Bank of Queensland

Submission to RBA

EFTPOS and Visa Debit Consultation Document

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Contents

1. Executive Summary

It is a matter of history that the differing reform processes adopted for credit card interchange and for EFTPOS interchange has resulted in the implementation of these reforms becoming “out of step”. All the benefits from the disconnect between these reforms have fallen on the side of the retailers.

In designating the EFTPOS system, we believed that the Reserve Bank would move to redress this situation and place the EFTPOS reforms back on track, as such we embraced designation as a positive development.

Clearly, the self-regulatory industry EFTPOS reforms were aimed at achieving concurrent interchange fee reform between EFTPOS and Credit Cards but were required to follow an onerous and uncertain regulatory approval process. The uncertainty of the process was highlighted by the Australian Competition Tribunal (ACT) decision in 2004 to overturn the successful Authorisation Application determination made by the Australian Competition and Consumer Commission (ACCC) in relation to Zero EFTPOS Interchange Fees.

For the record, Bank of Queensland supports the views expressed by the Reserve Bank[1] in the Consultation Document in relation to the ACT findings.

Throughout the whole Payments System reform process, the financial services industry has been characterised as being generally opposed to reform, when clearly this has not been the case. The industry work on Credit Card interchange reforms, EFTPOS interchange reforms and EFTPOS Access has demonstrated the industry’s acceptance of reform, albeit that the timetable or extent of proposed changes has not always struck accord with the regulators, nevertheless there has generally been an acceptance of the need for the reforms. In progressing self-regulatory reforms in the Credit Card environment, it is important to note that the proposed reforms presented to the ACCC by scheme participants was not that dissimilar from the cost based interchange standard finally adopted in October 2003 under the Reserve Bank’s designation process.

The same situation can, however, not be said of other stakeholders in this process, particularly the retailers. The retailer’s selective support for the reforms that only benefit their self-interests is clearly demonstrated in their current legal challenge to the Reserve Bank’s powers to designate the EFTPOS system.

It is disappointing that the Reserve Bank’s proposed standards for EFTPOS outlined in the Consultation Document are at a significant divergence from the position previously enunciated by the Reserve Bank. The Reserve Bank approach could be viewed as being an attempt to appease the retailer lobby rather than a serious attempt to address the core issue it had identified as impairing the efficiency and growth of the EFTPOS payments system, namely negative interchange fees.

2. EFTPOS Interchange Fees

Negative interchange fees have been a feature of the EFTPOS network since its inception and have simply outlived any original reason for their introduction all those years ago.

[1] Consultation Document, Section 2.3.4 – Further Considerations (page 25)

2.1 The Case for Zero Interchange Fees

Bank of Queensland has consistently advocated the adoption of zero interchange fees in the EFTPOS system.

The Reserve Bank has expressed its position in support of Zero EFTPOS interchange fees many times, with the most recent statement in the Consultation Document (page 17):

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

The Reserve Bank goes on to correctly note that any reimbursement of investment during the start-up phase of the system could no longer be considered as a justification for the continued existence of a negative interchange fee as the network has been in operation for around 20 years and there are no significant establishment costs remaining to be recovered[2]. Bank of Queensland also supports the position the Reserve Bank has taken in rejecting the argument proffered by retailers that the negative interchange is to compensate for banking services rendered by the merchant.

Therefore, in the face of strong evidence to support a Zero interchange fee model, it is important that the Reserve Bank clearly articulates its reasoning behind the proposed draft standards that would give regulatory approval for the continuation of negative EFTPOS interchange fees as outlined in the Consultation Document.

2.2 RBA's Draft EFTPOS Interchange Fee Standard

In sections 2.5 and 2.6 of the Consultation Document the Reserve Bank discusses the possible regulatory responses in imposing standards in the EFTPOS system and the Visa Debit system, which, they concluded should be considered together "given the similarities in the two systems".

Whilst the Reserve Bank is of the view that they are similar products, the proposed interchange fee setting standards for these systems are diametrically opposed in that the interchange for EFTPOS is still negative as opposed to the positive interchange for Visa Debit.

Bank of Queensland does not support the view that the systems are so similar that they should be afforded the same interchange fee setting standard. However, considering the Reserve Bank's position on the two systems being similar products it is then difficult to reconcile the Reserve Bank's position for the fundamental difference in the proposed standards for EFTPOS and Visa Debit.

