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4 September 2007

Ms. Michele Bullock
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SYDNEY NSW 2001

Review of RBA Payments System Regulation

Dear Michele,

I enclose a submission by Visa International Service Association (Visa) to the Reserve Bank of Australia's (RBA) review of its own reforms to Australia's card payment systems.

Visa welcomes the openness with which the RBA has embarked on the review and the opportunity for Visa to participate in it. Visa particularly welcomes the fact that the RBA has stated that it is willing to examine the fundamentals of the current regulations and the conditions under which these regulations could be removed or relaxed.

Visa does not support the current regulations or any strengthening of them. Consequently, it supports industry calls to remove the current standards and access regimes placed on credit and debit cards, and calls on the RBA to let competitive forces prevail.

The RBA's regulations are the most interventionist of any regulations imposed on any sector in Australia. Visa has argued consistently and vigorously against them and many of the negative or unforeseen outcomes that Visa forecast have since transpired. Many of the unintended consequences persist. There remain many unforeseen and unintended consequences that will still result from continued regulation.

While Visa's views will come as no surprise to the RBA, Visa nevertheless looks forward to discussing the contents of this paper as the review proceeds.

Yours sincerely,

BRUCE MANSFIELD
Executive Vice President and General Manager
Australia, New Zealand and South Pacific



**Visa International submission to the
Reserve Bank of Australia
Review of Australia's payments system**

September 2007



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Introduction

The Reserve Bank of Australia (RBA), has through its media release (Issues Paper) on 29 May 2007, sought submissions from interested parties regarding regulation of Australia's payments system (RBA regulations). These submissions, along with the deliberations at the planned November 2007 conference facilitated by the Melbourne Business School, will contribute to the Payments System Board's 2007-08 Review (Review) of the RBA regulations. The Issues Paper calls for evidence-based commentary on the effects of the RBA regulations to date and views in regard to the relevance of continued regulation of the payments system in Australia.

The current regulation of the credit and debit card networks in Australia is among the most interventionist set of regulations of any sector in the Australian economy. It is also more interventionist than payments system regulations applying in most developed economies around the globe. This position stands in stark contrast to the consistently stated objective of Australian policy-makers to strive to design and implement light-handed forms of regulation aimed at meeting clearly identified and measured benefits at minimal cost.¹

Many of the cost impacts of the RBA regulations are well documented in the Issues Paper. The reduction in merchant service fees represents a significant cost saving to merchants, which was intended to benefit consumers overall through merchants lowering prices. The RBA's own figures show that, at current levels, the savings to merchants from reductions in merchant service fees are worth around \$900 million annually compared with levels prior to the commencement of the RBA regulations. The RBA also acknowledges the absence of evidence that these savings have been passed on to consumers.

Against this background, it is ironic that cardholders see their financial institutions, not merchants, as the big winners from the regulations as a result of cardholders bearing increased fees and charges and receiving fewer loyalty benefits. At the same time, survey evidence indicates that many consumers that are not cardholders do not believe they have benefited from the RBA regulations either.

In addition, it is worth noting that the payments sector in Australia is currently undergoing a period of considerable consolidation with a number of smaller card issuers electing to sell their credit card portfolios to larger, specialist issuers. Much of this activity is reported to be the direct result of profitability pressures that flowed from the significant interchange reductions caused by the RBA's credit card regulations. This consequence was highlighted by Visa in its past submissions to, and discussions with, the RBA and is in direct contrast to the stated objective of the Payments System Board. It indicates unequivocally that a very likely outcome of the RBA intervention may be an acceleration of market consolidation of issuing and acquiring, leading to a reduction in competition and efficiency in the years to come. In stark contrast to the RBA's intended objective of developing a competitive and efficient payments system, the intervention may well have accelerated the consolidation of a vibrant, competitive industry with a large number of participants.

¹ See *Report of the Taskforce on Reducing Regulatory Burdens on Business (2006)*, Terms of Reference.



For all these reasons, it is important to scrutinize closely whether the current level and type of regulation of the payments system is warranted. Consequently, Visa welcomes the openness with which the RBA has embarked on the Review, as illustrated by the terms of reference in the Issues Paper. In particular, Visa welcomes the approach that the RBA has adopted, which indicates that the fundamentals of the regulations will be examined afresh during the Review and that the RBA will consider the conditions under which the current regulations could be removed or relaxed.

Visa's comments are set out in line with the format proposed in the Issues Paper, being responses to questions one through three. The Issues Paper seeks views on the regulation of credit and debit card networks, BPAY and the ATM system. Given Visa's position in the market, its comments focus specifically on the regulation of credit and scheme debit card networks. However, it agrees that the rapid evolution of other payments instruments highlights the importance of considering any regulation of the overall payments system in an integrated fashion and ensuring that any regulatory environment does not distort competition within it.

Visa looks forward to contributing to this important Review beyond providing this written submission and, consequently, would welcome an opportunity to present its views to, and discuss them with, the RBA prior to the planned November 2007 conference.

Question One: What have been the effects of the reforms to date?

