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Dear Dr Veale

### **EFTPOS and Visa Debit**

This submission by Credit Union Services Corporation (Australia) Ltd (CUSCAL) is made in response to the Reserve Bank of Australia (RBA) February 2005 consultation document *Reform of the EFTPOS and Visa Debit Systems in Australia*.

CUSCAL is the leading industry body for credit unions. CUSCAL represents 144 of Australia's 167 credit unions, provides credit unions with a range of banking and commercial services, and acts for and on behalf of our customers in accessing the payments systems.

Credit unions play an important role in the Australian retail banking sector. As mutual, member-focused institutions, credit unions offer a high quality and affordable range of financial and banking services to more than three million members.

The different kind of banking that credit unions offer is demonstrated not just in the very high satisfaction ratings<sup>1</sup> that the industry continues to record, but also in tangible value delivered to members. In 2004, analysis conducted by CANNEX showed that credit unions are delivering \$110 per year in additional 'member value' to their customers through interest rates and fees. This value dividend is in addition to the average \$70 per year added to retained earnings that is ultimately returned in the form of better products and services.

In the highly concentrated Australian retail banking market, the continued presence of credit unions and other smaller institutions is critical to the promotion of genuine competition. Payments reform and other forms of regulatory intervention must take into account the wider competitive environment.

CUSCAL has serious concerns about the potential harm to smaller financial institutions and their customers as a result of the RBA's proposed reforms to Visa Debit.

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<sup>1</sup> See Australian Consumers' Association banking satisfaction survey published in CHOICE Money & Rights Journal, April/May 2005.

**Overview – CUSCAL response to draft standards**

CUSCAL's member credit unions issue 1.2 million of the 3.8 million Visa Debit cards on issue in Australia and credit union member transactions represent more than 30 per cent of the Visa Debit retail sales volume. CUSCAL's member credit unions issue 1.8 million EFTPOS proprietary debit cards under CUSCAL's Redicard brand.

CUSCAL has expressed a consistent set of views about payments system reform throughout the policy debates sparked by the October 2000 Joint Study.

In line with these views, CUSCAL urges significant changes to Draft Standards 3, 4 and 5:

- We ask the RBA to withdraw its proposal to remove the Honour All Cards rule in relation to Visa Debit.
- We seek reinstatement of fraud costs and fraud prevention costs to the interchange fee cost benchmark for Visa Debit.
- We ask that costs of Visa Debit issuers, rather than credit card issuers, be used to calculate the benchmark.
- We recommend that EFTPOS interchange fees be set at zero, in line with the RBA's "pragmatic" approach, pending development of a consistent interchange fee methodology in the foreshadowed 2007 review.

The RBA's decision to take a "pragmatic" and "evolutionary" approach to reform has resulted in draft standards on interchange fees for EFTPOS and Visa Debit that are arbitrary and based on no discernible policy framework other than "narrowing the differential".

The proposed "narrowing of the differential" between EFTPOS and Visa Debit interchange fees would create a yawning new differential between Visa Debit and credit card interchange fees.

As a consequence, credit cards would become significantly more attractive to Visa Debit issuers and their customers.

Under the RBA's proposals, credit card issuers will continue to be able to recover costs of fraud and fraud prevention from merchants via acquirers through interchange fees while Visa Debit issuers will need to recover these costs directly from cardholders.

EFTPOS debit card issuers will continue to subsidise EFTPOS acquirers' costs, albeit at a lower rate.

The RBA strongly implies that the draft standards, and the existing credit card standard, are temporary stages along a continuing reform path. If this is the case, CUSCAL urges a fairer distribution of the disruption caused by the RBA's intervention.

**Draft Standard No. 3****The Setting of Interchange Fees in the EFTPOS Payment System**

Draft Standard No. 3 would give regulatory legitimacy to the highly unusual "negative" interchange fee flow in the EFTPOS system that the RBA has been encouraging industry to abolish for the past five years.

It offends logic to mandate acquirers' costs as the basis of interchange fees for a subset of payment cards, while for all other cards issuers' costs are mandated.

The Consultation Document says the RBA prefers a “gradualist” approach to reform but its proposal in this draft standard is even more gradualist than the proposal voluntarily agreed to by industry. That agreement, by EFTPOS issuers and acquirers to reduce EFTPOS interchange fees to zero, was itself a pragmatic compromise.

As previously advised to the RBA, CUSCAL’s view is that all interchange fees should be based on a consistent methodology – that is, eligible issuers’ costs that benefit merchants.<sup>2</sup>

In seeking to minimise “potentially disruptive changes” to acquirers and merchants, the RBA is proposing that issuers and cardholders continue to bear the costs of the discredited “negative” interchange system. The RBA’s sensitivity to the position of acquirers and merchants in the context of EFTPOS reform is astounding given the outcome so far of payments reform generally – an annual benefit of \$500 million to merchants reflecting much lower credit card interchange fees paid by acquirers to issuers.<sup>3</sup>

Smaller payments system participants and their customers, such as credit unions and their members, have borne the brunt of payments reform disruption so far.

