debit cards issued predominantly by smaller financial institutions on the eligible costs of credit cards issued predominantly by large financial institutions may well drive out the smaller institutions from the market. This would reduce competition and provide large financial institutions in Australia with a significant competitive advantage.

Visa International asked its independent consultants, Bayshore Consulting Inc. (who, as the RBA is of course aware, are also the independent experts appointed by the RBA for the purpose of calculating the credit card cost benchmark under Standard No. 1), to conduct a cost study in relation to the costs incurred by issuers of Visa Debit cards. The results demonstrate that the costs to existing Visa Debit issuers, based on the costs allowable under

Standard No. 1, are \$0.365 per transaction – significantly above the costs quoted or estimated by the RBA. Mandating a lower interchange fee will significantly impact the profitability of current issuers with obvious implications for consumer choice and competition.

Further, Visa International is concerned that excluding the cost of fraud management from the definition of eligible costs will reduce issuer revenues that are available to enable them to invest in such systems. If fraud levels rise, this will in turn erode confidence in the security of the Australian payments system generally. Fraud costs for PIN and signature based debit systems can increase rapidly – as seen by the Interac system in Canada – and the interchange structure should enable, if not encourage, early investment to address such risks.

#### *“Honour all Cards” Rule*

Visa International, along with other card schemes in Australia and overseas, has employed its “Honour All Cards” rule as a crucial element of developing a robust system that is open to a wide range of participants. Under the rule, all merchants who accept the Visa “flag” must accept all Visa-branded cards regardless of the issuer or the precise product. Similar rules require that MasterCard merchants accept all MasterCard branded cards and that American Express merchants accept all American Express branded credit and charge cards.

The “Honour all Cards” rule is fundamental to improving the efficiency of, and competition within, the Visa system. It facilitates the entry and expansion of new issuers and new products, both of which would face start-up hurdles if the rule did not operate. In turn, the rule has helped to underpin the growth of the card networks to the benefit of both cardholders and merchants. It is of benefit to the travel and tourism sectors of the economy, because it ensures that foreign visitors can be confident that they can use any type of Visa card when they visit Australia.

In our view the Reserve Bank has not made a case (in economic or policy terms) to justify the dropping of the “Honour all Cards” rule.

#### *Regulation of Three-Party Systems*

In its Media Release of 24 February 2005 on Payments System Reform, the RBA argues that it is not appropriate to regulate the payments made to issuers by closed schemes (most notably American Express and Diners Club) as these payments, in its view, do not significantly affect merchant service fees. The overriding principle should be one of competitive neutrality. In particular, Visa (and other open payment systems) should not be placed at a competitive disadvantage by regulatory intervention.

It is already evident from the Bank's regular reporting that American Express, in particular, has substantially increased its market share in the last twelve months and has done so while heavily marketing the advantages it has gained by virtue of this regulatory imbalance. The latest example of this phenomenon is the recently announce Qantas American Express card that is chiefly marketed on the basis of its frequent flyer rewards programme.

I look forward to your response to the matters discussed in this letter and would be happy to discuss any of the points we have raised.

Yours sincerely,

A handwritten signature in black ink that reads "Bruce Mansfield," with a comma at the end. The signature is written in a cursive, slightly slanted style.

Bruce Mansfield  
Executive Vice President  
Australia & New Zealand