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Building Society Comments on RBA Draft Standards for Visa Debit and EFTPOS

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Building Societies have read the Reserve Bank of Australia's (RBA's) proposed standards in regard to EFTPOS and Visa Debit and believe modifications to the proposed draft standards would be more effective in achieving the RBA's objective of greater efficiency and competition in Australia's payments system.

EXECUTIVE SUMMARY

In regard to Standards No. 3 and 4, Building Societies believe the proposed RBA interchange standards for EFTPOS and Visa Debit should be modified to better reflect the commercial realities of all participants in the payments systems.

1. The RBA has been investigating card based payment reform since early 2000, with the baseline "Joint Study" published in October, 2000. The investigations have continued for almost 5 years.

   In spite of the time involved, the vast and very able resources of the RBA in conducting the investigation, and the substantial body of knowledge related to this subject developed prior to and during this period, both in Australia and other markets, the RBA still has not developed a set of internally consistent commercial principles on which interchange fees are to be based for all card based payment products. Nor has the RBA indicated why each card based payment product is inherently different such that different methodologies for calculating interchange should be used.

   While acknowledging that it will review consistency of interchange methodologies across card-based payment products in 2007, this will have resulted in a period of over seven years in which financial institutions, such as Visa Debit issuers, must make business decisions with significant uncertainty of the future regulatory framework.

   In essence the RBA has undertaken at least a seven year empirical experiment of the impact of lowering interchange fees to assess whether actual marketplace behaviour is consistent with economic theory. Business decision-making is significantly and adversely impacted under this approach.

2. The lack of a consistent framework coupled with the specifics in the draft RBA standards appear to strike a compromise solution between (1) the policy direction of the RBA to lower interchange fees and (2) the vested interests of some debit scheme participants (such as retailers), without giving due consideration to the commercial interests of others (such as Visa Debit issuers). This results in the collective reforms having a disproportionate adverse impact on Visa Debit issuers. This can be avoided while still achieving the RBA's reform intents of moving toward transparent end-user pricing that reflect resource costs.

3. Without a modification to the reforms, Visa Debit issuers are highly likely to migrate their customers to payment products that can satisfy customer needs and are most

financially attractive to existing Visa Debit issuers.

In most instances, this means that existing Visa Debit issuers will migrate cardholders to a credit card/charge card with attributes that meet the cardholders' needs. The result will run counter to what the RBA anticipates:

a. There will be as many or more credit card transactions, not more EFTPOS transactions. Cardholders will use their credit card, not EFTPOS, in instances where they now use Visa Debit, not EFTPOS. As a result, merchants will pay merchant fees for a credit card transaction, and not a lower merchant fee that would have resulted from an EFTPOS or Visa Debit transaction.

b. Consumer (credit card) debt will increase to the degree that Visa Debit cardholders utilize a credit card's line of credit

4. With a more commercially viable interchange fee for Visa Debit, issuers will continue to offer the product. Consumers will continue to have the product functionality they desire, growth in consumer debt will be mitigated, and merchants will pay merchant fees lower than credit card levels.

In regard to Standard No. 5 Building Societies believe that the implementation of Visa Debit identification should commence on or before the effective date of the standard and that the period to complete implementation should follow typical cycles in terms of card replacement and the constraints, to the degree there are any, for Visa to develop and implement the international standards for electronic identification. There is no indication that the benefit of Visa Debit identification offsets the cost for having Visa Debit issuers undertake a forced reissue of all cards by 1 July 2006 or incur the cost, if any, that could come from Visa to comply with electronic identification by 1 July 2006.

COMMENTS ON STANDARDS

Standards No. 3 and 4

The credit and debit card reforms taken collectively attempt to address the RBA objective of consistency, amongst cards, between end-user pricing and resource costs, with the result of supporting a more efficient payments system.

There is a substantial volume of four-party, card-based payment transactions in Australia with significant value changing hands between issuers and acquirers in the form of interchange payments. This is summarised in the table below, including an estimate of the aggregate impact of the draft interchange reforms.

