Submission to the Reserve Bank of Australia

Response To EFTPOS Industry Working Group

By

The Australian Retailers Association

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Prepared with the assistance of

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1. Executive Summary

The Reserve Bank of Australia (RBA) over the course of 2001 ~ 2002 continued a reform process of the Australian credit card system begun in early 1997 [1]. At the time of writing (early September 2002), this process had just completed. The RBA as part of the credit card review process conducted an open and public discussion and proposed in its draft standards, the appointment of an independent expert to determine the appropriate level of credit card interchange[2]. In addition the RBA has issued standards relating to restrictions on entry to credit card issuing and acquiring, and restrictions on merchant pricing (merchants being able to surcharge credit card transactions). This entire process to date has been open and transparent.

The ARA has only recently learned that from early February 2002 a review of the Australian domestic debit card system has also been underway, with the RBA ostensibly playing a peripheral role. This review has been left to a group composed almost entirely of financial institutions with known, clear vested interests (the EFTPOS Industry Working Group – EIWG) that are not representative of all key stakeholders. The review of the Australian debit card system is ostensibly to remedy a number of problems, perceived by these same financial institutions.

The ARA contends that there is nothing fundamentally wrong with the Australian domestic debit EFTPOS system, with the exception of the issue of access. The Australian EFTPOS system is seen internationally as a world-class system. The Wallis Inquiry in 1997 made the following point in relation to the system[3]:

"The most visible forms of technology in retail financial services are the ATM and EFTPOS terminal, both of which have gained increased penetration, particularly EFTPOS. Use of ATMs and EFTPOS has led to a large shift towards electronic retail transactions, greatly reducing customer reliance on access to branches and providing cost savings and convenience of 24-hour service"

EFTPOS has been and continues to be, an efficient mechanism via which financial institutions 'outsource' their customer service obligations to retailers. In response to the EIWG paper on EFTPOS interchange reform, the ARA would recommend:

- that the EIWG be reconstituted under the auspices of the RBA, to ensure representation from ALL affected parties, particularly retailers – large and small;
- that such a reconstituted EIWG then be charged with determining an appropriate review timeframe, which allows for the proper evaluation of the Australian EFTPOS system and possible alternative access and processing arrangements;
- that the EIWG be asked to examine all aspects of debit cards in Australia, both the domestic debit (EFTPOS) and the international 'scheme' debit card products;
- that the EIWG be asked to establish one set of operating rules for all debit card products in the Australian market;
- that the EIWG present such a comprehensive, transparent and representative review to the RBA for final ratification and adoption.

We look forward to being part of a revised and transparent review process.

[1] The process was commenced by the *'Financial System Inquiry (Wallis Committee)'* – March 1997.

[2] Reserve Bank Of Australia *'Reform Of Credit Card Schemes In Australia – A Consultation Document'* Vol. 1 p. 59.

[3] Source: *'Financial System Inquiry (Wallis Committee)'* – March 1997 p. 100.

2. Introduction

2.1 The Australian Retailers Association

The ARA is the nationwide voice of the Australian retail industry. In December 1998 the ARA was registered as an organisation under the Federal Workplace Relations Act 1996 with coverage of the retail industry across Australia. The ARA has state Divisions in New South Wales, Victoria, South Australia and Tasmania and affiliations with the Retailers Association of Queensland, The Retail Traders Association of Western Australia, the Northern Territory Retailers Council and the ACT Chamber of Commerce.

The ARA's membership is comprised of over 12,000 retail businesses, which transact an estimated 75% of the nation's retail sales and employ around 75% of the national retail workforce.

ARA members operate around 40,000 retail outlets across the nation. Approximately 10,000 or 95% of the Association's members are small businesses (i.e. employing less than 20 staff) and operating in only one state.

Larger ARA members are also responsible for significant investments in the Australian payments infrastructure. These retailers have invested tens of millions of dollars in providing consumers with the ability to reliably make secure electronic payments and cash withdrawals.

3. Objectives

The ARA has five key objectives in making this submission:

- to highlight the fact that the Australian debit system is held up as an example of 'best practice' internationally, and therefore should not be altered without due consideration and appropriate consultation;
- to put forward the case for the Australian retailing community being recognised as a valid stakeholder in any examination of, or proposed changes to, the Australian debit EFTPOS system;
- to argue that an open and transparent process needs to be followed in any review of EFTPOS in Australia;
- to highlight the reasons why in any such examination of debit, the international (scheme) debit products must also be included; and
- to respond to the issues and options in the EFTPOS Industry Working Groups Paper.

4. Process & Scope

The ARA has three principal concerns relating to process, with the EFTPOS Industry Working Group (EIWG) and the paper circulated by that group[4, 5]:

- the composition of the EIWG;
- the scope of discussion and analysis in the group's paper; and
- the methodology and timeframe for review, evaluation and decision making.

Our concerns with these points are detailed below.

4.1 EFTPOS Industry Working Group – Composition

It is the ARA's view that such an important process as the evaluation of the Australian debit EFTPOS system should not be left to a group with such obvious vested interests as the members of the EIWG. If one excludes the existence of, Coles Myer Limited on the EIWG (Coles Myer' participation, is as a representative of CECS [6], and not as a retailer), there is no other party to provide counter arguments to the views and wishes of financial institutions. The ARA would strongly suggest that the open and transparent review process pursued by the RBA as part of credit card reform should also be followed with any examination of the Australian debit card system. Issues such as:

- optimum debit system access regimes;
- ongoing governance and review methods; and
- optimum debit interchange levels;

should be reviewed and discussed in an open and public forum. In addition, there is no representation of the broader retailing community and in particular small retailers as well as representation of consumer interests.

Under the current EIWG process, only those with a loose historical claim to 'ownership' of the debit system have been charged with overseeing its future and determining interchange levels. We would argue, as we have elsewhere in this paper, that the stakeholders in the EFTPOS system include Australian retailers (such as, supermarkets, department stores and oil companies as a minimum). These, along with consumers, should be involved in deciding the future of the Australian debit system. The future direction of this system is far too important an issue to be left to parties with a clear vested interest in certain outcomes. Should the EIWG remain unrepresentative of all debit stakeholders, any decisions made by the group may be open to challenge.

It is useful to examine the potential conflicts for the two groups of financial institutions that currently make up the majority of the EIWG [4].

[4] EFTPOS Industry Working Group membership: ANZ Bank, Australian Settlements Limited, Bank of Queensland, Bank of Western Australia, Cashcard Australia Limited, Coles Myer Limited, Commonwealth Bank, CUSCAL Ltd, National Australia Bank, St George Bank, Westpac Banking Corporation.

[5] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' July 2002.

[6] CECS: Consumer Electronic Clearing System.

4.1.1 Building Societies, Credit Unions & Regional Banks

Building Societies, Credit Unions and Regional Banks have a great deal at stake in seeing the current debit card system altered. Their principal aim would be to lower or remove debit interchange, for the simple reason that they are very small acquirers of debit card transactions while also having relatively substantial issuing portfolios. As a result, they are substantial 'net payers' of debit interchange to the larger acquirers. This, we believe, will result in them taking a self interest perspective when determining the optimum level of debit interchange. These same organisations however, have not seen fit to:

- invest in acquiring infrastructure;
- pursue acquiring business in the retailing market; and
- develop innovative debit products and services for use by retailers and cardholders (e.g. electronic fallback services, to enable cardholders to seamlessly use debit cards at the point of sale regardless of the status of the network).

They have however continued to heavily market their organisations in the area of card access. They have enticed new customers, despite their small geographic footprint (state based, or in the case of Credit Unions, industry or region based).

The major tool used to effect this, is the promise to the customer that despite their small size they can still offer national and global debit account access! In doing this they are leveraging off the investments made by retailers and acquirers in the necessary infrastructure – for which they must pay an ongoing fee.

These same organisations (particularly Building Societies and Credit Unions) have also been able to disingenuously over the years, extract ad-valorem fees (at the same merchant service fee rate as credit cards), from retailers for debit account access. They have achieved this by encouraging their cardholders to use Visa debit products that are simply debit account access cards in the same way as a credit card at the point of sale. These transactions attract the normal credit card ad-valorem fee when the cardholder selects 'credit' via point of sale PIN [18] pad devices. We would contend that this is an unconscionable practice. These organisations now stand to lose revenue from the RBA credit card reforms as announced, particularly in relation to reduced interchange rates. Their leading role in the current debit debate could also be viewed as an attempt to shore up their net position via reduced debit card interchange payments.

The national debit system has been used by these parties, to their advantage and they are now effectively seeking to continue using it at zero ongoing cost. Their track record in EFTPOS to date does nothing to inspire confidence in their objectivity or fairness. Their attitude towards retailers has also been made extremely clear. They also represent a small fraction of industry volumes.

The EIWG therefore has as a significant part of its membership organisations that in our view have a clear pre-disposition on questions relating to the Australian debit system.

4.1.2 Major Banks

The major banks in Australia have approximate debit market shares as per Table 1 below.

The table excludes other (smaller) debit issuers and acquirers.

	Debit Issuing	Debit Acquiring
ANZ	15%	22%
NAB	17%	25%
CBA	32%	38%
WESTPAC	26%	10%
TOTAL	90%	95%

Table 1 Comparative Market Shares [7]

It would therefore appear that the major banks in Australia have an overall equal weighting of issuing versus acquiring. The above information however, suggests that while the major banks are broadly in balance, the disparity between issuing and acquiring market shares for individual banks may lead to each bank pushing its own agenda.

Given that within the major banks there may be one and possibly two organisations favouring reduced or zero interchange, the EIWG therefore has, as part of its composition, a further group with predisposed views on the validity and levels of debit interchange.

4.2 Scope Of Discussion & Analysis

A further issue of concern relating to the process being followed by the EIWG is the scope of analysis presented by the Group's paper. The paper makes no attempt to discuss the relevance of interchange on all debit cards in the Australian market, but confines discussion to those cards that are part of the domestic EFTPOS arrangements.

This leaves aside the issue of card scheme or international debit cards[8]. This matter is of concern to the ARA and its members as it leaves open the possibility of debit issuers seeking to completely alter the economics of debit in Australia, once the current debit review process is completed. Issuers so disposed would be able to phase out proprietary EFTPOS debit cards and replace these with scheme debit cards. [8] This very issue is currently the subject of a class action led by the US retailer Wal-Mart against Visa and MasterCard. Wal-Mart is seeking to remove the requirement (placed upon it by the card schemes), that it accept all scheme cards. This is a direct result of Wal-Mart being forced to accept scheme debit products and having to pay an ad valorem fee for these.

The introduction of such products would have major ramifications for Australian retailers and the efficiency of the Australian payments system as they carry an ad valorem and positive interchange, while accessing the very same cheque and savings accounts accessed by domestic EFTPOS cards.

This migration from proprietary debit to scheme debit is already happening in other countries in this region such as Thailand and the Philippines[9]. The ARA also believes that the United Kingdom 'Switch' debit card system is in the process of being purchased by MasterCard, which will see all domestic Switch cards, converted to MasterCard 'Maestro' products (or

[7] Information on individual bank debit issuing and debit acquiring market shares is not publicly available. TransAction Resources estimates.

[8] Example – Visa Electron, Visa Interlink, MasterCard Maestro, MasterCard Electronic.

[9] The following Thai & Philippine banks are progressively issuing international scheme debit products: Thailand - Bangkok Bank (Visa Electron), Thai Farmers Bank (Visa Electron), Siam Commercial Bank (MasterCard Maestro and MasterCard Electronic), Philippines – Bank of the Philippine Islands (MasterCard Maestro), Equitable (Visa Electron).

Visa debit cards in some cases). This will almost certainly result in UK merchants paying higher fees in order for their customers to access domestic cheque and savings accounts.

Australian retailers, under their current merchant arrangements with credit card acquirers (who are also debit card acquirers) are obliged under the credit card schemes 'honor all cards rule' to accept ALL cards branded with a particular scheme's mark. This is regardless of card functionality, credit or debit.

For these reasons, scheme or international debit cards must be included and dealt with in the current review. Their interchange characteristics must match those currently being determined for domestic debit card products, to remove the possibility of Australian retailers and consumers being asked to shoulder substantial ad valorem fees for accessing domestic cheque and savings accounts.

It is vital that the current review covers all debit cards and not just those in the domestic EFTPOS system.

4.3 Methodology & Review Timeframe

The process being followed by the ARA in preparing and lodging this submission has been the result of representations by the ARA and others, to both the RBA and the EIWG. It is possible that the EIWG, left to its own devices may not have sought any significant input from the Australian retailing community on the future direction of the domestic debit system.