The RBA regulations have been introduced during a period of solid economic growth and continued evolution in financial markets. The shift from a paper to an electronic-based retail payments system continues apace – both physically via plastic cards and virtually over the Internet – making it difficult to isolate the effects of the RBA's regulations on the development of the various payment instruments. The value of transactions using debit and credit cards has increased, in each case, at around 10 percent annually over the four years since the RBA's current regulations came into force. Because of the strength of the countervailing influences on payment transactions (such as the solid economic growth), it is impossible to ascertain the precise effects of the RBA's interventions on aggregate growth rates.² Nevertheless, more detailed evidence on the impact of the credit and debit card regulations allows for a number of observations to be made, including:

- the first-round effects of the RBA regulations have involved a transfer of value from cardholders and financial institutions to merchants³;
- while there was a presumption that market forces would exert pressure to reduce the impact of these transfers, there are strong reasons to conclude that this has not occurred so that the changes have continued to involve significant net transfers to merchants – especially those with market power;
- the number of merchants surcharging has increased progressively and evidence again suggests that surcharging occurs primarily where merchants have market power;
- there is strong consumer dissatisfaction of surcharging;
- the failure to regulate the three-party schemes directly has given the closed schemes a clear competitive advantage, with the piecemeal nature of the intervention distorting competition in favour of the three party systems; and
- restrictions placed on the "Honour All Cards" (HAC) rule raise risks that are inhibiting product innovation and place Australia out of step with the expectations of foreign tourists and other visitors.

These points indicate that the RBA regulations have produced:

- no evidence that the regulations have improved competition and efficiency in the payments system;⁴ but

² See Graph 3 on page 17 of the Issues Paper.

³ At least, to an extent, financial institutions have been able to recoup some of the first-round losses to their revenue through reduced benefits to cardholders and repricing of credit cards and other elements of their retail customers' transaction accounts.

⁴ Competition and efficiency are the two main criteria in the Payments System (Regulation) Act 1998.

- in contrast, clear evidence exists that the regulations have distorted competition – providing certain players and platforms with a competitive advantage.

In addition, the regulations involve considerable compliance costs and distraction and continue to have created uncertainty throughout the payments industry. This burden is discouraging innovation in new products and technology, including innovation in relation to system safety and security, and threatens to put the Australian payments system, which was at the forefront of industry development in the Asia Pacific region, at a real risk of falling behind international standards and best practices.

Impact on cardholders and merchants

Evidence on how cardholders and merchants viewed the changes to RBA regulations, and how they intended to respond, is available from several sources, including the data summarized in Visa's submission to the RBA prepared by Network Economics Consulting Group and provided to the RBA in May 2005.⁵

Two central findings discussed in this submission were that:

- cardholders believe that they have been made worse off by the measures; and
- while the reduced interchange fees had been passed through in lower merchant service fees, very few merchants reported that they had passed the financial benefits they received through to consumers in the form of lower prices.

Visa recently commissioned UMR to conduct a further survey of cardholder perceptions of the RBA regulations. The survey, conducted in July 2007, interviewed 400 cardholders and asked them their views on the RBA regulations introduced in 2003.⁶ Of those surveyed, 83 percent were satisfied with how the credit card system operates and only 15 percent were dissatisfied with how the credit card system operates. Despite these positive attitudes, the survey revealed noticeably negative responses when the question concerned the regulatory changes, with:

- 27 percent judging they were financially worse off because of the changes; and
- only five percent judging they were better off⁷.

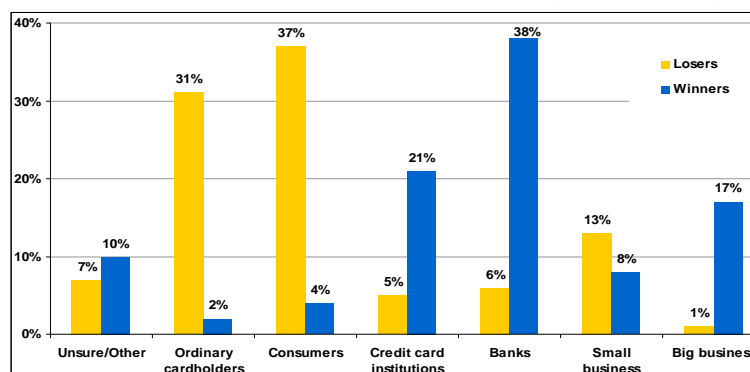
⁵ See Network Economic Consulting Group – 2005, *Early Evidence of the impact of Reserve Bank of Australia regulation of open credit card schemes*. (www.visa-asia.com/ap/au/mediacenter/hottopics/index.shtml).

⁶ See URM Research – 2007, *A study in community perceptions of the RBA changes to the card system in Australia*. (www.visa-asia.com/ap/au/mediacenter/hottopics/index.shtml)

⁷ The remaining 63 percent said they were left “about the same”.

Chart 1 outlines the perception of the winners and losers of the RBA regulations from a UMR survey conducted in 2004. Looking at the survey results, it is ironic that cardholders see their financial institutions rather than merchants, as the big winners from the regulations as a result of cardholders bearing increased fees and charges and receiving fewer loyalty benefits.