Payment Product	Transactions	Value	Pre Reform Interchange Fee[1]	**Interchange Value to Issuers**	Draft Interchange Fees[2]	**Revised Interchange Value**	**Change**
Credit and Charge Cards	1,134 m	$147.3 b	0.95%	**$1,400 m**	0.55%	**$810 m**	**($590 m)**
Visa Debit	92 m	$6.8 b	0.95%	**$64 m**	$0.15	**$14 m**	**($50 m)**
EFTPOS	917 m	$58.0 b	($0.20)	**($183 m)[3]**	($0.05)	**($46 m)**	**$137 m**
Total	2,143 m	$212.1 b		**$1,281 m**		**$778 m**	**($503 m)**

Table 1 – Card Based Payment Transactions and the Impact of Reform

The RBA states that in many instances these products are practicable substitutes but still provide different benefits to consumers. The objective therefore is not to conclude that one is "better" than another based on cost only (and should be promoted to the exclusion of the others), but to establish clear pricing signals such that the consumer can make an informed choice of which option to use, given accurately reflected relative prices, costs, and benefits.

The RBA has indicated that resource costs vary considerably amongst card-based payment options, as summarized in the table below. The resource cost of credit cards is highest ($2.01), followed by Visa Debit ($1.43) and then EFTPOS ($0.39).

	Cost per Transaction		
	Acquirer	Issuer	Total
Credit Card[4]	$0.43	$1.58[5]	$2.01
Visa Debit[6]	$0.43	$1.00	$1.43
EFTPOS[4]	$0.20	$0.19	$0.39

Table 2 – Transaction Costs for Cards

The RBA states that pricing signals for these three card-based payment options are distorted and these incorrect signals are in part the result of interchange fee levels. The table below indicates the issuers net cost of each payment product net of pre-reform and

[1] Percentages are applies to transaction values; dollar amounts are applied per transaction.
[2] The credit card interchange fees have been implemented.
[3] Shown as a negative because EFTPOS interchange fees flow from the issuers to the acquirers.
[4] Credit card costs are taken from the Joint Study; EFTPOS costs are taken from the Joint Study tempered by the RBA's comments in the February 2005 Consultation Document.
[5] Excludes credit losses.
[6] Visa Debit issuer costs are based on information in the Joint Study. The acquirers' cost is assumed to be the same for a credit card transaction. The issuers cost is assumed to be the same as for a credit card ($1.58 excluding credit losses) with adjustments as follows: reduced by $0.26 for the cost of funding the interest free period; reduced by $0.32 for the cost of loyalty programs and other miscellaneous costs incurred for a credit card but not a Visa Debit card.

draft interchange fees. The issuers' net cost (and presumably cardholder pricing reflects the net costs) is inversely related to the resource cost.

			Pre - Reform		Draft Reforms[7]	
Product	End-User Marginal Price	Issuer Total Cost Per Transaction	Interchange Fee	**Issuer Net Cost**	Interchange Fee	**Issuer Net Cost**
Credit Card	Zero to negative	$1.58	($1.24)	**$0.34**	($0.70)	**$0.88**
Visa Debit	Zero	$1.00	($0.75)	**$0.25**	($0.15)[8]	**$0.85**
EFTPOS	$0.00 to $0.60	$0.19	$0.20	**$0.39**	$0.05	**$0.24**

Table 3 – Issuers Net Costs Pre and Post Reform

Under the draft reforms the issuers' net cost for credit cards and Visa Debit increases and their net cost for EFTPOS decreases. This should result in stimulation in use of lower cost payments (EFTPOS) relative to higher cost payment (credit cards and Visa Debit). In a competitive market, issuers would raise prices for credit cards and Visa Debit (or reduce benefits) and decrease prices for using EFTPOS, thereby stimulating consumers to use EFTPOS (the lower cost resource) relative to credit cards and Visa Debit (assuming behavioural linkages exist as anticipated by the RBA).

One issue of concern for Visa Debit issuers is that the RBA framework for the collective reforms is inconsistently applied both in terms of direction and scope of costs included.