***Recommendation: At this stage, subject to a further review in 2007 of the merits of a consistent methodology for calculating interchange fees for credit and debit cards, EFTPOS debit interchange fees should be set at zero.***

#### **Draft Standard No. 4**

##### **The Setting of Interchange Fees in the Visa Debit Payment System**

The RBA calculates that Draft Standard No.4 would slash the Visa Debit interchange fee from an average of around 40 cents to a maximum of around 15 cents. The 15 cents is based on the actual costs of processing and authorising credit card transactions by the largest credit card issuers – most of whom do not even issue Visa Debit. As the RBA notes, the relevant costs of current Visa Debit issuers are likely to be higher.

So, under the RBA’s proposal, Visa Debit issuers would be under compensated for their actual costs of processing and authorising transactions and would receive no compensation at all for their fraud and fraud prevention costs. Further, the flat fee would be a departure from the ad valorem fee applying to credit cards. This is regulatory intervention that appears arbitrary and unfair and only serves the interests of larger institutions at the expense of credit unions and other smaller financial institutions.

Credit card issuers will continue to be compensated for their processing and authorisation costs, their fraud and fraud prevention costs and the cost of funding the interest free period on credit card transactions.

Visa Debit issuers will have to recover from cardholders a range of costs that credit card issuers can recover from acquirers. This will decisively advantage credit card issuers when consumers are choosing a card they can use overseas, over the internet, telephone or by mail.

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<sup>2</sup> CUSCAL submission, 9 July 2004.

<sup>3</sup> Payments System Board Annual Report, 2004.

As credit-worthy consumers are driven by price signals to replace their Visa Debit cards with credit cards, Visa Debit could become a niche product for lower income people and young people who may have to pay even more over time as the customer base of the product shrinks.

The RBA's approach of bracketing EFTPOS debit and Visa Debit because they draw on savings ignores the importance of payment functionality that brackets Visa Debit and credit cards. EFTPOS debit is a distinctly inferior product in terms of payment utility and channel availability and this is not adequately recognised by the RBA.

Draft Standard No. 4 will have the effect of promoting the highest cost payment card – the credit card. If only half the Visa Debit cards currently on issue in Australia are replaced by credit cards, there will be an additional 1.9 million higher cost payment products in the market.

The RBA's assumption that Visa Debit will grow rapidly at the expense of EFTPOS debit is not supported by evidence. Given that the big four banks have had 20 years to become Visa Debit issuers, in an environment where interchange fees were double what they are today, this is a highly questionable assumption – particularly when another reduction in Visa Debit interchange fees is in prospect. What can be very safely assumed is that the big banks will continue to aggressively promote the more profitable credit cards, regardless of whether or not they ponder incurring significant development costs for a low-margin Visa Debit proposition. As the Australian Securities and Investments Commission (ASIC) warns consumers, "credit cards are usually the most expensive way of borrowing money."<sup>4</sup>

The inconsistency between the treatment of Visa Debit and credit cards invites regulatory arbitrage by issuers and card schemes in pursuit of the additional compensation from "credit card" transactions. We note that RBA Standard No. 1 provides a very broad definition of a "credit card".

As previously advised to the RBA<sup>5</sup>, CUSCAL's Research Department estimates that 41 per cent of credit union Visa Debit cardholders also have a credit union overdraft facility,<sup>6</sup> compared to 12.5 per cent of Redicard holders. This data underlines the hybrid nature of Visa Debit. Further confirmation of the distinction between Visa Debit and our EFTPOS debit card product is provided by data on average transaction size: \$81 for Visa Debit; \$74 for Redicard.

Based on credit union member data held by CUSCAL<sup>7</sup>, higher value members are more likely to hold a Visa Debit card than a Redicard.

In the top three deciles of members by value to their credit union<sup>8</sup>, Visa Debit cardholders outnumber Redicard holders. This profile is sharply reversed in the bottom six deciles, although even in the bottom decile 25.5 per cent of members have a Visa Debit card.

Those higher value credit union members, i.e. members who use multiple credit union products and are likely to have a loan with the credit union, will switch to a credit card if Visa Debit is unavailable or uncompetitive in price terms.

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<sup>4</sup> *Avoid a financial hangover this Christmas*, ASIC media release, 22 November 2004.

<sup>5</sup> CUSCAL submission, 15 October 2004.

<sup>6</sup> Our data does not say whether the overdraft and the Visa Debit are always linked.

<sup>7</sup> CUSCAL's Movement Marketing Database (MMD) is a central data warehouse of 2.7 million credit union members. It contains detailed demographic, product and transaction data at an individual member level and is updated monthly.