The ARA is aware that the EIWG intends to accept submissions from interested parties, yet EIWG members are under no obligation to:

- present their views, arguments and intentions, publicly, as is the case with other parties, including the ARA;
- have these views, arguments and intentions open to scrutiny and comment prior to any final recommendations by the EIWG on the future direction of the domestic debit EFTPOS system to the RBA; and
- justify why they have accepted or rejected various arguments put forward to them.

Arguments have been made elsewhere in this paper on the validity of the whole EIWG process (those with obvious vested interests being left to decide the future of a system which impacts a number of different sectors). A further point however needs to be made on the logic of one party (again, EIWG members), in the review process having the ability to examine and comment on another party's views (Australian retailers), without the latter having a reciprocal right.

It is the ARA's opinion that in addition to being constituted in a representative manner, the EIWG must make public its views on the issue of debit reform and have these open to public scrutiny and comment. Further, those wishing to comment must be allowed to do so in a reasonable timeframe, rather than the completely inadequate time constraints being currently adhered to. Only after such a process should there be any final deliberation and recommendation to the RBA on the future nature of EFTPOS in Australia.

It should also be noted that the EIWG paper does not provide any indication of the views or philosophies of either the group or its members – it simply presents limited options for further comment.

5. The Differences Between Debit & Credit

There are a number of important differences between debit and credit card systems that need to be highlighted in the current debit debate.

It is useful in the current credit and debit review environment that the differences between the two payment systems are highlighted and understood. As a result of these differences, there is little if any rationale for linking credit card interchange methodology with that for debit, as appears to be suggested by the EIWG[10].

Table 2 lists the key features of:

- the domestic EFTPOS system;
- international scheme (MasterCard and Visa) debit card products;
- the domestic Visa debit product (as defined below); and
- credit card systems in Australia.

The table clearly demonstrates that there are many features of debit cards that differ significantly from credit cards. These include (for debit cards):

- PIN authorised transactions, which check the balance of the account prior to authorising a transaction;
- lower fraud risk;
- lower risk of bad debt;
- availability of cash out;
- lack of associated loyalty programs;
- no scheme fees; and
- lower cost of operation.

Two particular features of the EFTPOS system, as listed, provide strong support for the existence of the current negative debit interchange arrangements, these being the PIN based nature of all debit in Australia and the ability to access cash using a debit card, at the point of sale. These issues are discussed below.

[10] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' p 5.

	EFTPOS	Scheme Debit [8]	Visa Debit [11]	Credit
PIN-based transactions	✓	✓(Note 1)	X	X [12]
Signature based transactions	X [13]	✓(Note 1)	✓	✓
Cash back	✓	✓	✓	X
International card acceptance	X(Note 2)	✓	✓	✓
Credit account access	X	X	X	✓
Debit account access	✓	✓	✓	X
PAN key entry option[14]	X	X	X	✓
Positive interchange	X	✓	✓	✓
Negative interchange	✓	X	X	X
Ad valorem merchant fees	X	✓	✓	✓
Fixed per transaction fees[15]	✓	X	X	X
Cardholder chargeback right	X [16]	✓	✓	✓
ATM withdrawal capability	✓	✓	✓	✓[17]
Card scheme fees	X	✓	✓	✓
Loyalty point accumulation	X(Note 3)	X	✓	✓

Table 2 - Features of Debit (EFTPOS, Scheme & Visa) & Credit Cards

Notes To Table 2.

1. Maestro is usually PIN based, but MasterCard Electronic is normally signature based. Visa Electron can be either, but is usually signature based.
2. Many EFTPOS cards also have scheme debit affiliations for overseas use. For example, many CBA debit cards also have the Maestro logo – this means the card is used as an EFTPOS card domestically but as a Maestro card internationally.
3. While most EFTPOS cards do not earn loyalty points, the Woolworths Ezy-Banking debit card does earn points.

[11] The Visa debit product referred to is discussed in detail elsewhere in this paper. The product essentially facilitates a retailer paying an ad valorem fee for debit account access by the cardholder.

[12] PIN entry on credit card transactions is required in certain unattended retailing environments, e. g. fuel delivery.

[13] Signature based debit transactions are only possible in the event of system failure at the point of sale.

[14] PAN (Primary Account Number) key entry, is the ability to manually ‘key enter’ a credit card number into an electronic card terminal in the event of the card magnetic stripe being damaged or the card not being physically present at the point of sale.

[15] Certain financial institutions in Australia, do levy ad valorem debit card fees to merchants.

[16] The ability to repudiate a debit card transaction, once a PIN has been entered at the point of sale, is extremely limited.

[17] Cash withdrawal at an ATM using a credit card, is treated as a ‘cash advance’. This results in the full credit card interest rate being charged to the cardholder from the day of the transaction, for the amount withdrawn.

5.1 PIN Based Transactions

Debit EFTPOS transactions in Australia are PIN[18] based, that is they are processed as on-line authorised and PIN encrypted transactions via a PIN pad (linked to a card processing terminal) at the point of sale. It is a mandatory requirement for acquirers and all merchants to use PIN pads that satisfy minimum security standards set for the processing of such transactions[19]. **This requirement imposes on merchants and acquirers the necessity of making significant investments in complying with these standards**.

Such investments, as noted elsewhere in this paper, can be via direct investment in infrastructure by retailers and acquirers or, in the case of smaller retailers via paying rental and transaction charges for use of such equipment. It should be noted that neither acquirers nor merchants in some of the countries mentioned by the EIWG have had to make this investment in PIN pads. In the UK, for example, PIN's are not used at the point of sale (POS). In the USA, scheme debit cards are signature authorised and many retailers do not have PIN pads at the POS.

The PIN based nature of the Australian debit system, has two key benefits for both card issuers and card acquirers:

- in processing a PIN encrypted debit card, the issuer guarantees to pay the acquirer for all authorised on line transactions. An authorisation (and payment guarantee) is only given however, after the issuer checks that the PIN is correct and also checks the balance of the cardholder's nominated bank account. As a result, transactions conducted on line with a PIN have proven to be very secure and have experienced very low levels of fraud. Consequently the cost to the issuer of giving this guarantee is close to zero; and
- there are significantly reduced transaction processing costs as virtually all debit transactions are required to be electronically processed and authorised via PIN.

By contrast nearly all domestic credit cards are conducted using signature verification only, and some 9% of credit card transactions are still conducted using paper vouchers, thereby substantially increasing processing costs for the issuer, relative to debit cards.

Retailers, large and small, therefore play an important role through bearing specific costs, for the mitigation of debit card issuer risk.

5.2 Cash Back

A further major differentiator between credit and debit cards is the ability of the latter to effect 'cash back' or 'cash out' as it is more commonly known in Australia. This is a feature unique to on-line debit programs, in which retailers may provide cash to cardholders at the point of sale as a customer convenience. Credit card scheme rules do not allow cash out on credit cards[20] at merchant points of sale, further clearly differentiating the two payment card types. The 'cash out' feature has been a major contributor to altering customer service delivery for financial institutions in Australia. It has contributed to financial institutions being able to significantly reduce branch numbers and service delivery costs. This has been dealt with

[18] PIN – Personal Identification Number. Issued by the card issuing institution or selected by the cardholder.

[19] Source: Australian Payments Clearing Association, CECS Manual for Consumer Electronic Clearing System.

[20] Visa & MasterCard International Cash Advances can be obtained from Bank ATM and over-counter and charge an ad valorem fee.

extensively in our analysis of the economic impact of the EIWG's proposed interchange reforms, elsewhere in this paper.

In summary, credit cards and debit cards differ significantly in their usage patterns, operation and cost structure. There is therefore no logic in applying the credit card interchange arrangements or fee flows to debit cards.

6. Scheme Debit Vs Proprietary Debit

In order to highlight the irrationality of leaving scheme debit card reform out of the current review process, it is necessary to compare the two systems.

The EIWG discussion paper mentions that interchange fee reform for scheme debit cards has been initiated, however no mention is made of what these proposed reforms are and how they may relate to the EFTPOS reform process[21]. We would again highlight the US Wal-Mart case (described in 4.2 previously), and the current legal action against Visa and MasterCard, arising from these card schemes forcing retailers to accept scheme debit products on an ad valorem fee basis. Australian retailers could also face such outcomes, were scheme debit cards left out of the current review process.

6.1 Background To Scheme Debit

Globally, scheme-based debit cards such as Visa Debit/Electron & MasterCard Maestro have been in existence since 1975[22] and currently each have 600 and 450 million cards[23] issued respectively. Scheme-based debit cards may have either signature-based or PIN-based verification, depending on the arrangements in place with card issuers in each of their respective regions of operation. All, however, work on the debit card principle of "buy now, pay now" from funds on deposit.

In Australia, Visa is the only scheme-based debit card available to consumers and was introduced into the market in 1982. Both credit unions and building societies were earlier adopters of the Visa Debit card product given that they have been unable, until relatively recent times, to offer credit cards. Scheme debit also enabled these smaller financial institutions to offer a payment card to their customers who either wanted or qualified for a credit facility.

Today there are an estimated 2.5 million Visa branded debit cards in the Australian marketplace with 47.5% of this number on issue by credit unions[24], with the balance made up between the building societies and regional banks. This compares with a total of 19.4 million[25] proprietary debit cards on issue by the major Australian banks.

[21] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' p 6.

[22] Introduced into market by National BankAmericard Inc. (NBI), precursor to Visa USA.

[23] Source: Corporate Visa & MasterCard websites.

[24] Credit Union Services Corporation (Australia) Limited "CUSCAL's response to *Reform of Credit Card Schemes in Australia"* p.3.

[25] Source: Australian Payments Clearing Association Limited (www.apca.com.au - *Payments Information*).

6.2 Interchange Flows

As previously outlined, interchange for proprietary debit card transactions (EFTPOS) currently flows from issuer to acquirer (negative interchange) and is a fixed fee of between \$0.18 and \$0.25[26], depending on commercial arrangements and bilateral agreements between any two institutions.

The arrangement with scheme debit card transactions on the other hand, is in variance to this as interchange flows from acquirer to issuer (i.e. positive interchange). In addition, interchange is usually charged on an ad valorem basis.

The following diagrams clearly demonstrate the differences between the interchange arrangements and fee flows, for proprietary (EFTPOS) and scheme-based debit:

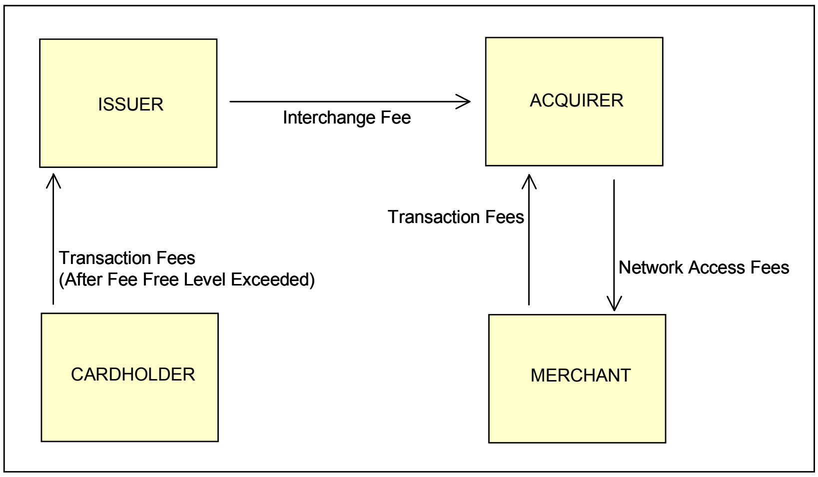


Diagram 1 - Proprietary Debit Cards Interchange/ Fee Flow

Diagram 1 above demonstrates that the fee flow between acquirer and merchant, in the proprietary EFTPOS system, may vary depending on whether the merchant is able to negotiate a network access fee income stream from the acquirer on debit card transactions processed. This is on the basis that the retailer receives compensation for the considerable investment made in EFTPOS infrastructure. Only retailers who have made significant investment in such infrastructure would be able to negotiate receipt of income. In the case of the vast majority of retailers a debit card fee is applicable for every transaction. What is also demonstrated, is that the issuer:

- appropriately collects transaction revenue from the cardholder[27]; and
- also appropriately, pays the acquirer for use of its acquiring infrastructure.

[26] Source: RBA & ACCC '*Debit and Credit Card Schemes In Australia: A Study Of Interchange Fees And Access*'. October 2000.

[27] Consumer fees of \$0.50 appear to be the norm for excess debit card transactions. See www.national.com.au, www.westapc.com.au, www.cba.com.au, www.anz.com.au .