- The cost of processing (and switching) transactions is included but it is the issuers' costs for credit cards and Visa Debit but the acquirers' processing costs for EFTPOS.
- The cost of fraud and fraud prevention is only included for credit cards. Fraud losses are incurred for EFTPOS and Visa Debit and there are additional issuer costs related to fraud prevention.
- Scheme fees related to fraud mitigation is included for credit cards but not for Visa Debit[9].
- Appropriately, the cost of funding the interest free period only applies to credit cards as there is no, or a negligible, timing difference between when the merchant receives good funds and when the consumers transaction account is debited for EFTPOS and Visa Debit.

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[7] Interchange reforms for credit cards were put in place in November 2003.
[8] Visa had reduced the interchange fee on Visa Debit to approximately 55 bps. This results in a current interchange fee on the average transaction of $0.43 and net issuer costs of $0.57.
[9] EFTPOS is not a scheme but a set of bilateral arrangements and there are no similar costs for EFTPOS.

In not adopting a consistent framework, the RBA states that "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". The RBA cannot be referring to the credit card interchange fees as those changes are a *fait accompli*. It is unlikely that statement applies to Visa Debit because the proposed level of interchange fees results in a larger decline to the fee than if the credit card methodology was applied.

This by default leaves EFTPOS interchange fees and the very large and potentially disruptive changes referred to by the RBA must be a change in EFTPOS interchange fees from $0.20 paid by the issuers to acquirers to either $0 interchange or a slightly positive interchange fee, as would be suggested by applying the credit card interchange framework.

It is not clear why the RBA is striving to support a negative interchange fee for EFTPOS. The RBA supported the banks in the recent Australian Competition Tribunal hearing at which the banks petitioned for a $0 interchange fee. The RBA in the February 2005 reforms states that it rejects the merchants' arguments that "investment depends on the payment of current levels of interchange fees". However, in retaining a slightly negative interchange fee for EFTPOS they implicitly admit that some level of fee is required, even though there is no evidence (other than arguably New Zealand) that this is the case.

It appears that the RBA has bowed to pressure from the retailers and the very disruptive changes referred to relate to the merchants involvement in the EFTPOS network. The Building Societies do not share this view. The electronic payment network is an integrated network that accepts credit cards, Visa Debit and EFTPOS. Prior to reforms, and assuming all interchange fees were passed on to merchants, a merchant paid on average $0.60 per card-based payment. Under the draft reforms the merchant would pay $0.36 and under the Building Societies' proposed level of interim interchange fees, the merchant would pay $0.45 per average payment (derived below). In both cases, the combined reforms result in the retailers paying less in merchant fees. It is difficult to see how a price reduction of one magnitude is acceptable to retailers while a price reduction of another magnitude would be "highly disruptive". The RBA presents no evidence to support this view and it does not logically follow from the core economics.

This lack of consistency may be acceptable to the RBA in that the results achieve their objective of lowering interchange fees and obtaining end user pricing which more accurately reflects the relative resource costs of different payment options. However, this inconsistent approach results in an unnecessarily disproportionate impact amongst scheme participants.

For retailers, there is a favorable impact. The average merchant cost (fee paid by retailers to financial institutions) would decline by $0.24, or 40% of the interchange component of the merchant fees they paid prior to reforms[10].

[10] Assuming the reduction in interchange fee is passed through *in toto* to the merchant.

Typical Australian Retailer – Per Transaction			
Payment Product / ATV	% of Transactions	Interchange Revenue	
		Prior to Reforms	Draft Reforms
Credit Card / $130	53%	($1.24)	($0.70)
Visa Debit / $79	4%	($0.75)	($0.15)
EFTPOS / $63	43%	$0.20	$0.05
Weighted Avg Interchange per Transaction	100%	($0.60)	($0.36)

Table 4 – Impact of Reforms on Costs for Retailers

For a credit card issuer that does not offer Visa Debit, there is an adverse impact. The average interchange revenue would decrease $0.19 per transaction, or 37% of its pre-reform level.