Chart 1: Cardholders' perceptions of the regulatory changes



Source: UMR Research (2004)

There is also substantial evidence from other sources to justify these perceptions:

- Visa's May 2005 submission to the RBA documents some of the changes to both rewards programs and fees on cards;
- A 2004 Cannex survey⁸ found that annual fees increased by around five to six percent between May 2003 and September 2004; and
- The majority of respondents to the UMR survey in 2007 reported that they now face higher charges (59 percent), higher annual fees (56 percent) and higher interest rates (52 percent). The corresponding figures for those that believed that fees, charges and interest rates had fallen were all below 10 percent.

As noted above, the first-round effects have seen net transfers from cardholders and, except to the extent financial institutions were able to recoup costs by increasing fees, charges and interest rates, from financial institutions to merchants. The Issues Paper notes that the direct costs to merchants have been reduced by around \$900 million on an annualised basis. The evidence to date casts doubt on whether merchants have passed any, or any substantive, amount of savings on to consumers.

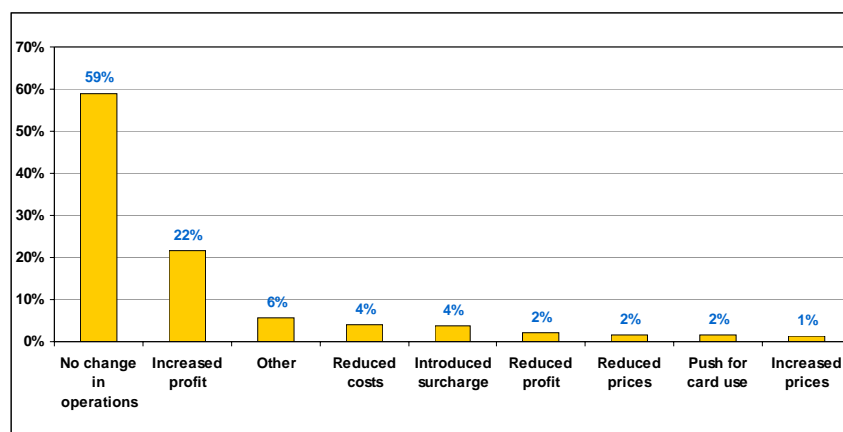
This issue was raised by the RBA in its opening statement to the House of Representatives Standing Committee on Economics, Finance and Public Administration in May 2006. Responding to industry questions on this matter, Assistant Governor (Financial System), Phillip

⁸ Cannex - 2004, *Market Trends Post the Introduction of Interchange Fee Regulation*.

Lowe, of the RBA said, it is “not possible to measure these price changes and their timing, particularly given other more significant changes in firms’ costs and prices that are going on all the time”.⁹ Clearly, this uncertainty around such a fundamental tenet of the intervention is to say the least, unfortunate.

When asked how they responded to any changes arising from the RBA regulations in the 2004 Cannex survey, very few merchants indicated that they had reduced prices of goods and services. Rather, most said the reductions had either no impact on their operations and some said they used the introduction of the RBA regulations and the associated fall in merchant service fees to increase their profit margins. (See Chart 2)

Chart 2: Impact on business as a result of fee changes – open card schemes



Source: Cannex Survey - August/September (2004)

In addition, Visa is not aware of any later research suggesting the overall attitude of merchants has undergone any significant change in this regard since 2004, although of course there is evidence of increasing levels of surcharging since 2004, which exacerbates the position.

In summary, the direct impact on cardholders has been an increase in fees and charges associated with credit cards. In contrast, merchants have benefited directly as a result of the RBA regulations and enjoyed a significant and ongoing cost saving through a reduction in merchant service fees, currently measured at \$900 million annually.

Impact of the removal of the “No Surcharge” rule

Where merchants, unhindered by restrictions on surcharging, may simply pass on the costs of the merchant service fee (MSF), they can effectively undo the transfer between merchants and cardholders brought about by the interchange fee.¹⁰ Thus, by banning the restrictions on surcharging negotiated between merchants and acquiring banks, the regulations limit the ability

⁹ See *Opening statement to the House or Representatives Standing Committee on Economics, Finance and Public Administration by Philip Lowe, Assistant Governor (Financial System) - May 2006*

¹⁰ For example, Gans and King (2003).

of card systems to use pricing structures to promote network growth and provide incentives to engage in cost-reducing practices.

These incentives, critical to the development of the system and to the creation of the profound consumer benefits that have flowed from the spread of card-based systems, are important even in a developed market such as Australia. Network effects are still present, both in regard to existing card products being accepted at new merchant locations and also to the acceptance of new card products across the entire network. There is no clear theoretical basis for concluding that the regulation abolishing "No Surcharge" rules (NSR) aids social welfare¹¹, nor is there clear evidence that NSRs were harming economic efficiency. In Visa's view, the case for abolishing NSRs through regulation has always been, and remains, weak.

In practice, merchants in Australia have not generally moved quickly to commence surcharging, despite the removal of the NSR. Not surprisingly, with the exception of merchants with market power (including through "captive" customers), they have apparently tended to "wait and see" whether their competitors commence surcharging, rather than being first-movers. The result has been that the initial adoption of surcharging was slow, but that it has been accelerating over time.