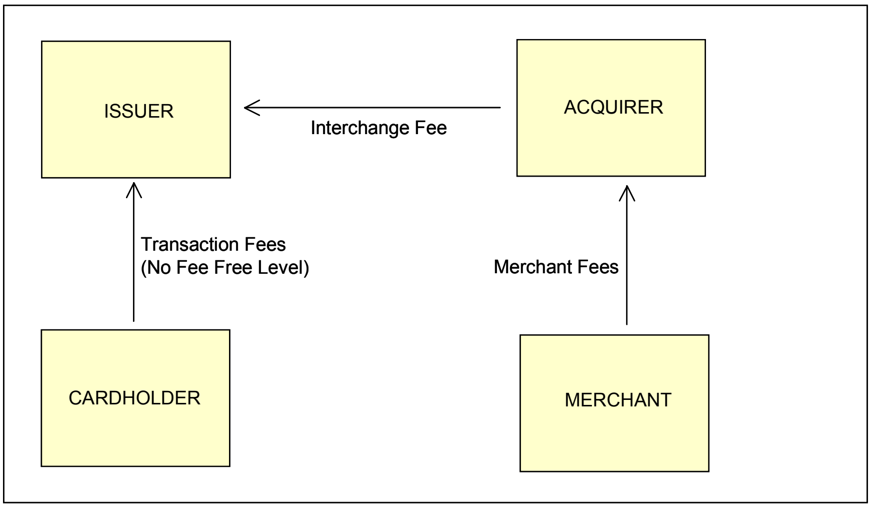


Diagram 2 - Scheme Debit Cards Interchange / Fee Flow

Diagram 2, illustrates the revenue flow for scheme debit transactions. Issuers derive revenue from both the acquirer and the cardholder for such transactions. In addition, scheme debit transactions do not have a fee free component for cardholders as is the case in the domestic EFTPOS system.

From the above, it is clear that if Australian debit issuers (as detailed in 4.1.3) were to migrate domestic debit card bases to international scheme marks, that there would be a major revenue realignment. This would unfairly favour the card issuer at the expense of acquirers, merchants and cardholders.

6.3 Impact/Implications of the Honour All Cards Rule

The '*honour all cards rule*' (HACR) mandates scheme debit acceptance by merchants where a scheme's credit card is accepted. While this rule appears eminently sensible at face value, it unfortunately has been used by issuers in some parts of the world to increase merchant service fee rates by introducing new card types at significantly higher interchange rates. A good example is the UK market where issuers introduced so-called "Corporate" cards with an interchange premium up to 80% above the interchange rate for "standard" credit cards. Some issuers are now actively converting many customers to these new cards. No justification was provided to merchants for this change.

In Australia we have seen the abuse of the HACR with Visa debit cards issued by the credit unions, building societies and some regional banks (as discussed in detail elsewhere in this paper). At the point of sale, the cardholder is actually instructed by the issuer to press the [CREDIT] account selection key on the PIN pad when using these debit cards. As a result, the retailer is charged a credit card MSF rather than the lower debit card merchant fee.

Consequently there is very real concern, that in a post EFTPOS interchange fee reform environment, debit card issuers could migrate all EFTPOS cards to scheme debit cards and mandate acceptance of these products by retailers. This would have major implications for retailers and the community. Any migration to scheme debit cards by issuers, would in effect introduce a credit card MSF for those debit card transactions. This would be levied on retailers, who in turn, would be forced to pass this cost onto consumers in the form of higher prices for goods and services.

While we do not necessarily advocate the abolition of the HACR, there needs to be some protection for retailers from this rule being abused by card scheme members seeking to generate new revenue streams and increase profits.

We believe scheme debit cards should be treated in exactly the same way as all other debit cards in the market and the merchant should not be forced to pay a higher fee or an ad valorem fee simply because of the scheme brand. It should also be noted that although issuers receive the credit card interchange rate, they incur virtually none of the costs or risks associated with credit cards.

Any review of the Australian debit system should be aiming to achieve optimum efficiency across the entire Australian payment system, rather than just the most efficient domestic EFTPOS system. For this reason, international card scheme debit products must be included in any reform measures going forward.

7. The History Of Debit

Electronic Funds Transfer at the Point of Sale (EFTPOS) was introduced into Australia in 1984. The four major banks initiated its release (in conjunction with increasing customer acceptance of ATM's) as a long term branch replacement strategy and to re-engineer their channel distribution strategy[28]. The aim was to ultimately reduce bank costs by moving customers out of branches and reducing the number of over-the-counter transactions processed.

EFTPOS was, and still is, primarily a 'branch replacement strategy' for financial institutions.

In order for the banks to effect this strategy, it was necessary for them to entice their customers to adopt electronic banking as the preferred method of accessing bank accounts instead of over-the-counter transactions. To achieve universal acceptance, banks needed to add value to debit cards beyond the use of ATM's – hence the significant push to EFTPOS in the late 1980's.

Typically, an over-the-counter transaction at a branch has a cost of \$3.50 - \$4.00 where as an EFTPOS transaction has a bank cost of under \$0.15 [29]

Although cost reduction through branch replacement and transaction migration was the primary motive for banks to introduce EFTPOS, there were also a number of other considerations that influenced this decision. These included:

- banks were keen to pro-actively encourage companies to directly credit wages and salaries into employee's bank accounts (through lower transaction costs and savings in Bank Account Debits taxes) [30]. This would replace the traditional and costly method (for banks as well as employers) of paying employees by cash or cheques. In addition, this would increase customer use and dependency on debit cards in order to access funds;

[28] ANZ, CBA, NAB and Westpac.

[29] Source: RBA / ACCC Joint Study – October 2000. p. 65.

[30] The Bulk Electronic Clearing System (BECS) only allows direct entry users to electronically credit nominated financial institution cheque and savings bank accounts. It does not permit the crediting of funds electronically to over-the-counter passbooks accounts.

- the introduction of debit cards saw the subsequent increase in the number of card terminals being used by retailers[31]. This in turn meant that credit card transactions at these retailer outlets were also being processed electronically, which improved transaction security (thereby reducing fraud) and achieved a major reduction in the number of paper-based credit card vouchers processed. These developments delivered further cost reductions for financial institutions;
- it was thought by some banks that the use of debit cards would migrate retail purchases away from credit cards, which were at the time being processed at a loss. Government regulations at the time restricted banks from charging customer fees (transaction or annual fees) on credit cards. Interest rates on credit were also regulated, which further limited the banks' ability to recover costs. This was seen as a further 'spin off' benefit of debit adoption; and
- debit was also identified as a business opportunity to derive new income streams from retailers, through the introduction of monthly terminal rental and debit transaction fees.

In the early days of development, the Australian banks decided that all debit card transactions would be on-line authorised and PIN-validated to ensure a zero-risk (or close to zero-risk) position for the issuer. This approach was designed to keep fraud costs to the absolute minimum and would allow the debit-issuing financial institutions to issue debit cards to any account holder regardless of their account balance or credit history.

It was also decided at the time, that all debit cards would be issued as domestic bank-branded cards and would NOT be Visa or MasterCard branded. This allowed debit transactions to be conducted in the domestic market without payments to the international card schemes and with processing rules set independently of these schemes by Australian issuers and acquirers.

The Australian banks also collaborated with industry suppliers and Standards Australia to develop the AS2805 electronic payment transaction processing and security standard. This is almost an exact equivalent of ISO 8583 (1987) but has been further refined over time. AS2805 was in fact the worlds first on-line debit transaction standard and predated ISO 8583.

Negative interchange on domestic debit cards was put in place to generate income to acquirers from all debit card issuers. The aim was to see acquirers charging debit card issuers for use of acquiring infrastructure put in place and maintained at considerable cost.

Initially, EFTPOS was slow to take off in the Australian market. By the late 1980's EFTPOS was still not meeting the banks' expectations and the banks were concerned about its success. Although EFTPOS transaction levels were slowly increasing, such increases were incremental and had little impact on reducing branch transaction levels.

It was not until the early 1990's that EFTPOS gained momentum, and this was due to strong marketing programs by a number of major retailers and oil companies rather than any initiatives by the banks themselves.

It also was not until the major retailers installed their own card terminal networks that they were able to negotiate any income from acquirers. These negotiations were based on retailers receiving compensation for the considerable investment they had made in EFTPOS infrastructure.

[31] In Australia, all debit (EFTPOS) card transactions are on-line authorised and PIN validated and may only be processed on paper in the event of a card terminal failure, and even then only under strict conditions. Australian retailers have made a significant investment in the acquisition or rental of card terminal equipment to comply with these security requirements.

The introduction of ATMs, EFTPOS and secure debit cards has moved the Australian bank customer towards electronic banking and has increased the profitability of Australian banks dramatically over the last 20 years by substantially lowering operating costs. It has also facilitated the implementation of "branch replacement strategies", further lowering overheads.

Interestingly, these cost savings are generally not included in any study of debit card economics conducted by the banks, nor is any reference made in the EIWG paper. Such savings must be included in any comprehensive review of the Australian debit system.

8. Access

The issue of access to the EFTPOS network is an area where the ARA concurs with the EIWG discussion paper; that gaining access to debit card acquiring is a cumbersome and difficult task, but not exclusively due to the number of bilateral interchange arrangements that must be negotiated by a prospective participant. The ARA believes that the issue of access requires a greater degree of reform than is proposed by the EIWG paper. Matters such as completely open access to debit card acquiring and issuing by third parties, and the ability to conduct self-acquiring activities [33], subject to prudential and regulatory oversight, must also be dealt with in any debit reform process.

8.1 Rationale For Open Access

The restrictions that currently exist for third parties gaining access to the EFTPOS system are very similar to those which exist for organisations wishing to gain access to credit card issuing and acquiring. In both cases a group of financial institutions have developed a set of restrictive entry criteria to a payment system that is critical to the operation of retailing and the economy in general. The RBA, in its draft credit card rulings described restrictions on entry to a market as:

" Prima facie, restrictions imposed by existing participants on entry to a market are anti-competitive, and against the public interest. Such restrictions inhibit normal market processes, under which resources are free to enter a market in response to profit opportunities; in doing so, or threatening to do so, new entrants drive profits down to 'normal' rates. "[32]

The RBA's desire to see competition in credit card issuing and acquiring, would be enhanced if potential entrants (particularly acquirers) were able to offer both credit and debit acquiring services. The likelihood of 3rd party acquirers successfully attracting retailers on the basis of credit card acquiring only, would be quite small. Retailers in such an environment would be required to have differing business and technical arrangements for their credit and debit card acquiring needs – quite an unlikely possibility. This would therefore detract from the RBA's aims to enhance competition.

[32] Reserve Bank Of Australia *'Reform Of Credit Card Schemes In Australia – A Consultation Document'* Vol. 1 p. 83.

The ARA wishes to see a debit access regime which:

- allows self acquiring[33] and third party debit card acquiring[34], subject to adequate and independent prudential and regulatory supervision; and
- allows third party debit card issuing access. For example, the Swedish supermarket chain ICA GROUP has operated such a system successfully[35]. In the case of ICA, the chain has been allowed to take limited deposits and grant its customers debit card access to these funds. Subject to adequate regulatory supervision, there is no reason why such a facility could not be operated, in the Australian market.

Opening access for both acquiring and issuing would lead to the following benefits:

- increased competition in the debit acquiring market which would lead, in turn, to cheaper prices for merchants and consumers and a more efficient payments system; and
- potentially a wider range of choices of debit accounts for customers.

The access reforms proposed above would be far more beneficial than the EIWG's limited focus on bilateral versus multilateral interchange arrangements and attempts at reducing or eliminating debit interchange.

9. Economic Impact Of Proposed Options

The EFTPOS interchange options as proposed by the EIWG will have far reaching and to date undocumented, economic consequences for all participants in the Australian debit card market[36]. Any changes will have an economic impact on issuers, acquirers, merchants and consumers.

The EIWG has proposed three alternative interchange structures, in an attempt to address perceived problems with the current EFTPOS arrangements[37]. What the EIWG has failed to assess however, is the economic impact of these proposed alternatives. The options proposed by the EIWG are:

- retention of the existing bilateral interchange arrangements, with two options for reducing interchange levels (immediately and over time), within a 'to be agreed' methodology or framework;
- the introduction of multilateral interchange arrangements with two options for fee setting; and
- the complete abolition of interchange fees.

[33] Defined as a retailer accepting debit cards for payment, being able to direct such debit card transactions directly from their points of sale / in store systems, to card issuers, without the requirement of an 'acquiring' intermediary.

[34] Defined as a 3rd party transaction processing organisation, which is not a retailer or an issuer, being able accept retailer sourced transactions and direct these to card issuers, without the requirement of an 'acquiring' intermediary.

[35] Source: www. ica. se

[36] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' July 2002.p 8 ~ 11.

[37] Ibid. p. 8.