<sup>8</sup> Value is derived from members' account balances and interest margins, together with transaction costs net of transaction fees.

**Recommendation: Visa Debit interchange fees should be based on Visa Debit issuers' processing and authorisation costs and fraud and fraud prevention costs.**

#### **Draft Standard No. 5**

#### **The 'honour all cards' rules in the Visa Debit and Visa credit card systems and the 'no surcharge' rule in the Visa Debit system**

CUSCAL does not oppose removal of the no surcharge rule. Nor do we oppose distinguishing Visa Debit at the point of sale.

However, we strongly oppose removal of the Honour All Cards (HAC) rule that requires a merchant accepting Visa credit cards to accept Visa Debit.

As the RBA recognises, a key feature and strong public benefit of the HAC rule is the 'honour all issuers' dimension. As representative of small institutions that have faced significant barriers to entry to payments systems, CUSCAL strongly endorses the view that removal of HAC and the possibility of selective refusal of certain cards would raise the costs of participating in the payments system, impair efficiency, and potentially disadvantage cardholders of certain institutions.

Visa Debit in Australia well illustrates this danger, because the major issuers of the product are the smallest players. Visa Debit is the primary access vehicle for the transaction and savings accounts of around half of Australia's credit union members. The prospect of credit union members facing a situation where access to their accounts is disabled by merchants is a grave concern.

As previously advised to the RBA<sup>9</sup>, CUSCAL believes the HAC rule facilitates access to card issuing, promotes product development and innovation, and guarantees consumer choice. Getting rid of the HAC rule will shift power from issuers and consumers to acquirers and merchants.

Australia's biggest merchants are aggressively promoting their own payment card products, including the Coles Myer Source MasterCard and the Woolworths Ezy MasterCard. It is reported that the number of CML Source MasterCards on issue is now approaching 870,000.<sup>10</sup> There is every reason to expect big retailers to ruthlessly use their market power to push their own card products at the expense of Visa Debit cards issued by small ADIs. An illustration of the big retailers' aggressive approach came to light with this week's admission by Coles Myer about breaches of the Trade Practices Act by its liquor business Liquorland.

*"In 2003 the ACCC commenced proceedings against Liquorland and Woolworths alleging contraventions of the Trade Practices Act in entering into agreements with applicants for liquor licences which contained restrictive terms," Coles Myer said. "The ACCC alleged 30 breaches against Liquorland. Liquorland and the ACCC have reached an agreement that will see Liquorland admitting 5 breaches. It will be submitted to the Court that a penalty of \$950,000 per contravention (total \$4.75 million) is appropriate, although the final amount is a matter for the Court to decide. In addition Liquorland has agreed to pay \$250,000 toward the ACCC's costs."<sup>11</sup>*

<sup>9</sup> CUSCAL submission, 26 March 2004.

<sup>10</sup> Source nears 870,000, Australian Financial Review, 6 April 2005.

<sup>11</sup> Coles Myer settles with ACCC, CML media release, 26 April 2005.

Merchants who wish to directly recover the cost of accepting particular payments instruments should be entitled to do so – particularly if they feel that the cost (the merchant service fee) is above the value they receive. However, it is a step too far to intervene into the market to allow merchants to choose which cards under a scheme umbrella they will accept. Big merchants pushing their own credit card brands will be able to tell consumers: “Your Visa Debit card is no good here, but we can offer you our credit card.”

Visa’s card offerings include Visa Classic, Visa Gold, Visa Platinum, Visa Corporate, Visa Purchasing and Visa pre-paid as well as Visa Debit. Why is the RBA singling out Visa Debit? Any doubt about the acceptability of Visa Debit will add to the commercial advantages conferred on credit cards by regulatory intervention.

If the HAC rule is abolished, and a well understood system is overturned, a major consumer education campaign will be needed. In an environment where some Visa cards are accepted but others are not accepted, there is potential for chaos at the point of sale as consumers and counter staff argue about the acceptability of a card that accesses consumers’ funds.

The RBA observes that some merchants would rather not accept Visa Debit on its current terms because they object to paying the same merchant service fee for Visa Debit as they do for Visa credit cards. This problem is removed with the implementation of a separate interchange fee benchmark for Visa Debit. CUSCAL has accepted the need for a separate Visa Debit interchange fee benchmark throughout the payments reform debate. Such an approach was advocated in our September 2001 Discussion Paper *Visa Debit Australia*.<sup>12</sup>

The RBA also observes that for domestic point of sale transactions EFTPOS and Visa Debit are effectively interchangeable – “all that is required is the press of a different button at the terminal.” The same observation can be made about credit card transactions and EFTPOS transactions. Approximately 50 per cent of credit cards on issue in Australia are multi-functional via account linkages; that is, they are capable of acting as a debit card as well as a credit card.<sup>13</sup>

In addition to the substantive concerns outlined above, a number of practical and implementation issues flow from other elements of the draft standard.