The Reserve Bank's stated dilemma[3] in setting a zero interchange fee in EFTPOS, and therefore in Visa Debit due to their linking of these two systems, is their claim that this may induce some issuers to promote credit cards over Visa Debit cards. Clearly this situation could be overcome by the Reserve Bank acknowledging that the

[2] Consultation Document, Section 2.1.3 (page 18)
[3] Consultation Document, Section 2.6 (page 30)

Visa Debit product, whilst sharing some common functionality with both the credit cards and EFTPOS debit cards, is a system that needs to be considered on its own merits rather than aligning it totally to the EFTPOS system, as the Reserve Bank has incorrectly done.

In looking at the reasons provided by the Reserve Bank for adopting the proposed standard for EFTPOS interchange fee setting we note that the following factors were considered:

- In setting a zero interchange fee it may be considered that the Bank went beyond its powers by setting a price,
- That the Bank was concerned that a zero interchange in Visa Debit (but not in EFTPOS) <u>may</u> induce some issuers to promote credit cards over debit cards.
- That using the credit card standard, either rightly or wrongly, would "entrench the credit card standard to a degree that the Bank does not believe is justified."
- That using the credit card standard would involve reversing the direction of interchange fees in the EFTPOS system which would change long-standing business arrangements, and may cause substantial disruption to some institutions (although no further explanation was provided to elaborate on these "substantial disruptions").
- That the preferred approach is to "determine standards that would move the EFTPOS and Visa Debit interchange fees closer together, but maintain their current direction."

The Reserve Bank's response to these issues was to then propose a standard as follows:

"It is proposed that the maximum interchange fee in the EFTPOS system be based on acquirers' eligible costs, with eligible costs being restricted to processing and switching costs."

The Reserve Bank has provided no justification for adopting this standard other than to say it "is consistent with an evolutionary, rather than a revolutionary, approach to reform." This simple paragraph is the only justification offered by the Reserve Bank for proposing such an extraordinary divergence from its previous public position on EFTPOS interchange.

Rather than being a "consistent" approach, Bank of Queensland rejects this standard as being totally <u>inconsistent</u> with the standards already implemented by the Reserve Bank for credit cards and the proposed standard for the Visa Debit system.

In the absence of any justifiable rationale for adopting this standard in setting EFTPOS interchange fees, the standard is seen as merely a means to justify an "acceptable' solution for retailers which potentially brings the credibility of the whole Reserve Bank reforms into question.

2.2 Potential impact of the reforms on product pricing

In our view, the Reserve Bank correctly rejects the claim by retailers that the change in credit card system interchange has resulted in a change in the prices charged for the use of credit cards and that no further reform is necessary (presumably in relation to the EFTPOS system).

Curiously, the retailers have not suggested that the savings to merchants as a result of the reductions in Merchant Service Fees (MSF) flowing from the credit card reforms, which the Reserve Bank estimates to have been around $500 million in 2004, have actually been passed onto consumers as reductions in prices of goods and services. In fact, in some cases the costs of goods and services to consumers have actually increased, these increases taking the form of surcharges levied by some merchants for credit card payments, notably Qantas and Virgin in situations where the only method of payment offered by the merchant is a credit card. The Reserve Bank sees the introduction of merchant surcharges for accepting credit cards as a "welcome development"[4], but we are not sure whether consumers would share the Reserve Bank's seemingly strong endorsement of surcharging in the majority of cases.

Bank of Queensland is concerned that the quantum of the changes in interchange fees between credit cards and EFTPOS are so disparate. In the estimates previously advanced, the level of savings afforded to acquirers (which were passed on to merchants) in the credit card reforms were seen as being in excess of $500 million annually. By comparison, the saving to all issuers as a result of the proposed reform in EFTPOS interchange is estimated to amount to around $125 million annually – a ratio of 4:1.

This relatively minor change in EFTPOS interchange to flow from these proposed reforms will make it difficult for institutions, particularly smaller institutions, to justify the costly exercise of changes to product repricing for the relatively short period of operation before the Reserve Bank intends to review the process in 2007. These costs reflect the onerous process that financial institutions must endure to change financial services product pricing as required by the various regulatory bodies.

3 Visa Debit Reforms

It is acknowledged that the Visa Debit system shares many features with the credit card system, with the fundamental difference being that an interest free period is not a feature of the product. However, the fact that the system operates along the same scheme arrangements as credit, has the same fraud exposure as credit and requires similar authorisation processes means that it is appropriate that a similar interchange fee setting standard to credit be adopted.

As such, Bank of Queensland does not oppose the proposed draft interchange fee standard proposed for Visa Debit.

The consultation undertaken by the Reserve Bank on Visa Debit appears to focussed on the impact on issuers, however, the implementation of Standard No. 4 will have a significant impact on all acquirers in that it will require the separation of Visa Debit transactions from the mainstream volume of Visa credit transactions, for which there will be no benefit for acquirers. Acquirers face significant systems development to identify Visa Debit transactions and to report these transactions separately in internal and external reporting as well as in calculating and reporting Merchant Service Fees.