Typical Australian Credit Card Issuer – Per Transaction			
Payment Product / ATV	% of Transactions	Interchange Revenue	
		Prior to Reforms	Draft Reforms
Credit Card / $130	50%	$1.24	$0.70
Visa Debit / $79	0%	--	--
EFTPOS / $63	50%	($0.20)	($0.05)
Weighted Avg Interchange per Transaction	100%	$0.52	$0.33

Table 5 – Impact of Reforms on Costs for non Visa Debit Issuers

For a Visa Debit issuer, there is an adverse impact that is substantially greater than a credit card issuer. The average interchange revenue per transaction would decline by $0.19, or 82% of the average revenue pre-reforms. This is a significantly greater decline than the 37% decline in revenue for non-Visa debit issuers.

Typical Visa Debit Issuer – Per Transaction			
Payment Product / ATV	% of Transactions	Interchange Revenue	
		Prior to Reforms	Draft Reforms
Credit Card / $130	0%	--	--
Visa Debit / $79	45%	$0.75	$0.15
EFTPOS / $63	55%	($0.20)	($0.05)
Weighted Avg Interchange per Transaction	100%	$0.23	$0.04

Table 6 – Impact of Reforms on Costs for Visa Debit Issuers

It is clear from the tables above that Visa Debit issuers would bear a disproportionate burden after the debit reforms are implemented:

- Retailers are better off by 40%
- Credit card issuers are worse off by 37%.
- Visa Debit issuers are worse off by 82%.

If the reforms were based on irrefutable economic and commercial logic, one might say – "Such is the market…" Given the collective interchange reforms are based on directional objectives and no consistently applied framework, such an outcome is not supported by fact or theory and results in a disproportionate impact, which is not warranted. The RBA acknowledges this inconsistency and states "if the standards are implemented, different interchange standards would apply in the credit card, Visa Debit and EFTPOS payment systems and that it may review the interchange landscape in 2007 to determine if consistency across payment products is warranted". In the meantime, the relative brunt of the RBA's empirical test will have fallen on Visa Debit issuers.

The RBA states that "At the time the [credit card] 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 to all time and to be applied to other systems". Applying the same framework now does not constrain the RBA to apply it for all time to all card-based payment systems. However, if this interim set of reforms is intended to be a vehicle to reduce interchange fees, why not use a consistent framework that achieves that result and is more equitable for all payments system participants?

Consistently applying the credit card framework would result in the following cost elements being applied to each of the card-based payment options. Because different cost elements are applied and the cost levels for these elements are different amongst card based payment products, the interchange costs would vary.

Issuers' cost of:	Credit Cards[11]	Visa Debit[11]	EFTPOS[11]
Authorisations	X	X	X
Transaction Processing	X	X	X
Fraud Losses	X	X	--[12]
Fraud Mitigation	X	X	X
Funding the Interest Free Period	X		

Table 7 – Issuers' Costs Included in Costings

Building Societies estimate that the resulting interchange costs for the three designated card-based payment products would be as indicated in the table below, with the interchange fees using a consistent framework provided in the column labeled "Proposed".

[11] "X" denotes included.
[12] Estimated to be negligible.

Typical Australian Credit Card Issuer				
Payment Product / ATV	% of Transactions	Interchange Revenue		
		Prior to Reforms	Draft Reforms	Proposed
Credit Card / $130	50%	$1.24	$0.70[13]	$0.70[11]
Visa Debit / $79	0%	--	--	--
EFTPOS / $63	50%	($0.20)	($0.05)	$0.15
Weighted Avg Interchange per Transaction	100%	$0.52	$0.33	$0.43

Typical Australian Retailer				
Payment Product / ATV	% of Transactions	Interchange Revenue		
		Prior to Reforms	Draft Reforms	Proposed
Credit Card / $130	53%	($1.24)	$0.70	$0.70
Visa Debit / $79	4%	($0.75)	$0.15	$0.30
EFTPOS / $63	43%	$0.20	$0.05	($0.15)
Weighted Avg Interchange per Transaction	100%	($0.60)	($0.36)	($0.45)

Typical Visa Debit Issuer				
Payment Product / ATV	% of Transactions	Interchange Revenue		
		Prior to Reforms	Draft Reforms	Proposed
Credit Card / $130	0%	--		--
Visa Debit / $79	45%	$0.75	$0.15	$0.30
EFTPOS / $63	55%	($0.20)	($0.05)	$0.15
Weighted Avg Interchange per Transaction	100%	$0.23	$0.04	$0.22

Table 8 – Interchange Costs of Designated Card Products

With the proposed interchange fees, the impact on the parties would be as follows:

- A reduction in average interchange revenues of 18% to credit card issuers, compared to 37% under the draft reforms
- A reduction in average merchant fee cost to retailers of 25%, compared to 40% under the draft reforms

[13] Interchange reforms for credit cards were put in place in November 2003.