The proposed interchange structures have been presented in isolation without a strong case having been made for the need to alter current arrangements. It can be argued that the problems identified by the EIWG have little relationship with the magnitude of a debit interchange fee. Some of the perceived problems listed by the EIWG (e.g. shifting of issuer and consumer incentives away from promotion and use of EFTPOS) would in fact be exacerbated by the complete abolition of interchange fees, as one of the options proposes[38].

9.1 Economic Impact – Issuers

As noted elsewhere in this paper, debit card issuers have been major beneficiaries of the widespread adoption of debit processing systems and card usage. The existence of negative debit interchange (the issuer paying the acquirer) is an acknowledgment of this fact as issuers would not have continued to issue EFTPOS cards if there was no value in them doing so.

Debit issuers, since the late 1980's have been able to provide their customers with cheque and saving account access at significantly lower cost than traditional 'over the counter' (OTC) services. OTC service provision has a cost of $3.50 to $4.00 per transaction[39]. Table 3 illustrates the comparative costs of OTC transactions versus EFTPOS and other transaction types, using branch withdrawal and deposit costs as a baseline (i.e. 100). The institutions are not identified in the Australian Bankers Association (ABA) source information cited below, but are identified by them as five Australian financial institutions.

	In Branch Cash Deposit Or Withdrawal (Baseline)	Cheque	Own ATM Withdrawal	EFTPOS Transaction
Institution A	100		31	18
Institution B	100	80	33	18
Institution C	100	109	25	24
Institution D	100	121	59	29
Institution E	100	116	57	29

Table 3 - Comparative Costs – Branch vs Electronic [40]

It is interesting to note from the ABA data in Table 3 that EFTPOS as a service delivery channel is some 70% to 80% cheaper than an institutions branch network. The EFTPOS channel is still 40% to 60% cheaper than providing services through an institutions own ATM network.

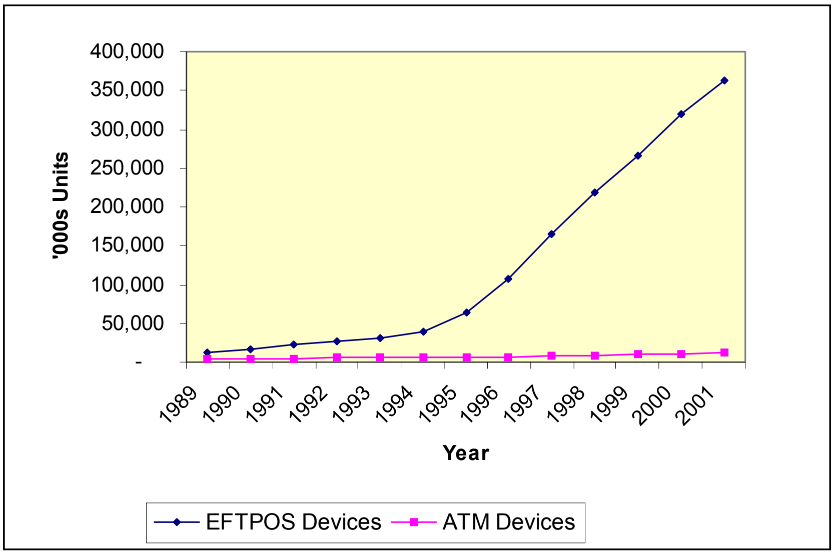
It is therefore reasonable to conclude that the Australian EFTPOS network provides one of the lowest cost methods for a financial institution to service its customer base.

[38] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' July 2002.p 5.

[39] Source: TransAction Resources.

[40] Source: Australian Bankers Association: Supplementary Submission to The House of Representatives Standing Committee on Financial Institutions & Public Administration *"Inquiry Into Alternative Banking Services In Regional And Remote Australia"* July 1998 p. 23.

The widespread availability of retail EFTPOS networks, combined with ATM services and other electronic delivery channels has significantly reduced the need for consumers to visit an issuers branch network to conduct a number of transaction types, including cash withdrawals, balance enquiries and inter-account funds transfer.



Graph 1 - EFTPOS Vs ATM Device Population [41]

Graph 1 illustrates the relative growth of EFTPOS and ATM devices in Australia over the period 1989 to 2001. In this period EFTPOS device penetration has grown by over 3,000% compared to growth in ATM numbers of some 290%[42]. The rapid take up of EFTPOS devices commenced in the late 1980's and very early 1990's when major retailers in partnership with acquiring banks, made substantial investments in EFTPOS infrastructure.

The ABA ascribed the major impact on bank branches to rapidly expanding EFTPOS networks, with ATMs playing a lesser role: "*in terms of technological alternatives to services provided by bank branches, the statistics indicate the use of EFTPOS is pervasive in the Australian community with the availability of EFTPOS machines growing exponentially. ATM usage appears to be relatively steady* ". [43]

The pervasiveness of EFTPOS networks over the 1990's, fed by retailers either investing directly in EFTPOS infrastructure or indirectly by renting equipment from acquirers, allowed issuers to rollout larger volumes of proprietary debit card products (as well as credit products) as demand was driven by greater numbers of access points for such cards. Consumers who were under pressure to accept electronic payment of wages and salaries (in order to reduce employer and bank cash handling costs) were now more inclined to agree to such arrangements. In turn, the costs of customer service delivery fell for issuers, allowing them to realise major savings in areas such as staff numbers and branch operating costs.

[41] Source: Australian Payments Clearing Association Limited (Internet - www.apca.com.au '*Payments Information*').

[42] Ibid.

[43] Source: Australian Bankers Association: Supplementary Submission to The House of Representatives Standing Committee on Financial Institutions & Public Administration *"Inquiry Into Alternative Banking Services In Regional And Remote Australia"* July 1998 p. 13.

EFTPOS has therefore been crucial to issuers in their attempts to reduce their distribution costs. Electronic service delivery has allowed branch rationalisation to proceed and has provided issuers and their shareholders with a major economic benefit.

Each of the alternative interchange structures proposed by the EIWG involves a staged or immediate reduction in the current EFTPOS interchange level. At no stage does the EIWG propose an objective examination of current debit interchange arrangements taking into account the above facts. It is assumed that a reduction or elimination of the current fee is the optimum outcome.

9.2 Economic Impact – Retailers

Retailers, as noted elsewhere in this paper, have been an integral part of the growth and success of the EFTPOS network. The introduction and continued existence of negative debit interchange in Australia was aimed at compensating acquirers for the necessary investment in EFTPOS infrastructure which would allow debit volumes to grow and thereby allow issuers to achieve their cost reduction aims.

It does not make economic sense for the EIWG to suggest in its proposed three alternative interchange structures that negative debit interchange needs to be reduced or removed completely. It appears that the role of retailers has been omitted from the EIWG's rationale for the points advanced! The effects of an arbitrary reduction or total removal of debit interchange will have major consequences for all retailers.

9.2.1 Effects On Small Retailers

Small retailers in Australia currently use EFTPOS equipment supplied by acquirers[44]. Such retailers range from small 'mum and dad' stores through to larger multi location chain stores. The rental charge by acquirers to such retailers is typically inclusive of:

- terminal hardware;
- data communications facilities;
- consumables; and
- technical and customer support services.

Acquirers, by being recipients of debit interchange are able to factor this revenue stream into rental price setting for smaller retailers. Anecdotal evidence suggests that the major banks in Australia each have approximately a 25% acquiring and 20% issuing market share. Typical fees acquirers charge <u>small</u> retailers for provision of EFTPOS facilities are[45]:

- Monthly terminal rentals $30
- Per debit transaction fee $0.25

Given that acquirers incur both fixed and variable costs in providing facilities to small retailers, any reduction or elimination of debit interchange will see acquirers attempting to recover this lost revenue from their sole remaining revenue source – the merchant. It is quite plausible to suggest that a <u>typical major acquirer</u>, would be faced with the following small

[44] Source: RBA / ACCC – *Debit and Credit Card Schemes In Australia, A Study Of Interchange Fees & Access*. Oct. 2000. p 55.

[45] Source: TransAction Resources.

merchant pricing scenario, were debit interchange to be reduced to zero (from the current average of $0.20[46]):

- interchange revenues currently generate $0.20 for debit transactions acquired;
- were interchange to move to zero then the acquirer would need to recover this lost revenue from the party to whom acquiring services are being supplied (the merchant). The reduction in interchange does NOT result in a reduction in acquiring costs, therefore this lost income would need to be recovered elsewhere. In fact, under a zero interchange scenario, the acquirer does not have the ability to recover fees from any other party other than the merchant;
- the small retailers debit transaction fee cost (or possibly a mix of terminal rental charges and transaction fees) would rise by the equivalent of $0.20. That is, the small retailer would now typically be required to pay $0.45 (or equivalent) per debit transaction as opposed to $0.25 previously; and
- once the average small retailer is faced with **an 80% increase** in debit transaction processing costs (from $0.25 to $0.45) then three options remain for such a retailer:
    - cease the acceptance of debit cards;
    - actively encourage alternative payment methods;
    - increase prices to compensate for the higher acquirer costs.

  Cessation of debit card acceptance would not be an option for a small retailer, in order to remain competitive. It is therefore very likely that, at the least, an increase in prices would be an outcome of downward movements or a removal of negative debit interchange.

  A potentially worse outcome would be that these merchants would actively encourage alternative payment methods, such as cash, particularly for low value transactions. This is the exact opposite of the intended outcome of this EFTPOS review, at least from the RBA. Debit cards are the cheapest and most efficient payment method and it is ridiculous to implement changes that would result in incorrect pricing messages being sent to merchants.

The EIWG does not appear to have considered the above consequences on acquirers and retailers of a reduction in the debit interchange arrangements in Australia.

In either case, the efficiency of the EFTPOS payment system would be reduced.

Such movements would result in a transfer of costs from major beneficiaries of the Australian debit EFTPOS system (card issuers), to the consumer, with the retailing community acting as the conduit via which this would occur.

9.2.2 Effects On Larger Retailers

There has been a great deal of comment and debate about larger retailers receiving a fee from acquirers for each debit transaction processed. The payment of such a fee has usually been portrayed as acquirers and merchants sharing the debit interchange fee, as paid by the issuer to the acquirer. This is not an interchange sharing arrangement at all – it is payment to the retailer in recognition of the investment made and as payment for the service provided.

[46] Source: RBA / ACCC – *Debit and Credit Card Schemes In Australia, A Study Of Interchange Fees & Access*. Oct. 2000. p. 61.

This payment is made for exactly the same reason as an issuer makes a payment to the acquirer, both for EFTPOS transactions and for ATM transactions. It is useful to state the specific reasons why an acquirer may pay such a network access fee to a larger retailer.

These large merchants have assumed the responsibility of providing most, if not all, of the infrastructure necessary for debit and credit card processing. The retailer's costs may include:

- system (hardware) development;
- card terminal equipment;
- card terminal implementation and integration with POS equipment;
- data communications facilities;
- on-going maintenance and support services; and
- software development activities.

The acquirer, by not having to meet these costs is able to compensate the retailer for doing so. The retailer in turn, has the benefit of designing a processing system to suit its business needs. The historical use of the debit interchange fee by the acquirer, as the revenue source for the network access payment has implications for larger retailers, as we will detail below.

If the EIWG's proposed options, of reducing or removing the debit interchange arrangements were to be implemented, the acquirer for a larger retailer (in receipt of a network access fee payment) would simply stop making such payments. Merchant agreements between acquirers and retailers who are paid a network access fee, invariably link such payments to the level of debit interchange. Reductions or a removal of debit interchange fees would see an immediate reduction in network access fee payments to larger retailers.

The acquirer would still need to recover the lost income of $0.20 as it does with small retailers (as detailed earlier). This means that the large retailer will be worse off by this amount. In other words, if a retailer is currently receiving $0.10 per transaction, they will now have to pay $0.10 to the acquirer.

The effect on larger retailers of such a revenue decrease would be a major increase in costs for the provision of consumer debit card services. These same larger retailers have been and continue to be instrumental in the widespread use of EFTPOS in Australia. A reduction or removal of such a major compensation source would lead to:

- extended equipment life cycles, ultimately leading to a 'step back' for Australia's current world class debit EFTPOS network;
- delayed or non-introduction of new card technologies, to the detriment of all parties; and
- increased costs for consumers as retailers are left with no other means to recover EFTPOS network costs.

Larger retailers would be left with operating and supporting (and over time upgrading) an EFTPOS network, at their sole cost, which was delivering utility to issuers at zero cost. It would be quite reasonable for larger retailers, (and smaller retailers as noted earlier) to seek to recover such cost imposts from consumers.

Again, the interchange reform options put forward by the EIWG would result in a transfer of costs from card issuers to the consumer, with the retailing community acting as the conduit for this.