[4] Address to Visa International Member Forum March 2005 by Philip Lowe, Assistant Governor (Financial System)

The development effort required at Bank of Queensland to implement Standard No. 4 has not yet been fully estimated and will depend on changes to the Visa scheme rules to enable electronic identification of Visa Debit cards as required in Standard No. 5.

As a consequence of the requirements to implement Standard No. 4, Bank of Queensland requests that an appropriate implementation timeframe be determined in consultation with acquirers, but that the implementation date be set not less than 6 months after the Standards are finalised.

3.1 The 'Honour All Cards' Rule

The Reserve Bank states that its concern with the 'Honour All Cards' rules of scheme arrangements is focussed on the honour all products aspect. However, the proposed Standard No. 5 potentially puts a significant feature of card schemes at risk, and one that will particularly impact on smaller institutions that currently issue Visa Debit cards.

It is accepted that the intent of the Standard is to enable merchants to selectively accept Visa Debit cards or Visa Credit cards. However, the potential outcome of the application of this standard will adversely impact smaller institutions who predominate in the issuance of Visa Debit cards.

Furthermore, with the adoption of Standard No. 4, which is aimed at establishing interchange fees for Visa Debit at an appropriate level for both issuers and acquirers, combined with the effect of abolition of the 'no surcharge' rule for Visa Debit transactions makes the need for the changes in the 'honour all cards rule' obsolete.

If a merchant is able to recover the cost of accepting a Visa Debit card (refer Standard No.5), which costs have been appropriately set through the adoption of Standard No.4, then it is considered detrimental to the interests of issuers to allow merchants to selectively accept Visa cards.

3.2 Visa Debit – Transparency

Standard No. 5 requires that Visa Debit cards "must be identifiable as such, both visually and electronically". Obviously, this will result in all Visa Debit cards being reissued over an agreed timeframe as well as significant systems changes for acquirers.

As noted in Section 3.1 above, Bank of Queensland is concerned at the impact on acquirers to be able to electronically identify Visa Debit cards in order to implement Standard No. 4. The extent of systems development will in turn depend on the Visa scheme response to give effect to the adoption of Standard No.5.

4. EFTPOS Access

In relation to the work that APCA has undertaken to address the issue of EFTPOS Access, the Reserve Bank has raised some concerns with APCA as to its proposed EFTPOS Access Regime[5], namely:

"These concerns relate to whether the proposed regime provides sufficient certainty on the cost and timing of entry and whether volume requirements are necessary for new entrants."

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[5] Consultation Document, Section 1.6 (page 13)

It is important to note that the "volume requirements" referred to by the Reserve Bank relate to quite separate, but complimentary, changes to the Consumer Electronic Clearing System (CECS) Regulations. The CECS Regulations changes have introduced new rights, and obligations, for CECS members to directly clear and settle both ATM and EFTPOS transactions which is a significant and fundamental change in CECS.

Bank of Queensland is concerned that the Reserve Bank views the potential impact of these new provisions in the CECS arrangements in a negative light, when in fact the amendments to the regulations were designed to provide smaller issuers and acquirers (including potential new participants) with rights to directly clear and settle that do not currently exist.

Bank of Queensland supports the proposed changes and regards the proposed volume criteria as being one option to ensure the efficiency of settlement arrangements between CECS members given the bilateral nature of the network. It is noted that similar provisions apply in the Interac arrangements in Canada.

The direct connector cost recovery arrangements proposed in APCA's EFTPOS Access Regime reflect the difficult nature of adding new participants to the current physical network of bilateral arrangements, which in the timeframe available to consider EFTPOS Access was seen as the only possible way to progress the matter.

Bank of Queensland is confident that over time the development of new network architecture, possibly a closed user group IP network, would better cater for both new and smaller participants into the EFTPOS system.

5. Conclusion

Bank of Queensland welcomes the intervention by the Reserve Bank in providing regulatory certainty in the level of EFTPOS interchange fees, however, we do not support the Bank's views in proposing a cost based standard based on a defined range of acquirer's costs.

The reason provided by the Reserve Bank in diverging from the interchange fee setting standards in other payments systems based solely on taking an evolutionary approach to change, simply cannot be justified.

In considering the quantum of the resultant shift in revenues resulting from the Credit Card and EFTPOS Reforms, the relatively minor adjustment in issuer's costs that would result from proposed draft standard simply does not warrant the evolutionary approach proposed by the Reserve Bank.

Bank of Queensland urges the Reserve Bank to reconsider the proposed draft Standard No.3 and to implement a standard that would give regulatory certainty to Zero EFTPOS interchange fees.