- A reduction in average interchange revenue to Visa Debit issuers of 4%, compared to 82% under the draft reforms

The resulting reduction in the degree of change to Visa Debit issuers is likely to allow them to continue to retain a viable commercial proposition of offering Visa Debit and EFTPOS. At the same time, as indicated in the table below, the proposed levels of interchange based on a consistently applied framework results in a better alignment of net resource costs and is consistent with the draft RBA reforms.

			Pre - Reform		Draft Reform		Proposed[14]	
Product	End-User Marginal Price	Issuer Cost Per Transaction	Interchange Fee	**Issuer Net Cost**	Interchange Fee	**Issuer Net Cost**	Interchange Fee	**Issuer Net Cost**
Credit Card	Zero to negative	$1.58	($1.24)	**$0.34**	($0.70)	**$0.88**	($0.70)	**$0.88**
Visa Debit	Zero	$1.00	($0.75)	**$0.25**	($0.15)	**$0.85**	($0.30)	**$0.70**
EFTPOS	$0.00 to $0.60	$0.19	$0.20	**$0.39**	$0.05	**$0.24**	$(0.15)	**$0.04**

Table 9 – Better Alignment of Net Resource Costs Based on ASL's Proposal

There is no evidence the magnitude of the impact on relative transaction volumes would be more or less with either approach but with the proposed approach, the disproportionate impacts on payments system participants is mitigated.

If the draft reforms are adopted the resulting impact on the Building Societies' revenue streams would be such that they would have little choice but to mitigate the impact. The primary options available to them would be to:

- Recover costs of EFTPOS from customers (per transaction fees and account maintenance fees) and Visa Debit (annual fees)
- Migrate as many customers from Visa Debit to credit cards and charge cards that contain functionality that their customers desire.

These are similar (although not exactly the same) as the approach used by credit card issuers to mitigate the impact of the loss in credit card interchange revenue. They raised credit card fees, reduced the cost (and value to cardholders) of reward programs (not an option for Building Societies) and migrated credit cardholders to Amex and Diners.

It is highly likely that the Building Societies would move as many customers to credit cards (or charge cards) as possible because these customers have a need for functionality offered by Visa Debit that cannot be offered by EFTPOS. For example, based on data collected by ASL, in a typical period over 25% of Visa Debit transactions were made in situations in which EFTPOS could not be used (eg MOTO transactions; international transactions). Other data indicates that over half of Visa Debit cardholders use Visa Debit as the preferred payment option when EFTPOS could have been as readily used.

[14] Interchange reforms for credit cards were put in place in November 2003.

Visa Debit cardholders that make a non face-to-face purchase or travel outside Australia have no choice but to have a Visa debit card, credit card or charge card.

Where consumers are not averse to carrying a credit card (or charge card) in place of Visa Debit and if the Building Societies commercially prefer a credit card over EFTPOS (which they would under the RBA draft reforms), credit cards would be issued. These cards could either be structured to have low credit limits at very attractive interest rates for customers that did not want access to a full credit line or structured as a more traditional credit card for those customers that want access to an extended credit facility.

While it is not difficult to predict if credit cards would displace Visa Debit cards (which they would), it is more difficult to predict the magnitude of the impact on the payments system. However, the directional outcome is apparent:

- Outstanding consumer debt levels would increase. If 60% of Visa Debit cards are converted to credit cards, consumer debt levels in Australia could rise by about $4.5 billion[15].
- Existing Visa Debit transactions levels would not continue (at the lower draft reform interchange fee levels) nor be displaced by EFTPOS (at a lower interchange fee level) but would be displaced by credit card transactions, which have the highest interchange fees. Merchants in turn would not realise any reduction in merchant service fees for these transactions.