CUSCAL urges an appropriate transitional period for full implementation of the requirement that Visa Debit cards be identifiable as such, both visually and electronically.

Cards on issue can have a life span of three years. CUSCAL suggest three and a half years as the transition period to minimise the cost of the changes to issuers and cardholders and acquirers and merchants.

At the checkout, the current options of “credit” (or “Visa”/“MasterCard”), “savings” and “cheque” may have to expand to include “Visa Debit” and perhaps also “MasterCard Debit”.

The draft standard also leaves open significant issues regarding electronic identification of Visa Debit. It is unclear: whether electronic identification will be at pre

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<sup>12</sup> Produced jointly with St George Bank, Bendigo Bank and the Australian Association of Permanent Building Societies.

<sup>13</sup> *Payments Monitor* APCA, Fourth Quarter 2004.

or post purchase; what obligations will flow between merchants, acquirers and issuers; and, how costs of systems changes will be met by merchants and acquirers.

CUSCAL urges reconsideration of the public benefit that flows from the HAC rule, taking into account the benefit to merchants of significantly lower Visa Debit interchange fees (compared to credit card interchange fees) and the capacity to surcharge.

***Recommendation: Abolish the 'no surcharge' rule. Preserve the 'honour all cards' rule. Allow a three and a half year transition period for the separate identification, visually and electronically, of Visa Debit.***

## CONCLUSION

The RBA's punitive proposals for Visa Debit are based on the assumption that with the removal of "regulatory uncertainty" about Visa Debit interchange fees and the 'honour all cards' rule, big banks will switch their EFTPOS debit portfolios to Visa Debit. This assumption is not justified.

Firstly, "regulatory uncertainty" about Visa Debit has only been apparent since the October 2000 Joint Study. Two decades of regulatory certainty about Visa Debit before the Joint Study only attracted credit unions, building societies and smaller banks to the Visa Debit product.

Secondly, the RBA's Consultation Document makes it clear that "regulatory uncertainty" is going to be a feature of the payments landscape at least until after the next RBA review in 2007. The RBA says setting interchange fees to zero "has considerable appeal."<sup>14</sup>

It is arguable that "if the current regulatory uncertainty was removed and interchange fees were to remain at current levels, an incentive would exist for issuers to migrate debit card users from the EFTPOS system to scheme-based debit systems."<sup>15</sup>

However, neither of these conditions is proposed by the RBA. Debit and credit card systems are to be subject to a further round of review and possible reform in 2007 and interchange fees for debit cards will not remain at current levels prior to the review.

Rather than avoiding an outcome where the much larger EFTPOS system is swallowed by the much smaller Visa Debit system, a much more likely outcome from the RBA's proposals is Visa Debit issuers switching their Visa Debit portfolios to credit cards.

What is absolutely certain if the RBA's proposals are implemented unchanged is a very tangible and very heavy impact on credit union Visa Debit issuers. Since 2003 the interchange fee flowing to issuers on a \$100 Visa Debit purchase has dropped from 95 cents to 55 cents and the RBA is now proposing to take it down to 15 cents. The same purchase on a credit card will continue to earn 55 cents.

If fraud and fraud prevention costs were included as eligible costs for the proposed Visa Debit interchange fee standard, the Visa Debit interchange fee on the \$100

<sup>14</sup> Consultation Document RBA, February 2005, p30.

<sup>15</sup> Consultation Document RBA, February 2005, p30.

purchase would be around 29 cents – based on the RBA's estimate of "total fraud-related costs" for credit cards of around 0.14 per cent.<sup>16</sup>

This would reduce the differential between interchange fees for credit cards and Visa Debit proposed in Draft Standard 4, while still delivering a significant benefit to acquirers and merchants. In turn, setting EFTPOS interchange fees at zero would deliver a narrowing of the differential between EFTPOS and Visa Debit similar to that proposed in Draft Standards 3 and 4, and would deliver a significant benefit to cardholders.

If the RBA is determined to reform Visa Debit, EFTPOS and credit card interchange fees in a "pragmatic" manner, one step at a time, CUSCAL submits that our proposals are more consistent with established policy and are fairer and less disruptive than the current draft standards.

Most importantly, we believe that our proposals will improve the efficiency of the payments system by encouraging the use of lower cost means of payment.

We look forward to the opportunity to discuss our views with you in more detail. Please contact me on 02 8299 9046 or Luke Lawler on 02 6232 6666 to discuss any aspect of this submission.

Yours sincerely



**LOUISE PETSCHLER**  
Head of Public Affairs

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<sup>16</sup> *Consultation Document* RBA, February 2005, p21.