As the Issues Paper states, since the surcharge restrictions were lifted in 2003, there has been a steady increase in the number of merchants that levy a surcharge.¹² The Issues Paper quotes East and Partners' data from 2005 – 2006 and confirms that the incidence of surcharging increases proportionately with the size of the merchant. At the beginning, surcharging was being applied by merchants of varying size, however, the prevalence of large merchants surcharging is now increasing at a rapid rate, with more than 14 percent of very large merchants (those with turnover greater than \$340 million) surcharging. This is significantly higher than the level of surcharging by other merchants, which varies from five percent of small merchants to nine percent of large merchants. This momentum is increasing, with the East and Partners' data confirming that there has been a 100 percent increase in the level of surcharging across merchants of varying sizes over an 18-month period.

A number of observations can be made from the evidence currently available:

Firstly, merchant surcharging does not appear to be reflective of transaction costs. In particular:

- the **incidence** of surcharging appears to vary with the relative market power of merchants (as Visa had predicted before the regulations were introduced). This is indicated by the positive correlation between surcharging and merchant size as well as the frequency with which surcharging occurs at merchant categories where there is a limited number of participants or alternatives;¹³ while the level of surcharging varies considerably.

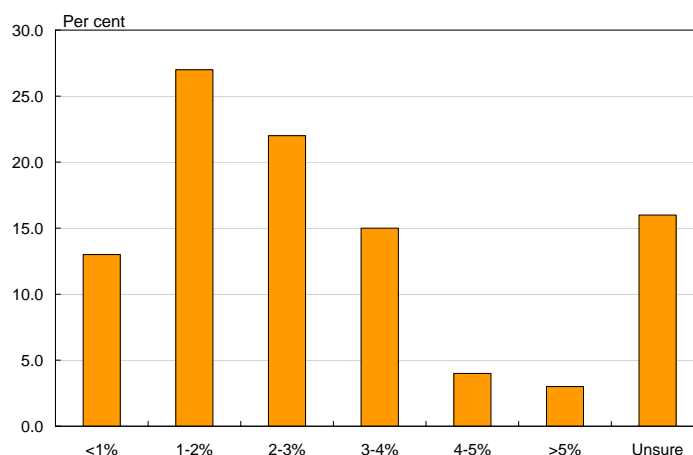
¹¹ See Wright (2004) for a discussion of the state of the relevant theory.

¹² See paragraphs 83 and 84 on page 18 of the Issues Paper

¹³ Anecdotal evidence suggests that surcharging is more prevalent among 'captive' markets such as airlines.

- While the East and Partners' data suggest that the average level of surcharging where it occurs is around one percent for Visa and MasterCard transactions – which is a little above the average MSF published in the Issues Paper for Visa and MasterCard transactions – survey evidence suggests that some merchants impose much higher surcharges.¹⁴ For example, Chart 3 depicts the highest level of surcharging faced by cardholders in the recent 2007 UMR survey. Again, this experience is consistent with the notion that the level of surcharging varies with the degree of market power (rather than being closely related to the costs involved).

Chart 3: Highest surcharge paid by cardholders



Source: UMR (2007).

Secondly, where merchants have chosen to surcharge, they have only partially differentiated between cards from open and closed schemes. As Visa reasoned before the introduction of the RBA regulations, this is not surprising since many merchants would be restrained from differentially surcharging because of the confusion it would cause. The Issues Paper reports that the East and Partners' data suggest that the average surcharge for the closed schemes is around two percent, which is below the average MSF for the closed loop schemes¹⁵.

Finally, surcharging has reached the point where an increasing number of merchants expect to impose a surcharge and this will have a significant impact on cardholders:

- while around 10 percent of merchants may surcharge on a regular basis, a much higher proportion indicates that they are considering doing so in the future;¹⁶

¹⁴ Earlier evidence from both East and Partners and Cannex indicated that the average level of surcharging where it occurs was between 1½ percent and 2 percent. A higher level of surcharging found in the latest East and Partners data reinforces the point that the surcharging that is occurring is not reflective of actual costs. See also points 83 and 84 on page 18 of the Issues Paper.

¹⁵ See Visa International (2005) and graph 7 on page 22 of the Issues Paper.

¹⁶ Cannex (2004) indicated that around 26 percent of merchants surcharged at least some of the time, while other survey evidence indicated more would consider doing so at some point.

- cardholders overwhelmingly disapprove of surcharging. For example, the recent UMR survey found that 77 percent disapproved of the practice of surcharging; and
- there are signs that this disapproval is having an impact on cardholder behaviour. For example, 50 percent of respondents to the UMR survey stated that they had at some point paid cash to avoid being surcharged.

Impact of the removal of the “Honour All Cards” rule

The "Honor All Cards" (HAC) rule is very important in the development and delivery of the well known network benefits to merchants and cardholders. As outlined in earlier submissions¹⁷, the HAC rule has been very important in establishing competitive markets for issuers and acquirers, and in assisting smaller financial institutions with their entry and participation in what is an essential part of retail banking.