The RBA would like to pursue reforms that promote efficient payment systems. The Building Societies do not disagree with that objective. The Building Societies, as with any commercial enterprise, pursue revenue and profit streams. The proposed reforms create a conflict between these two forces and the Building Societies believe the interchange approach as proposed above will reconcile these two conflicting forces, to the benefit of consumers, merchants, Visa Debit issuers, and other financial institutions in Australia.

Standard No. 5

Standard 5 states in part that “Visa Debit cards must be identifiable as such, both visually and electronically.” This standard comes into effect on “[01 July 2006]” without any consideration of timing required to implement this aspect of thee standard[16] and no consideration of the costs of implementing in this time frame, compared to the benefits; no time for conversion.

The requirements mean that all Visa Debit cards will have to be re-issued. The cost to a large Building Society to re-issue all Visa Debit cards is in the order of $80,000. At an industry level this could be in the order of $4 -$6 million.

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[15] This applies the average outstanding balance per credit card of approximately $2,500 to 1.8 million Visa Debit cards converted to credit cards.

[16] The majority of institutions will be requiring the production of new card plastic and with the limited number of manufacturers available; this will severely limit the number of cards that can be re-issued before July 2006.

Reissuing of cards along normal reissue cycles can begin once the exact requirements are known but it is likely that only 6 months will have passed before the standard, as drafted, comes into effect. With an average card life of say 2 to 3 years, this means that only about 20% of cards will have been reissued when the standard comes into effect without imposing an unnecessary economic hardship on issuers by forcing them to reissue.

There are potential fraud costs arising from having 2 unexpired cards on issue if customers do not return or destroy their old card. These cards are more likely to be lost and unreported than a primary card.

It is not clear what the offsetting benefit is of 100% re-issued cards by 01 July 2006 compared to letting the cards be re-issued in line with the standard as part of the typical re-issue cycle. Furthermore, there is no apparent benefit to the issuers of this standard, regardless of the time period.

Therefore, the Building Societies would like the standard modified to say “all new Visa Debit cards issued from the effective date must be visually identifiable as such” such that re-issue would commence once detailed specifications are agreed and the re-issue would follow normal cycle dates. The issuers would agree that all cards would be issued consistent with the standard by 31 December 2008.

The Societies will work with Visa to determine the changes to International Standards to enable the electronic identification of Visa Debit cards. This may take some time as the changes must be coordinated to ensure the continued operation of the cards both domestically and internationally. Therefore the wording of the standard would be modified to include electronic identification consistent with Visa’s ability to provide that functionality.

CONCLUSIONS

The Building Societies believe that economic theory has a valid place in providing appropriate frameworks for market-driven economies and that commercial realities will determine the specific outcomes of regulatory change that impacts commercial behaviour.

The draft debit reforms are part of an economic objective of increasing payment systems efficiency. The reforms as constructed don’t adequately consider the commercial realities for Visa Debit issuers. This submission provides reconciliation between the economic objectives of the draft reforms and commercial objectives of Visa Debit issuers.

The volume of Visa Debit transactions in Australia is relatively small. The impact of reform on Visa Debit cards on issue is, in and of itself, unlikely to determine the overall success or failure of the RBA’s reforms. However, small impacts resulting from not correctly assessing commercial impacts – displacement of credit cards by Amex and Diners, displacement of Visa Debit cards by credit and charge cards, and so forth -- can have a cumulative impact.

If the RBA accepts the proposed interchange fee approach as described in this submission, the impact on the retailers, banks and Visa Debit issuers will not change in direction, only in magnitude. The impact on pricing will not change in direction, only in magnitude. The impact on relative transaction volumes will not change, only in magnitude.

Economics provides the basis for the reforms but there is no econometrics that can be used to confidently predict the magnitude of the change. The commercial reactions can be predicted with far more certainty. Based on that, the Building Societies believe a modification to the draft reforms as discussed above is in the best interest of Australia.

Australian Settlements Limited

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