9.3 Economic Impact – Acquirers

Acquirers, under the EIWG proposals to reduce or remove debit interchange would be largely unaffected, at least from an economic perspective. As detailed above acquirers will either:

- pass on increased costs resulting from a fall in, or removal of, debit card interchange, to the merchant. This would occur mainly in dealings with small retailers who have no option but to source EFTPOS equipment and services from acquirers; and
- cease paying network access fees to larger retailers who have made major investments in EFTPOS infrastructure.

In the absence of ACCC mandated cost absorption by acquirers (quite unlikely), the economic impact of the EIWG proposals on acquirers, would be minimal. Were interchange reductions or abolition to come into force, acquirers may however find it more difficult to extract debit fees from merchants and may also experience lower debit volumes as a result of acquirer fees being passed to consumers. This may result in a lower propensity for acquirers to make major investments in acquiring infrastructure. Again, this would be to the detriment of payment system as a whole.

9.4 Economic Impact – Consumers

Any move to reduce or eliminate debit EFTPOS interchange would leave consumers worse off. Initially, as holders of a particular issuer's debit card, it is likely that consumers would be faced with the following sequence of events:

- debit interchange is lowered or removed;
- acquirers increase charges to retailer; and
- retailers pass on cost increases to consumers.

In the above sequence, consumers would be asked to pay the foregone net acquirer interchange (an average of $0.20[47]), as this would be levied by the acquirer to the retailer. The consumer could have to pay this increased cost either directly (as a transaction fee levied by the retailer) or, more likely, indirectly as a result of increased prices.

If retailers were forced to use the direct charging model (i.e. charging the customer a fee at the time of the transaction), this would lead to increased time processing each transaction and expensive changes to EFTPOS and point of sale software. In the direct charging model, customers must be asked if they are willing to pay the fee and given the chance to use another payment method or cancel the transaction. This is the procedure contemplated under the proposed new ATM fee regime.

[47] Source: RBA / ACCC – *Debit and Credit Card Schemes In Australia, A Study Of Interchange Fees & Access*. Oct. 2000. P. 16. Allowance made for average issuing market share.

Even where issuers increase the number of 'fee free' transactions available to consumers per month, consumers would still be worse off. Consumers are typically allocated 8 fee free transactions per month, with excess transactions being charged by issuers at $0.50[48]. If issuers moved the number of fee free transactions from 8 per month to 10 or 12 per month (in the latter case a 50% increase), the initial benefit for consumers, assuming an increase in fee free transactions to 12, would on average be $2.00 per month:

4	X	$0.50	=	$2.00
Extra fee free transactions		Excess transaction fee		Benefit

However, after the effects of retailers' added costs are factored in a different situation would confront the consumer. As noted, acquirers, where they are unable to receive a debit interchange fee, would recover this amount from the retailer either via increased costs or via a reduced or zero network access fee. Retailers, either through direct fees or via generally higher prices for goods and services would seek to recover this increased cost if they are to continue providing EFTPOS services. The following situation would then emerge for consumers:

12	X	$0. 20	=	$2. 40
Transactions paid for		Acquirer fee recovery by merchant		Cost

Even in this most optimistic example, consumers will be disadvantaged by the reduction or elimination of debit EFTPOS interchange as advocated by the EIWG. **Should issuers not provide any additional fee free transactions in the above example, or consumers do not use more than eight transactions, then the consumer would face a net cost of $2.40 per month.**

9.5 Debit Interchange As A Compensatory Mechanism

The economic impacts of the changes to the EFTPOS system proposed by the EIWG have been dealt with elsewhere in this paper. From this analysis, it is apparent that those with the most to gain from the EIWG proposed interchange structures[49], namely:

- the retention of existing bilateral interchange arrangements, with two options for reducing interchange levels immediately and over time, within a 'to be agreed' methodology or framework; or
- the introduction of multilateral interchange arrangements with two options for fee setting; or
- the complete abolition of interchange fees;

are the smaller card issuers, building societies, credit unions and regional financial institutions. These organisations have unbalanced debit card issuing and acquiring portfolios, with their acquiring market share being very small indeed relative to their issuing share. Table 4 illustrates the relative shares of credit card issuing and acquiring, enjoyed by smaller financial institutions, this position would also be reflective of their relative debit card issuing positions:

48 Source: RBA

49 EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' p. 8.

	Issuing	Acquiring
Four Major Banks	87%	91%
Next Four Banks	10%	9%
Others	3%	1%
TOTAL	100%	100%

Table 4 - Share Of Credit Card Issuing & Acquiring [50]

Smaller financial institutions are 'net payers' under the current debit interchange arrangements, would welcome any reduction in (or elimination of) debit interchange. For the reasons detailed elsewhere in this paper, the current 'net paying' position of such organisations is totally appropriate. Smaller financial institutions have for many years extracted ad-valorem fees from retailers for debit account access. They have surreptitiously achieved this by encouraging their cardholders to press the [CREDIT] key when using these Visa debit products. This has allowed them to earn credit card interchange rather than pay out debit interchange. Such products have contributed to the size and profitability of card issuing portfolios of these smaller organisations.

As the RBA is currently examining this practice, smaller players must be viewing with some concern the possible reduction in card numbers and overall profitability if they were unable to issue debit cards that attract an ad valorem fee. Credit Union Services Corporation of Australia (CUSCAL) has publicly advocated what they call a 'more balanced' approach to the issues of credit and debit card reform. CUSCAL, in an August 2001 media release stated the following:

" Australia's smaller financial institutions have called for a more balanced approach to the Reserve Bank of Australia's reform of credit card and debit card interchange arrangements"[51]

One can only interpret this statement as advocating a reduction or elimination of debit card interchange if there was to be any reduction in credit card interchange. It is also interesting to note that the media release above was published in August 2001, while the EIWG did not form until early 2002. A further conclusion that can therefore be drawn is that these smaller financial organisations were pushing, from mid to late 2001 for a review of debit card interchange as a possible compensatory mechanism for them, were the RBA to mandate credit card interchange reductions.

These same organisations, or their representatives, constitute six of the eleven members of the EIWG[52]. This is a major concern to the ARA as the likelihood of the smaller financial institutions (which constitute a majority of the EIWG) voting en-masse for debit card interchange elimination or reduction, in which they have a vested interest, is quite high.

[50] Source: Reserve Bank Of Australia *'Reform Of Credit Card Schemes In Australia – A Consultation Document'* Vol. 1 p. 85.

[51] Source: Credit Union Services Corporation of Australia Limited – Media Release, August 21 2001.

[52] EFTPOS Industry Working Group membership: ANZ Bank, Australian Settlements Limited, Bank of Queensland, Bank of Western Australia, Cashcard Australia Limited, Coles Myer Limited, Commonwealth Bank, CUSCAL Ltd, National Australia Bank, St George Bank, Westpac Banking Corporation.

10. International Debit Systems

The EFTPOS Industry Working Group has raised the point that consideration of debit payment systems in other countries "may provide a useful reference point for EFTPOS in Australia". Accordingly, a description of the debit payment systems in Canada, the United Kingdom and Germany follows, with some conclusions that may be drawn from each example.

Information presented for each country is primarily sourced from field research conducted by TransAction Resources.

The time constraints imposed by the EIWG for submission of this paper, have not allowed a more thorough investigation of the debit schemes in a greater number of countries. We would however highlight the fact that two countries not dealt with in detail below, South Africa and New Zealand both have negative interchange regimes, very similar to the Australian system. In both cases the issuers pays the acquirer or the acquirers network, a fee. In the South African case the issuer pays the acquirer an "authorisation fee". This is currently R0.35 for debit cards.[53] It is also pertinent to point out that New Zealand and Australia have respectively:

- the highest usage of debit cards per capita[54]; and
- the highest global penetration of EFTPOS devices.

We would contend that these outcomes are a direct result of the interchange flows in Australia and New Zealand, and that these flows have contributed significantly to the success of the debit systems in these two countries.

The ARA would support changes to the Australian EFTPOS system, in line with other overseas systems provided:

- any review was undertaken with appropriate retailer representation, as discussed above;
- the interests of ALL stakeholders were taken into account; and
- it was then determined that a particular country model or derivative, was appropriate for Australia.

The ARA would not support the adoption of a particular debit model without due consultation and representation. In addition, it is highly likely that the Australian market would warrant its own unique arrangements.

[53] Source: TransAction Resources.

[54] Sources: Reserve Bank of New Zealand *'Payment & Settlement Systems In New Zealand'* February 2002. p. 9, and Bank For International Settlements '*Statistics On Payment Systems In the Group of Ten Countries*' March 2001. p. 116.

10.1 The United Kingdom

10.1.1 Background

All retailer card payments in the UK, both credit and debit, are authorised by signature at the point of sale. There are no PIN based payment cards, although the UK debit cards are used with a PIN to withdraw cash from bank ATMs.

Barclays Bank launched Connect, the UK's first debit card, in 1987. This was a Barclays-only debit product, and sought to charge Barclay's merchants the same ad valorem merchant service fees as for the Barclays credit cards.

A group of three banks, National Westminster Bank, Midland Bank (since acquired by HSBC) and Royal Bank of Scotland, then launched the Switch debit card scheme in 1988. The Switch scheme was also a local proprietary scheme not affiliated with either Visa or MasterCard. The operating entity is Switch Card Services plc. Switch offered a fixed price merchant service fee, regardless of transaction value.

Barclays later changed their Connect card over to Visa Delta, to enable other Visa issuers to join the debit market. Connect did not have enough scale to survive in the market as a Barclays-only product. The Visa issuers have also introduced Electron as an on-line authorised debit product to compete with Solo in the youth market. Visa Delta also offered a fixed price merchant service fee in order to compete with Switch.

Switch has a single, centralised, front-end transaction processing system called SwitchNet, funded jointly by the (end 2001) thirty one scheme issuers – twenty nine banks and two building societies. As most of these issuers are small institutions, they have been reluctant to invest in upgrading the Switch technology. A majority of transactions are still processed off-line, in batch mode. Even where transactions are authorised on-line, these transactions are processed again later, in batch mode, for value. The authorisation transaction is an authorisation-only transaction. Cardholder's accounts are debited "within a few days" according to the Switch website.

Interchange fees for debit in the UK are on the basis of a fixed price per transaction, regardless of value, and paid from the acquirer to the issuer. The Switch interchange fee is £0.045 per transaction, whereas the Visa Debit interchange fee is £0.07 per transaction.

In 1987 Barclays intended to charge the same ad valorem MSF's for Connect as for their Visa credit cards, but UK retailers refused to accept these cards until a fixed fee per transaction was introduced. Switch later introduced a second debit brand – Solo, which is a debit card that must be authorised on-line. This card was introduced to allow younger people and higher credit-risk customers to be issued with a debit card. As the Switch product is often authorised off-line, the issuers have some bad debt exposure.

Cash back is only available at merchants with on-line authorisation facilities. These merchants are primarily supermarkets and some petrol stations. Due to the off-line nature of UK debit cards, cash back is not commonly available from the majority of high street retailers. Cash back has also been the subject of some fraud in the past.

In recent years, the Switch scheme has struggled to make ends meet, with only very small acquiring margins as most funds received from merchants are transferred to the issuer owners of Switch, leaving almost nothing for re-investment in acquiring infrastructure. Switch have preferred to remain with off-line debit processing wherever possible, to reduce the load on their front-end processing system, which cannot handle the steadily increasing transaction volumes.

Most Switch cards now have a Maestro logo on the back of the card, allowing them to be used as Maestro cards outside the UK. The Switch debit card scheme is now to be acquired by MasterCard Europe, following the merger of MasterCard and EuroPay in Europe. Under this proposal, all Switch domestic debit cards will be re-branded Maestro over the next five years and the Switch brand will eventually disappear. Rather than investing to upgrade the SwitchNet systems, all card processing will move across to the MasterCard Europe system, EPSNet.

10.1.2 UK Statistics

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Visa Credit	15,941	16,019	15,916	16,225	17,646	19,710	22,275	25,018	27,806
MasterCard Credit	11,554	11,169	10,351	10,891	11,656	12,829	14,533	14,749	15,510
T&E Cards	1,531	1,442	1,321	1,340	1,476	1,599	1,635	1,801	1,824
TOTALS	**29,025**	**28,631**	**27,588**	**28,456**	**30,778**	**34,139**	**38,443**	**41,568**	**45,140**
Switch Debit	11,804	12,377	12,930	13,811	15,162	16,295	18,287	21,791	23,047
Visa Debit	8,310	10,219	11,188	12,238	13,279	16,178	18,359	20,737	23,035
TOTALS	**20,114**	**22,596**	**24,118**	**26,049**	**28,441**	**32,473**	**36,646**	**42,529**	**46,082**

Table 5 - United Kingdom Cards On Issue (000s) [55]

Since 1998, debit cards have outnumbered credit and charge cards in the UK market. This largely reflects a recent move to issue on-line authorised debit cards (e.g. Solo & Electron) to young people and to those without a high credit rating.