In particular, the HAC rule has formed a vital part of the Visa service to cardholders and promotes efficiency, innovation, convenience and competition in several ways, including:

- reducing search costs to cardholders – that is, when cardholders see the Visa acceptance logo at a merchant’s premises, they know that their particular card will be accepted, rather than having to search for a merchant that both provides the goods or services the cardholder is seeking and accepts the particular Visa card held by the cardholder;
- allowing schemes to launch new products without incurring the substantial additional costs of re-creating their acceptance networks, product by product;
- providing consumers with confidence in the widespread acceptance of an existing product and of new products, thus strengthening the positive network effects in the system; and
- facilitating greater competition among issuers and acquirers.

In Australia, credit unions and building societies provide valuable competition to the retail banking products offered by the large banking institutions and are very popular with a wide range of consumers. They report that payment card products are fundamental to their ability to offer an acceptably wide range of retail banking services to their customers.

During the development of the Visa system in Australia, regulations did not allow credit unions and building societies to provide credit, including credit in the form of credit cards. Today they are generally able to do so, although many of their customers are credit averse. It therefore has been, and continues to be, fundamental to the competitive position of credit unions and building societies and, consequently, to their being important in contributing to real competition in retail financial services in Australia, that they are able to offer their customers Visa Debit cards. They can only continue to compete on an equal footing with banking institutions if their customers can

¹⁷ See Network Economics Consulting Group (2003) - *Economic Analysis of Visa’s “Honor All Cards” rule*.



be assured that their Visa Debit cards will be accepted, rather than potentially being refused by some merchants.

The decision by the RBA to abolish the HAC rule has not to date had an adverse impact on the acceptance of scheme debit cards, primarily because Visa Debit is a long-established product with widespread community support in Australia¹⁸. Its more than 4.5 million bank, building society and credit union customers have resulted in merchants choosing to accept Visa Debit, notwithstanding that they are not compelled to do so. As discussed below, as illustrated in the case of Visa Prepaid cards, the picture is different for new products and consumers who wish to use them.

Visa Prepaid cards have been introduced into Australia over the past twelve months. They involve value being “loaded” onto a Visa-branded card, which the cardholder can use at merchants displaying the Visa acceptance mark. Unlike a Visa Debit card, a prepaid card does not require the holder to maintain a deposit account with the issuing financial institution. Visa Prepaid cards are typically used by individuals who wish to control their, usually discretionary, spending closely or who, for whatever reason, do not want a card attached to their deposit account. They may, for example, be given by parents to their student children in order to provide either for emergencies or for the student’s general living expenses. Prepaid cards are also popular as gift cards, giving the recipient the option of purchasing a gift from the merchant of their choice rather than only from a single specific merchant.

The first Visa Prepaid card program was launched in Australia in 2006, with three further programs following more recently; others are in the pipeline. The number of cards on issue now is relatively small compared with, for example, the number of Visa Debit cards. This means that there is significantly less cardholder demand for merchants to accept Visa Prepaid cards. Woolworths, the issuer of the “Woolworths Wish Gift Card”, is one major retailer that has used the RBA’s abolition of the HAC rule in order to refuse to accept Visa Prepaid cards through its 3,000 stores (Woolworths, Caltex/Woolworths, Dick Smith, Tandy, Powerhouse, BWS Liquor, Dan Murphy’s, Woolworths Liquor and Big W) covering supermarkets, petrol, liquor, consumer electronics, hotels and general merchandise.

These stores account for approximately 18 percent of retail spending in Australia. Consequently, their refusal to accept Visa Prepaid cards imposes a significant hurdle to the successful introduction of this new product into Australia for the benefit of Australian consumers as a whole who might otherwise benefit from its general availability.

This example starkly illustrates the fact that the HAC rule is an essential element to encourage innovation in the payments system.

The Issues Paper raises the suggestion that the HAC rule could be further dismantled to allow merchants to discriminate between premium cards – gold cards and platinum cards – and so-called “standard” cards. The justification given is that premium cards typically attract higher interchange rates, although the Issues Paper does not mention that premium cardholders are typically higher than average spenders who could therefore be expected to increase merchants’

¹⁸ Credit unions and building societies have been significant issuers of Visa Debit cards since 1985.

sales disproportionately. Any such suggestion suffers from the same factors as mentioned above generally and in the contextual example of prepaid cards. In addition, the risk that a Visa card carried by a tourist or other international visitor would not be accepted by a merchant displaying the Visa acceptance logo because it does not appear to a sales assistant to be of the “right kind” should not be underestimated. Even overseas perceptions that this might be the case could be sufficient to deter visitors or to prompt them into carrying alternatives, such as travellers cheques. Given that Australia should have a world class payments system, this would be a clearly ludicrous outcome.

In summary, the HAC rule is pro-competitive and encourages continued innovation in the payments system by all participants. Without the HAC rule, the value of Visa-branded cards to both local cardholders and foreign visitors to Australia would be reduced and the guaranteed acceptance promise would diminish. At the same time, the use of interchange as a mechanism to promote innovation, both in terms of product development and merchant acceptance, relies on a merchant environment in which all products are accepted under negotiated commercial arrangements between merchants and acquirers.

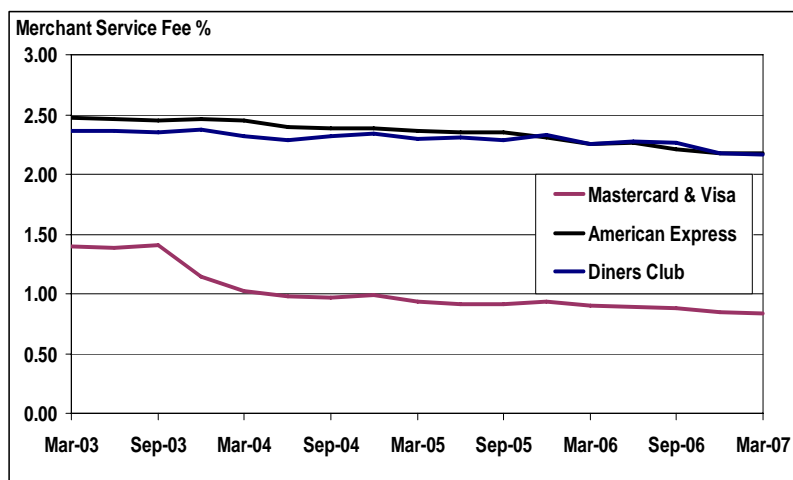
Impact on the competitive position across the payments system

A fundamental problem with the RBA interchange regulations has been the failure to regulate directly the closed (or ‘three-party’) schemes in a manner consistent with the regulations imposed on the open (or ‘four-party’) schemes - a clear departure from the core principle of competitive neutrality. The fact that the closed schemes do not face regulations comparable to the interchange fee regulations imposed on the open schemes appears to reflect more the practical difficulties that the RBA perceives it faces in regulating the closed schemes rather than any economic or policy principle¹⁹. Even the possible existence of actual practical difficulties does not, however, justify regulating some competitors and not others – in such circumstances, neither should be regulated.

The RBA had expressed the view that reduced interchange fees in the open schemes would force down the MSFs of the closed schemes as a result of competitive forces and potential merchant suppression. The results of this aspiration appear minimal, with only small reductions in actual levels and even smaller reductions proportionately in closed scheme MSFs being reported to the RBA, as outlined in Chart 4.

¹⁹ As Visa has reasoned in previous submissions, the differences between open and closed schemes are a matter of form rather than substance. In particular, Visa strongly disagrees with the views expressed in paragraph 60 to 63 of the Issues Paper which asserts a difference in substance between the open and closed schemes. While interchange is not explicitly identified in the closed schemes, a transfer does occur within the closed schemes and this is happening with the American Express companion cards marketed by a number of financial institutions.

Chart 4: Reductions in MSF for the schemes since the changes



Source: RBA

This demonstrates the two basic points in relation to MSFs that are mentioned above:

- In absolute terms, the MSF reduction in the open four-party schemes has been substantially greater than those of the closed three-party schemes. For the open schemes, this represents a reduction of 56 basis points, while for American Express and Diners Club, the reduction has been 30 and 20 basis points respectively, and;
- Proportionally, the fall in open scheme MSFs has been even greater. MSFs of the open schemes have fallen 38 percent, while those of American Express and Diners Club, have fallen by 12 percent and 8 percent respectively.

Also, as Graph 4 of the Issues Paper shows, the combined market shares of American Express and Diners Club increased by around two percent in 2004 following the introduction of the RBA regulations, and have remained at that higher level. The lift in market share, at around 13 percent in absolute terms, represents a significant gain which can be attributed directly to the unilateral regulation of the open schemes while the closed schemes have benefit free to operate outside the regulations.

A direct example of this regulatory arbitrage is the issuance of “companion” American Express cards – that is, as a companion to a Visa card or MasterCard card – by a number of financial institutions and the promotion of double points when the American Express card is used for purchases at merchant locations. The Visa card’s status is that it is promoted for use only where the companion American Express card is not accepted.

Anecdotal evidence received informally from a reasonably wide range of merchants, together with the aggressive advertising campaigns of issuing banks and the inherent appeal of the value propositions to high spending cardholders, suggests that it would be very surprising indeed if the gains by American Express and Diners Club are only of the size shown by the RBA’s data in Graph 4 of the Issues Paper. Visa does not have visibility into the data collection process,

though it is aware that there exists a wide range of legitimate nuances as to how these companion cards are described and treated giving rise to concerns about whether they are consistently reported. (For example, where part of the value proposition is that at the end of the billing cycle month, any unpaid balance of a companion card would/could be transferred to the linked Visa card, is this reported as companion card volume or Visa card volume?)

Given the above, Visa considers that it is essential that the RBA review in detail with the issuers the data collection and reporting processes in order to ensure the accuracy of the current market share data that is being published and to confirm that companion card volume is fairly and consistently reflected in the market share figures for the closed schemes.

In summary, the decision by the RBA not to regulate the three-party schemes will continue to provide these schemes with the opportunity to expand aggressively both proprietary and companion card issuing until such time as the approach to credit card regulations are revised to restore competitive neutrality.