[55] Source: APACS – UK.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Visa Credit	387	416	431	472	532	601	661	733	822
MasterCard Credit	274	265	272	295	325	364	404	422	455
T&E Cards [56]	38	42	44	47	51	60	63	68	68
TOTALS	**699**	**724**	**748**	**815**	**908**	**1,025**	**1,128**	**1,224**	**1,345**
Switch Debit	169	269	344	425	535	684	802	919	1,106
Visa Debit	190	253	315	383	468	587	701	817	956
TOTALS	**359**	**522**	**659**	**808**	**1,004**	**1,270**	**1,503**	**1,736**	**2,062**

Table 6 - United Kingdom Transactions At Merchants (millions) [57]

Debit transactions at merchants have outnumbered credit transactions since 1995. These transactions exclude transactions at ATMs.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Visa Credit	14,907	16,526	17,789	20,055	22,821	27,292	31,718	35,940	43,317
MasterCard Credit	11,046	10,905	11,776	13,149	14,729	17,239	19,760	21,781	24,434
T&E Cards [56]	2,662	3,296	3,776	4,327	4,958	5,800	6,579	6,754	7,889
TOTALS	**28,615**	**30,727**	**33,341**	**37,532**	**42,508**	**50,330**	**58,057**	**64,475**	**75,640**
Switch Debit	4,507	6,997	9,134	11,602	14,971	19,697	23,789	28,199	33,658
Visa Debit	5,001	6,844	8,735	10,822	13,485	17,358	21,270	25,521	30,992
TOTALS	**9,508**	**13,840**	**17,870**	**22,424**	**28,456**	**37,056**	**45,058**	**53,720**	**64,650**

Table 7 - United Kingdom Spend At Merchants (£ millions) [58]

Due to the higher average value of credit card transactions, credit spend still exceeds debit spend at UK merchants. In 1999 the average credit transaction value was £56, compared to the average debit transaction value of £31.

	1992	1993	1994	1995	1996	1997	1998	1999
Credit cards	76. 7	57. 6	43. 5	38. 3	43. 7	60. 4	68. 8	100. 9
Charge cards	16. 2	13. 9	11. 6	10. 0	14. 2	16. 6	6. 1	23. 6
Debit cards	43. 9	35. 8	23. 9	20. 0	25. 4	33. 9	39. 6	54. 9
TOTALS	**136. 8**	**107. 3**	**79. 0**	**68. 3**	**83. 3**	**110. 9**	**124. 5**	**179. 4**

Table 8 – United Kingdom Fraud Losses By Card Type (£ millions) [59]

[56] T&E Cards – Travel and entertainment, or charge cards. E.g. American Express & Diners Club.

[57] Source: APACS – UK.

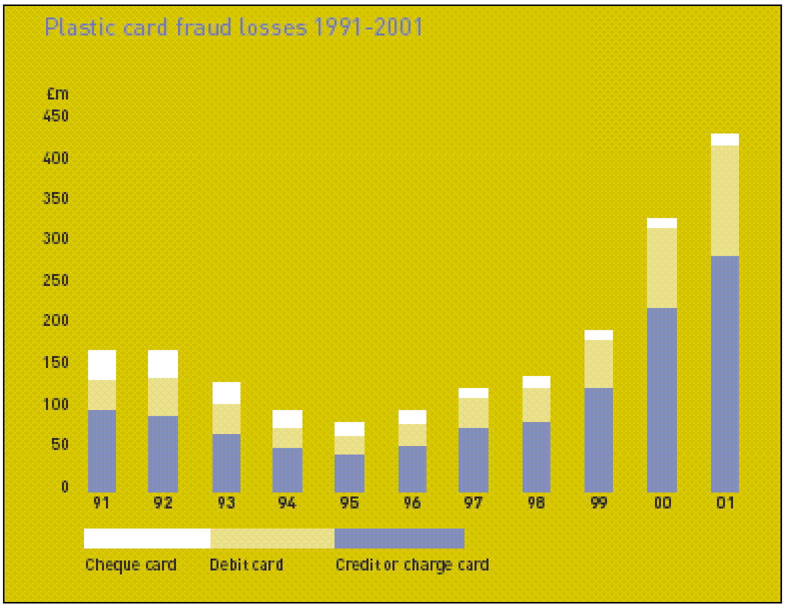
[58] Ibid.

In 1999 fraud on debit cards was 0.085% of merchant spend, compared to fraud on credit cards of 0.133% of spend at merchants.

Fraud on credit cards, debit cards and cheque guarantee cards rose to £411 million in the UK in 2001, an increase of 30% over the previous year. Fraud on debit cards accounts for around 30% of this amount or £123 million. Total fraud on cards is running at 0.183% of turnover.

Graph 2 below, illustrates UK cheque card, debit card and credit / charge card fraud for the period 1991 to 2001.

It is evident that the greatest rate of increase has been in the credit / charge card arena followed by debit card fraud. As noted below, this can be attributed (in the case of debit) to the non-PIN based infrastructure in the UK.



Graph 2 – United Kingdom Card Fraud 1991 to 2001 [60]

10.1.3 Interchange Fees

The median merchant service fees paid by large retailers in the UK in 1998 were £0.09 for debit cards and 1.16% for credit cards (£0.56 on an average £48 credit transaction), reflecting the difference in underlying interchange fees, according to the British Retail Consortium.

The interchange fees for credit cards are 1% for on-line authorised electronic and 1.3% for off-line, paper and card not present (CNP) transactions.

[59] Source: APACS – UK.

[60] Source: *UK Card Fraud Facts*, APACS Fraud Watch, 2002.

There is around a 60% premium levied for the commercial scheme credit cards, either corporate or purchasing cards, with an interchange rate of about 1.6%. Merchants who accept Visa or MasterCard are forced to accept these more expensive cards under the terms of the “Honour All Cards” rule.

For debit cards, the interchange fees are a fixed price per transaction, paid by the acquirer to the issuer (positive interchange). The fee for Switch debit cards is £0.045 (A$0.122) per transaction (increased by 15% from £0.0392 in 2001) and for Visa debit is £0.07 (A$0.189) per transaction. While the Visa rate is still 50% higher than the Switch rate, the service offered is the same, as the Switch cards have the Maestro logo on the back to offer the same international facilities as the Visa cards. One key difference is that the Switch issuers do not currently have to pay a fee for each domestic transaction to MasterCard Europe, unlike the Visa debit issuers who must pay a fee per transaction to Visa for processing.

10.1.4 Impact

The UK implementation of debit interchange payments from the acquirer to the issuer has not resulted in a debit card system that is superior to the Australian model. The majority of debit card transactions are conducted off-line, with signature. This has resulted in high levels of card fraud compared to the Australian on-line, PIN based debit system.

The UK banks have recognised this and are now spending hundreds of millions of pounds to implement PIN-on-chip technology in an attempt to cut the very high cost of card fraud. However, there is little incentive for retailers to invest in chip card terminals to replace all their existing magnetic stripe card terminals.

The proprietary debit card schemes are being replaced. The original Barclays Connect card was converted across to a Visa scheme debit card and it is now proposed that the 23 million Switch debit cards will be replaced with Maestro cards over the next five years.

The Switch Card Services transaction processing system SwitchNet is completely out-of-date and needs to be replaced. The solution has been to recommend that all processing should migrate across to MasterCard Europe’s EPSNet. This situation has arisen because the Switch debit card issuers have not been prepared to invest their interchange income into acquiring infrastructure.

The migration of proprietary debit cards across to scheme debit cards such as Electron or Maestro is also a real danger in Australia. Local debit card issuers will be very attracted to this idea if the interchange for scheme debit cards remains a positive interchange, as at present. EFTPOS reforms will possibly be for nothing if the scheme debit cards are excluded from the outcome of this EFTPOS review, as EFTPOS card portfolios may be completely migrated across to scheme branded debit cards within three to four years.

The UK acquiring market has become highly concentrated with NatWest Streamline and Barclays Merchant Services sharing around 65% of the business between them. These two acquirers have their own processing infrastructure, where their competitors all have outsourced processing systems. First Data and EDS are the main outsourcing suppliers to the other UK acquirers who each have very small market shares. The only new acquirer to enter the UK market in the last ten years is Girobank, a small subsidiary of Alliance & Leicester.

In 1999 fraud on UK debit cards was around 0.085% of spend, and this has increased to around 0.1% of spend in 2001. By contrast, fraud on Australian debit cards was 0.0015% of transactions in 1997 (no dollar figures are available). The Australian debit system has lower fraud costs by several orders of magnitude compared to the outdated UK system.

Australian acquirers and large merchants have a financial incentive to invest in modern infrastructure, on-line communications and security systems. A summary of the UK debit system would conclude that:

- the system is old, outdated and incapable of meeting modern debit card processing requirements such as on-line and / or PIN based debit transactions;
- this has occurred because the interchange arrangements provide no incentive for merchants or acquirers to invest in card processing infrastructure;
- the systems and procedures mandated by the banks have led to very high fraud rates and now these organisations want retailers to pay for this, by paying for and implementing new chip based card processing systems; and
- proprietary debit cards are being converted to scheme debit cards, with resultant higher costs for merchants and consumers.

The Australian negative debit interchange model has delivered a vastly superior system to the UK's positive interchange model.

10.2 Canada

10.2.1 Background

The Canadian Payments Association (CPA) was established in 1980. This was done to formally recognise the growing importance of non-bank deposit-taking institutions in the payments system. "The CPA provided a framework for operating the payments system in Canada, and guiding its development, in a manner consistent with public policy objectives at the time. "[61] Only regulated deposit-taking institutions are eligible for membership of the CPA. There are twelve Direct Clearers, 127 Indirect Clearers and the Bank of Canada, making 140 members in all. All final multilateral clearing and settlement services are provided by Direct Clearing CPA members, including the Bank of Canada (the Canadian equivalent of the Reserve Bank of Australia).

Canadian government policy is aimed at promoting competition in the provision of financial services. Other public policy objectives are the efficiency and safety of the payments system and the consideration of consumer interests.

The final settlement functions provided by the network of CPA members are equivalent to the On-Line Net Settlement system that operates between financial institutions in Australia.

A number of downstream payments acquisition and processing networks exist in Canada for credit card and debit card payments, such as those of Visa, MasterCard and Interac, which act as gateways to the 'upstream' final clearing and settlement system.

[61] *Access to Payment Networks in the Canadian Payments System*, The Bank of Canada & The Department of Finance, July 1997.

These payment card acquiring networks "are joint venture, or shared, networks that also provide some initial 'downstream' clearing services, such as verification, authorisation, and initial netting of payments. "[62]

The credit card networks, Visa and MasterCard, enter their net payment obligations, for settlement at the Bank of Canada, through a Direct Clearing member of the CPA acting as their banker, via the Automated Clearing and Settlement System (ACSS).

The Bureau of Competition Policy does not permit duality of issuing in Canada. This means that an institution may issue either Visa credit cards or MasterCard credit cards, but not both. This prevents the same large institutions from controlling both organisations and ensures that an effective monopoly does not eventuate. If a Visa issuer acquires, or merges with, a MasterCard issuer then one of the card portfolios must be sold. This occurred recently when the Toronto Dominion Bank (a Visa issuer) merged with the Canada Trust Bank (a MasterCard issuer) to form a new entity called TD Canada Trust.

The debit card network, the Interac Association, provides transaction processing services for the national networks of ATMs and EFTPOS terminals. Until late 1996, membership in Interac had been restricted to deposit-taking institutions that were CPA members. However, following an agreement between Interac and the Bureau of Competition Policy in December 1995, membership was opened in late 1996 to both financial and non-financial institutions, but with some tiering and functional restrictions.[63]

The structure of the Canadian payments system is essentially "a combination of networks that provide acquisition, clearing, and settlement services, linked together through communications networks. "[64]

10.2.2 Interac

The Interac Association was a privately formed entity founded by Toronto Dominion Bank, Bank of Montreal, Royal Bank, Canadian Imperial Bank, Bank of Nova Scotia, National Bank, Canada Trust, the Confederation des caisses populaire et d'economie and the Credit Union Central of Canada. These organisations, all deposit-taking institutions and members of the CPA, established Interac as a for-profit organisation in 1984 to operate networks of shared ATMs and EFTPOS terminals nationally.

The first Interac shared ATM transaction was processed in 1986 and the first EFTPOS debit payment in 1990. The debit payment service was available nationally from 1994.