Impact on access to the payments system

Membership rules for card schemes allow for membership by authorised deposit-taking institutions (ADIs). This prerequisite is to ensure a minimum level of quality of prospective members and also to provide an assurance to other members and participants in the system. Indeed, Visa's objective has always been to increase membership to facilitate the growth of both issuing and acquiring in any market. The existing members do not benefit from restricting access unless the participant threatens the integrity of the payment scheme - the overall network benefits are well understood.

The decision to introduce a new access regime under the control of APRA has added an extra layer of compliance and, in practical terms, has had little impact on competition in the market. As the Issues Paper notes, to date only GE Money and MoneySwitch have been granted Specialist Credit Card Institution (SCCI) licenses. It is worth noting that prior to the access regime commencing, GE Money had already been a Visa (and MasterCard) member in Australia through an offshore license and that its Australian operation had satisfied the formalities required in order for it to become a Visa member. Consequently, GE Capital's SCCI application was more administrative than substantive and, indeed, added an otherwise unnecessary layer to the membership process. The only genuinely new entrant, MoneySwitch, has just commenced operations after a considerable period of certification and has elected to participate as an acquirer of credit card, debit card, BPAY and direct debit services.

The Issues Paper notes that "the majority of new entrants" in the credit card market over the past five years have been the result of co-branding partnerships with existing issuers. These programs have not involved new issuers, but are additional programs of existing issuers in partnership with co-brand partners - something that was already popular prior to the RBA access regime. In other words, these are not "new entrants" into the market facilitated by the access regime, rather they are non-bank co-branding participants which already had the opportunity to launch such programs in conjunction with existing issuers.

The Issues Paper mentions "low rate cards" as another successful outcome of the access regime. In fact, these kinds of programs were first introduced by issuers in Australia in the late 1990s, well before the RBA regulations.

In addition, as mentioned earlier, it is worth noting that the payments market is currently undergoing a period of considerable consolidation with a number of smaller issuers electing to sell their credit card portfolios to larger, specialist issuers. In stark contrast to the RBA's intended objective of developing an efficient payments system, the intervention may well have accelerated the consolidation of what was previously a vibrant, competitive industry.

Impact on innovation

Visa continues to devote considerable effort and resources to product innovation and the development of its payments network. In recent years, a central focus has been the need to improve security of card-present and card-not-present transactions for both cardholders and merchants. Much of what needs to be implemented to address a growing concern by stakeholders requires significant investment, both on the issuing and acquiring sides of the network. While the RBA regulations provide some scope for the costs involved to be reflected in the level of interchange fees, this is done in an inflexible and cumbersome manner that is unlikely to be particularly effective, nor is it timely.

Visa's experience acquired over the past many years and in multiple markets, has been that a combination of factors – rules, interchange rates, liability shifts, mandates, incentives and penalties – is required to assist with the development and adoption of new products, acceptance locations and technology. These tools, used carefully and under the guidance of industry participants, can achieve significant breakthroughs and provide a balance such that the implementation costs are borne equally by all stakeholders in the network.

From a product perspective, there remain significant market opportunities to introduce a range of card products designed to meet the evolving needs of consumers, businesses and merchants. Recent examples include the introduction of commercial cards for small businesses, corporate and government purchases and premium cards for high spenders. Both programs required a range of supporting incentives, including product rules and interchange rates, to overcome local obstacles and to ensure their successful development and adoption. Visa expects similar challenges with other new initiatives and has already highlighted the challenge it is facing with prepaid cards as a result of the RBA's regulations.

Likewise, there remain significant opportunities to expand acceptance of payment cards, both in new merchant locations and by encouraging acceptance of payment cards in preference to alternative payment instruments at existing merchants. In most cases, a combination of rules, interchange rates and incentive programs designed to support merchant adoption has been used to deliver real benefits and efficiency gains to both cardholders and merchants.

Finally, the implementation of new technology such as EMV chip cards and the investment in securing the Visa network are costly exercises, particularly when undertaken on a global scale. Again, a combination of rules, interchange rates, liability shifts, mandates, incentives and penalties is required to ensure this technology is implemented in a timely manner and that the costs are borne equitably by issuers and acquirers.



In summary, the impact of the RBA interchange regulations on innovation will become increasingly apparent. However, Visa is of the view that the regulations are already working against efforts to invest and innovate in an optimal fashion and that Australia is at a real risk of falling behind other markets.

Question Two: What is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach?

The continuing worldwide development of electronic retail payment systems means that it is difficult to isolate in the data, the precise effect of the RBA regulations over the years since they came into force. The continuing impacts of robust economic growth and the strategic shift away from more costly paper-based payments systems have masked the impact of the RBA's prescriptive regulatory intervention. Visa believes that the RBA's regulations have not improved competition or efficiency and that the current regulations continue to harm the development of an innovative and competitive local industry.

The RBA regulations do not represent best practice regulation. In particular, some canons of good regulation that they fail to meet are:

- meeting clearly defined and measured objectives;
- ensuring the outcomes are met without undue complexity or compliance costs;
- not restricting innovation; and
- ensuring competitive neutrality.

There is no public policy case for on-going regulation. The RBA is unable to demonstrate any tangible benefit to the public from its credit and debit card regulations. At the same time, Visa and other members of the financial services industry have been able to provide evidence of a number of distortions and competitive imbalances that, if left un-checked, will have long-term negative consequences for the industry and its participants. Indeed, when the risks of regulatory error are large, such as the case here, the presumption must be in favour of light-handed regulation. These sentiments were emphasised recently in the Taskforce on Reducing Regulatory Burdens on Business in the following terms²⁰.

A 'regulate first, ask questions later' culture appears to have developed. Even where regulatory action is clearly justified, options and design principles that could lessen compliance costs or side-effects appear to be given little consideration. Further, agencies responsible for administering and enforcing regulation have tended to adopt strict and often prescriptive and legalistic approaches...

The case for regulation was not clearly justified in 2003, especially in demonstrating that the proposed actions would improve efficiency, nor did they follow good design principles. The case for continued regulation today is even less strong. The market has evolved in several ways over the last few years, and continued regulation is unjustified. In particular, it is worth noting that:

²⁰ See Regulation Taskforce (2006), p.ii.

- the market is considerably more transparent (including through the data on market growth, market shares and fees that the RBA regularly publishes);
- the incidence and level of merchant surcharging have expanded and will continue to do so if the RBA regulations continue to set aside the NSR;
- continued technological development unrelated to the regulatory intervention has led to increased competition between payment instruments; and
- the card networks have become more responsive to all participants in these networks.

Taken together, these developments should provide greater confidence that a more light-handed regulatory approach could be adopted relying on market forces, especially in regard to interchange fee regulation. The market is competitive and transparent and the costs to merchants have reduced and are among the lowest in the developed world²¹.

Continued prescriptive regulations would only place unnecessary burdens and constraints on a dynamic and still evolving market. In addition, as is all too evident from the series of amendments that the RBA has felt the need to introduce since the main regulations on credit card interchange, access and surcharging were imposed, a messy patchwork of regulations will be required in the future to ensure that different payment instruments are treated consistently and appropriately.

The remaining points are in response to questions raised in the Issues Paper and focus specifically on possible reforms to the current RBA regulations.

The future role of the access regime

The SCCI access regime has added to the complexity of the regulatory regime while producing no material change to the market, other than inserting an additional regulatory hurdle for a potential participant in the market.

The future role of surcharging

The impact of removing the NSR has been discussed and there is no evidence that abolition of the NSR has resulted in improved efficiency.

The future role of the “Honour All Cards” prohibition

Visa sees no reason for prohibiting the "Honour All Cards" (HAC) rule, rather, there are strong theoretical and empirical reasons to expect the HAC rule to be welfare-improving. With substantial benefits and uncertain costs, Visa believes that there are insufficient grounds for continued prohibition of the HAC rule. The existing regulations are stifling innovation. The HAC rule has clear benefits in reducing the costs of bringing new products to market and in stimulating competition.

²¹ See Weiner and Wright (2005).

If the RBA elects to retain its prohibition on the HAC rule, any further dismantling of this principle to allow merchants to decline certain card types or specific issuers would compound an already delicate situation in which merchants with market power take advantage of this prohibition for competitive benefit, which is obviously to the detriment of consumers.

In response to a specific question raised in the Issues Paper,²² Visa has never prohibited the adoption of bi-lateral switching of credit and debit transactions between members and directly with merchants; in fact, issuer-direct switching is already in place in Australia.

The role for continued interchange fee regulation

Interchange fee regulation is a blunt instrument in what is an evolving, dynamic and complex market. The current regulations only add to this complexity and continue to distort competition by the illogical imposition of constraints on significant players in the payment system, while at the same time leaving other participants outside of the regulations.

In addition, the combination of:

- the increased competition between different payments instruments,
- improved transparency,
- the difficulties in implementing competitively neutral regulations, both among card systems and other platforms,
- the prospect of an endless set of amendments to address new developments in the market as a result of either new technologies or responses to existing regulations,
- the signs that innovation in areas such as security and new products is being hampered, and
- the costs of compliance,

imply that the RBA could, and should, cease regulating interchange fees directly and instead rely primarily on market disciplines to deliver competitive outcomes.

Visa believes that there are insufficient grounds for continued regulation of interchange fees in Australia and that the current regulations should be abolished.

The regulation of American Express and Diners Club

Any regulations adopted by the RBA should be consistently applied to both the open and closed schemes in a competitively neutral manner given that the underlying economic positions are the same and notwithstanding the outwardly apparent differences between the two business models.

²² See paragraph 125 on page 28 of the Issues Paper.

Question three: If the current regulatory approach is retained, what changes, if any, should be made to standards and access regimes?

Given the responses to questions one and two above, Visa does not believe that the current approach to regulating, especially, interchange fees, should be maintained. Visa also believes that speculation concerning further possible modifications to a flawed regulatory framework would not be helpful.

If, however, the RBA decides to retain the current regime, Visa reserves the right to comment further on its design at a later stage in the review process.

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