The Bureau of Competition Policy initiated an investigation into Interac in 1992, following complaints of restrictive trade practices. In December 1995, an agreement was reached with the Interac Association, comprising the original, founding members, resulting in the membership being opened up to non-deposit-taking institutions and non-financial institutions such as retailers, insurance companies and securities brokers, effective from November 1996.

[62] *Access to Payment Networks in the Canadian Payments System*, The Bank of Canada & The Department of Finance, July 1997.

[63] *Access to Payment Networks in the Canadian Payments System*, The Bank of Canada & The Department of Finance, July 1997.

[64] Ibid.

This was achieved by the issuing of a Consent Order, in June 1996, "requiring the organisation to broaden access to its POS and ABM networks, alter its pricing policies, and become more responsive to new service demands and new members. "[65]

The original members retain ownership of the operating computer software used by each member and the licenses for that software. They also own a non-profit organisation, Interac Inc., which services the Interac network. The Interac Association, which operates the Inter-Member Network, now has a broader membership base, which includes deposit-taking institutions, non-deposit-taking institutions and non-financial institutions.

Interac members fall into three categories of membership – direct connector financial institutions, direct connector non-financial institutions and indirect connectors. A direct connector is licensed to use the Interac computer software that is able to exchange transactions with all other direct connectors. An indirect connector sends transactions into the Interac network via the system of a direct connector at a negotiated rate.

Retailer members are permitted to self-acquire, and also to acquire on behalf of other merchants.

Interac now has a fourteen member board, with two places reserved for direct connector non-financial institutions and three places reserved for indirect connectors.

The revenues of the Interac Association are generated from switching fees on a per-transaction, cost-recovery basis, paid by the direct connector members to the Association.

A member of Interac may carry out one or more of four functions. These are:

- issuer;
- acquirer;
- connection service provider; and
- settlement agent.

Only deposit-taking institutions may be an Interac card issuer, although they may be either direct or indirect connectors.

Only Direct Clearing members of the Canadian Payments Association may be settlement agents. Settlement agents provide access to the Automated Clearing and Settlement System (ACSS) on behalf of other Interac members for a negotiated fee.

Connection service providers are direct connector members that provide access to the Interac network for indirect connector members.

Acquirers that are not members of the CPA must have a settlement agent that is a Direct Clearing member of the CPA. All funds paid by issuers to non-CPA acquirers on behalf of merchants, are held in a settlement account by the acquirer's settlement agent. This arrangement is to protect against the financial failure of any non-CPA acquirer. The Interac Association is registered as a preferred creditor of the acquirer's settlement account to ensure that merchants will get paid in the event of an acquirer failing.

[65] *The Payments System in Canada: An Overview of Concepts and Structures*, The Bank of Canada & The Department of Finance, February 1997.

Diagram 3 below illustrates the network topography of the Interac system.

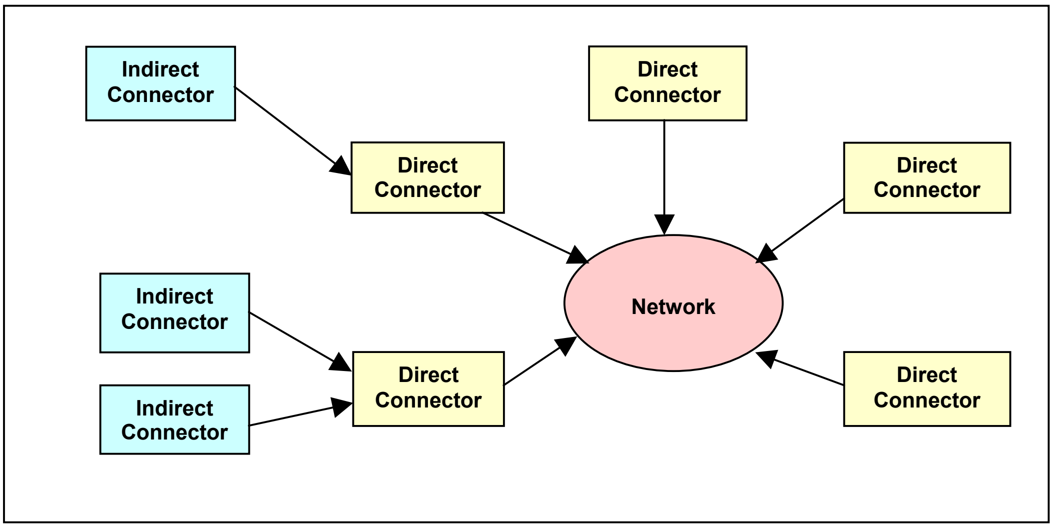


Diagram 3 - Interac Network Structure

As all direct connector members each have a computer system using the same licensed software, the cost of maintaining separate links to each other issuer or acquirer does not exist. A single connection to a shared network allows transactions to be exchanged with any other direct connector using the same messaging protocols and security standards. The Interac Association maintains the technical standards and all members must maintain compliant systems.

A further benefit of this distributed approach is that, if the system of a direct connector fails, it has almost no impact on the continued operation of the network. It also allows each direct member to have different sized computing infrastructure, depending upon his or her own forecast transaction volumes. This is much more flexible and economical than the “single large central system” approach (such as ETSL in New Zealand used to be).

The average response time for debit transaction authorisation is 1.12 seconds. The network protocol is ISO 8583 with PIN encryption and MACing. Session keys are used for PIN encryption. Keys are rolled over once each day and also on the first transaction of each day. The debit interchange timeout is set at fifteen seconds for all “direct” members. There is no stand-in if the issuer is not available.

New services may be introduced via bilateral or multilateral agreements between existing members to encourage innovation and competition in the market.

10.2.3 Canadian Card Growth & Interac

The growth in card usage in Canada over the last few years has been very strong, as evidenced by Table 9.

	1994	1995	1996	1997	1998	98 vs 94
Debit Cards (millions)	24.0	25.9	27.6	30.8	34.2	43%
Credit cards (millions)	29.0	30.3	31.7	33.5	37.1	28%
Terminals	119,733	189,898	253,089	330,530	393,730	229%
Transactions (millions)	185.2	393.8	676.5	1,039.9	1,355.4	632%
Value (C$ millions)	9,400	18,800	30,200	44,300	58,500	522%

Table 9 - Canadian Card Market Indicators 1994 to 1998

Interac has a zero interchange fee for debit transactions between direct connectors but connection service providers charge a processing fee to cover their costs and to make some margin on each transaction. Interac charges each direct connector member an "Assessment Fee" of C$0.0036 cents per transaction to cover operating costs.

In November 1996 there were nine members of Interac when the Canadian competition authority opened up the membership. At the end of 1999 there were 83 members, which included 39 credit unions and 21 banks. Another 17 were service or technology suppliers. There are currently 63 members issuing debit cards.

All the debit transactions are on-line and PIN-based without exception and fraud rates are very low.

A small retailer in Canada would typically pay about C$0.16 cents for each debit transaction and around C$40.00 per month to rent a card terminal. These rates are negotiable.

Since 1996 the larger retailers (who are not direct members of Interac) have seen their debit transaction processing fees fall from around C$0.15 cents to around C$0.05 cents per transaction. This is primarily due to increased competition from new acquiring members of Interac.

Cardholders have a transaction fee of around C$0.40 cents per debit card transaction but this is often waived for bank customers with mortgages, reasonable account balances and so on. Cardholders pay no fee at the ATMs of their own bank but pay C$1.25 to withdraw cash from the ATM of another bank.

	1996	1997	1998	1999
Cards (millions)	27.6	30.8	34.2	36.2
Terminals (000s)	253	331	394	406
Merchants (000s)	181	235	280	290
Transactions (millions)	676.5	1,003.9	1,355.4	1,661.4
Value (C$ billions)	30.2	44.3	58.5	72.1

Table 10 - Interac Debit Payment at the POS 1996 – 1999

Between 1996 and 1999 the number of debit card transactions in Canada increased by almost 250%. This is extremely strong growth and shows the impact of the sudden increase in the number of card issuers and acquirers. Every Canadian who opens a bank or credit union account now receives an Interac debit card automatically.

There is one umbrella Interac processing agreement. This is a multilateral agreement covering all members.

Interac debit cards are issued in Canada with a Maestro logo (MasterCard's international debit brand), but they are only treated as a Maestro card when used outside Canada.

10.2.4 Impact

Since 1996 the Interac debit system has experienced enormous growth. **This is primarily due to the actions of the competition authority in opening up access to membership.** An influx of new issuers and acquirers has stimulated growth and made the system almost universal in Canada.

At the same time, increased competition in the market from new acquirers has seen merchants' costs for debit transactions declining steadily.

The use of a common technical standard for all Interac members has eliminated a barrier to entry that exists in Australia where all acquirers and issuers have slightly different message protocols, requiring new interfaces to be established for each direct connection. The Canadian approach is much more elegant and much more cost efficient.

The composition of the Interac board guarantees reasonable representation for the newer members, with five of fourteen positions reserved for the new categories of membership.

A number of Canadian retailers are now seeking the ability to issue cards to customers with a debit payment function, where the card would access a deposit account nominated by the customer at a deposit-taking institution of their choice. This is very similar to the Swedish example cited elsewhere in this paper[35]. This would allow the retailer to have access to the names of these customers for direct marketing purposes.

The Canadian decision, in 1995, recognised the potential value of wider access to the debit payments system in terms of improved efficiency and a long-term reduction in operating costs. It also recognised the problems inherent in leaving the system in the hands of a small group of organisations that were seeking to use the national debit payments system as a revenue-generating enterprise. This mode of operation was determined not to be in the public interest.

The Australian debit system would benefit from a more liberal access regime, as is the case with the Canadian system. Greater levels of access in the Canadian system have lead to increased competition in acquiring which, in turn, has driven down merchant costs. The access regime has also lead to a more open and transparent debit system.

The ARA would support such initiatives in the Australian system, again, provided that:

- any review was undertaken with appropriate retailer representation, as discussed earlier;
- the interests of ALL stakeholders were taken into account; and
- it was then determined that the Canadian, or any other country model or derivative, was appropriate for Australia.

10.3 Germany

10.3.1 Background

Despite the high number of cards on issue in Germany, card usage is relatively low, particularly for purchases at the point of sale. In a review of 12 major trading nations in 1998 by the Bank for International Settlements, Germany was second last in terms of both EFTPOS terminals and card transactions per million inhabitants. Only Japan, with its extremely low card usage and no debit cards, was lower.

Germany has a high penetration of debit cards with almost one card issued for every man, woman and child, but the penetration of credit cards is very low with the number on issue being less than 20% of the number of debit cards.

There are more than 3,000 banks in Germany, including co-operative and rural banks, virtually all of which issue debit cards. Of these, around 600 are Sparkassen (savings banks) and they account for 51% of retail banking. To put things in perspective, Deutsche Bank (Germany's largest bank) has only a 7% retail banking market share. There are some 1,800 Visa issuers in Germany.

There were only 10.5 transactions per debit card in 2000. This low card usage may be partly explained by the integration of East Germany in recent years with a large number of debit cards being issued by the savings banks to former East German residents.

10.3.2 Debit Cards

Debit card usage is growing at a far higher rate than credit. Over the past four years the number of debit cards on issue has grown at almost seven times the rate for credit cards with an additional 27 million debit cards issued over this period versus 4 million credit cards.

The main debit card in Germany is the national "eurocheque" debit card (commonly known as ec Karte or ec Cash), although there are also small numbers of Visa Debit, Visa Electron and domestic Maestro cards issued. There is also a variant of the ec Karte without the cheque guarantee function. The ec Cash card is generally branded Maestro for international use, but these cards are treated as domestic cards when used within Germany and are processed via the domestic debit system rather than the MasterCard network. This is much the same as Canada's Interac card, Switch in the UK and some domestic debit cards in Australia that are also branded Maestro only for international use.

The ec Karte is very important to the banks, as it is the key to current accounts for private retail customers.

The ec Karte is generally authorised on-line with a PIN, although it can be used with signature verification. The Geldkarte chip on the card (see below) also allows off-line PIN authorisation, although at present many merchants do not have chip-capable terminals and are unable to use this functionality.

There are now 46 million ec Karte cards in Germany. In addition there are more than 20 million bank debit cards, which are basically the same as ec Karte cards but without the cheque guarantee function. Most of these bank debit cards can be used at the POS, but not all. Around 65 million cards can effectively be used as an ec card at the POS.

The total spend on ec debit cards is four times higher than on credit cards. The main reason for this is that ec cards come with an overdraft facility on the current account to which the card is linked. The overdraft interest rate is cheaper than the interest rate charged for late payments on charge cards or the APR (annual percentage rate) on revolving credit cards, therefore most people don't want to use credit cards.

Cash back on debit cards is prohibited by law in Germany.

There are four authorisation centres for ec debit cards, and transactions are routed to the appropriate centre depending on which bank issued the debit card. The banks in Germany have not formed a common or shared network switch. Instead, several companies (owned by both financial and non-financial institutions) provide the switching services. These switches are not linked together. The POS terminal networks of the various competing network operators are linked to the banking industry's authorisation centres that are interposed between the service providers and the large number of card issuing institutions.

10.3.3 Credit and T&E Cards

In Germany, the term "T&E cards" covers credit cards and Visa and Europay/MasterCard charge cards as well as the traditional T&E cards of American Express and Diners Club. There are some 18 million of these credit and charge cards on issue in Germany. The Europay/MasterCard volume in Germany is about double the Visa volume. Most Visa and Europay cards in Germany are charge cards. Traditional credit cards with revolving credit are relatively rare and have only recently been introduced to the market. Only an estimated 15% of "credit cards" actually have revolving credit.

Some retailers don't accept credit cards because the MSF is so much higher than for ec debit cards.

Fraud is not a problem in Germany for PIN authorised transactions (i.e. debit), but it is increasing for signature based transactions.

10.3.4 Geldkarte

Germany has an electronic purse product called Geldkarte. The Geldkarte microprocessor chip has been added to all ec debit cards and ATM cards and there are now more than 60 million cards with the Geldkarte chip. The card can be loaded with an amount of up to DM 400 and this can be done at approximately 600 ATMs. The card has not been successful and those few merchants who have installed chip card readers specifically for Geldkarte, such as McDonald's, have reported very low usage. It is apparently expensive to issue and operate.

10.3.5 Interchange and Merchant Fees

There is no interchange on ec Karte and ec Cash cards, but merchants are charged a standard processing and authorisation fee of 0.3% of value.

The merchant's cost of processing an ec card without a PIN (i.e. using signature authorisation) is DM 0.35, but the fee is ad valorem for PIN authorised transactions – this is an anomaly the banks are trying to remove as some merchants are taking advantage of what is effectively a lower merchant fee for what is a less secure transaction.

All Visa scheme cards (credit, charge, Visa Debit and Visa Electron) have the same interchange fee – the issuer's claim it is not possible to distinguish between these Visa card types from the card number.

Many German merchants refuse to accept the scheme branded debit cards, as they are expensive compared to the ec cards. In February 2001, a group of German banks made an application to the Anti-Trust Commission seeking permission to introduce positive interchange fees on ecKarte and ecCash cards. The Anti-Trust Commission let it be known that they were not in favour of this idea and German retailers also raised early objections. In April 2001 the banks withdrew their application rather than pursue it in an environment where it had no chance of succeeding.

10.3.6 Statistics

The vast majority of debit cards in Germany are ec cards, not scheme branded debit cards. The Bank for International Settlements does not distinguish between the various types of debit cards and therefore separate statistics are not available without detailed research.

Many Visa acquirers will not provide merchants with a split between Visa credit and debit purchases in markets where they are charging the same merchant fees for both debit and credit products. There is no justification whatsoever for having the same interchange rates for both types of cards (see Scheme Debit).

	1996	1997	1998	1999	2000
Debit					
Cards (millions)	71.8	75.8	81.1	90.2	99.2
Terminals (thousands)	157.1	251.8	362.8	472.9	591.3
Transactions (millions)	214.2	225.8	675.2	860.3	1,037.1
Spend (€ billions)	16.7	14.8	51.4	64.4	76.1
Credit					
Cards (millions)	13.5	14.2	15.2	17.0	17.7
Terminals (thousands)	1,000	1,100	1,141	1,219	1,352
Transactions (millions)	289.9	303.4	317.4	338.1	351.6
Spend (€ billions)	30.0	32.1	28.9	31.6	33.5

Table 11 - Card Market Indicators for Germany [66]

Some of the credit card terminals are double-counted and therefore this figure is inflated.

More debit transactions from different accepting networks were reported from 1998.

German debit cards have more than triple the number of transactions, and more than double the spend of credit and charge cards.

[66] Source: Bank for International Settlements, July 2002.

10.3.7 Impact

The German market has debit cards without interchange fees (the ec cards) and also debit cards with positive interchange fees (the scheme branded debit cards). The ec cards have the majority of the market share as they are much less costly for merchants to accept and there are many more issuers of these cards.

The ec or "eurocheque" cards may provide a payment function, a cash withdrawal (ATM) function and may also provide a cheque guarantee function. Many cards also have the Geldkarte electronic purse but this is not popular with cardholders and is poorly used.

Merchants may elect whether they wish to pay for a payment guarantee on the ec cards or may elect to take third party insurance.

In 2001 the German debit card issuers attempted to introduce positive interchange fees on the ec cards as they wished to increase their revenues from card issuing. The German Anti-Trust Commission is of the view that the national debit payments system should not become a business designed to generate additional revenue for card issuers by taxing merchants. The card issuers recover their costs from the cardholders via transaction fees.

The German system provides a number of points worthy of note in the current Australian debit reform environment, these being:

- that both scheme and proprietary (ec-Karte) debit cards are issued in the German market, with proprietary debit cards dominating the market;
- that Visa scheme debit cards have the same interchange as credit cards, thereby imposing higher costs for German merchants;
- the attempted introduction of an interchange fee (<u>acquirer to pay issuer</u>) by issuers in 2001, failed. The issuers withdrew their application to the German Competition Authority once it was evident that the Authority would reject the application; and
- general card usage is relatively low in Germany, but debit cards have far higher usage rates than credit cards.

It is therefore reasonable to conclude that support for proprietary debit and an aversion to positive debit card interchange are key features of the German system. It may be argued that the current EIWG process presents a threat to both these, in the Australian environment.

10.4 Country Comparisons

10.4.1 ATMs

In all countries (including Australia), the banks, which operate ATM networks, negotiate interchange fees between themselves that are designed to recognise the investment in capital and operating costs incurred by the owner of the ATM. Card issuers pay a per-transaction fee to the ATM owner each time one of their cards is accepted at an ATM belonging to another institution or company. This is eminently fair and reasonable. In most of these countries, all or part of this fee is recovered by the card issuer from the cardholder who made the transaction.

Banks globally, are happy to accept the principle that the owner of the infrastructure should receive a processing fee from the card issuer. When the owner of the infrastructure is a merchant, rather than a bank however, this principle is denied. Indeed, many banks claim that merchants should pay the card issuers for transactions conducted using merchant-owned infrastructure. This is completely inconsistent and has no credibility as an argument.

In Australia, merchants who do not invest in card processing infrastructure pay debit transaction fees to their acquirers. These same acquirers do not pass any of this on to the card issuers. In fact they also receive a fee from the issuer for the same transaction. This fee recognises the high investment made by acquirers in secure on-line processing networks that are required to operate a fully on-line PIN-based national debit payments system.

Such a system results in very low fraud, no bad debt risk and much lower retail banking costs. As the cardholder's identity and account balance are checked for every transaction, a debit card may be given to anyone opening a bank account, without restriction. There is no need to undertake credit checks, as there is no exposure to credit risk.

Australian retailers who choose to invest in secure card processing equipment and communication networks are recognised in most cases by receiving a debit processing fee from their acquiring bank, in exactly the same fashion as the owner of an ATM. This is entirely consistent and reasonable.

10.4.2 International Conclusions

The competition authorities in Canada and Germany have recognised that an efficient and safe national debit payments system is definitely in the public interest. They have also recognised that it is not in the public interest to leave the payments system in the hands of a small group of institutions that would, over time, seek to use it to generate additional profits for themselves.

The Bureau of Competition Policy in Canada decided to open up access to the debit payments system, effectively ending the plan of a small group of institutions to use the Interac debit payments network to generate profits for themselves. The effect of increased access, and the removal of barriers to entry, has been to make the Interac system universal in its reach and has increased usage many times over. It has also seen costs steadily decline through the impact of increased competition and increased volumes.

The Interac system also has an elegant and cost-effective technical structure, which makes the addition of new members straightforward and relatively inexpensive. It also makes the Inter-Member Network inherently very reliable.

In Germany, the Anti-Trust Commission has effectively prevented the card issuing banks from introducing positive interchange fees on the eurocheque debit cards. The lower acceptance cost of these cards makes them more attractive to merchants and they have achieved a much higher market share than the scheme debit cards, which follow the model of positive interchange.

In the United Kingdom, the off-line signature-based debit card system suffers from high levels of fraud and some level of bad debt risk. The positive interchange model in the UK has not resulted in a national debit payments system that is in any way superior to the Australian system. Indeed, the UK system has so many problems that a major investment is being made to put anti-fraud chips on cards. Most of the transactions will still be conducted off-line however so the account balance will not be checked on every transaction. This will result in some residual fraud and bad debt risk.

The debit cards in the UK will all be either Visa or MasterCard branded within five years. This raises an issue for Australia, where potentially the same thing could happen if card issuers believe they will earn higher revenues from scheme-based debit cards. The payment of transaction fees to the card schemes for these cards adds an additional layer of cost to the debit payments system that does not need to be there.

The experiences of other countries should be factored into any reform of the Australian EFTPOS system. The access benefits of the Canadian system together with the fraud lessons of the UK system should form part of the knowledge base used by a <u>representative</u> and <u>open</u> EIWG process.

11. Response To EIWG Discussion Paper

The discussion paper prepared by the EIWG warrants specific discussion and analysis. It is disappointing to note that the paper contains a number of fundamental inaccuracies and omissions. Of major concern to the ARA is that the parties responsible for the preparation of the discussion paper may ultimately be those charged with the responsibility of deciding on the nature of debit EFTPOS reform. If so, these parties will be basing their deliberations on inaccurate and incomplete information. In this part of our paper, we intend to provide a critique of the issues and options raised in the EIWG document, and seek to place on the public record a balanced view of the Australian debit EFTPOS system. For simplicity and ease of co-relation we will follow the EIWG papers' section naming convention.

11.1 Background

The historical context of the EIWG discussion is relatively accurate, however several key facts have been overlooked or misrepresented:

- that the major retailers and oil companies have been <u>instrumental</u> in the development of technical interchange arrangements between acquirers and issuers. The bilateral linking of the proprietary debit systems developed by the major banks in the mid-1980's was a result of retailers and oil companies pushing for such linkages in order to provide uniform service to their customer bases. Retailers did not want to be able to accept only those debit cards issued by the supplier of their card terminal. Nor did they want multiple terminals from different banks at their point of sale. Accordingly they lobbied the banks to allow cards from all issuers to be processed through a single terminal. This led to the introduction of EFTPOS interchange;

- the 'cash out' or 'cash back' feature is described as a '*customer convenience and as a means of minimising cash handling costs*'[67] for retailers. While both these statements are correct, they also overlook the fact that there are also major benefits accruing to debit card issuers. These include branch rationalisation, and major 'over the counter' service cost reductions, which have not been mentioned by the EIWG.

[67] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' p. 3.

We understand that branch rationalisation savings deliver per branch / per annum cost reductions of $760,000 per branch. Given that approximately 2,000 bank branches have closed over recent years, this represents a per annum saving to banks of over $1.5 billion.; and

- there is comment that '*interchange fees are set bilaterally between issuer and acquirer, and in some cases, merchant principals*'[68]. A definition is then given that '*merchant principals are merchants that are members of CECS*'[69] (Consumer Electronic Clearing Stream). Two inaccuracies need to be highlighted in relation to this point;

  a. merchants have no role whatsoever, in the setting of interchange fees between issuers and acquirers. Merchants are currently not allowed to be either debit issuers or debit acquirers. The bilateral negotiations between an issuer and an acquirer have never involved a merchant as a negotiating party;

  b. CECS contains a single retailer (Coles Myer Limited) therefore the implication that CECS contains multiple retailer members is not correct.

11.2 Perceived Problems With EFTPOS

The EIWG argues that bilateral contracts within the EFTPOS system hinder access and make negotiation of such arrangements costly and very time consuming[70]. There is however, no attempt to determine and present the pros' and cons' of bilateral arrangements. It is simply assumed that current bilateral arrangements are problematic and must be changed. Certain aspects of the current arrangements are worthy of continuation in any reform process. We present such analysis, in the Governance section of this paper.

The EIWG discussion paper states that the current EFTPOS interchange arrangements have *the potential to shift issuer and consumer incentives away from promotion and use of EFTPOS, particularly relative to credit cards* [71]. We would argue that this is completely unfounded for a number of reasons:

- as discussed elsewhere in this paper, issuers have been the major beneficiaries of the domestic EFTPOS system. EFTPOS has allowed them to dramatically reduce their customer service costs and deliver major benefits to their shareholders, largely via the efforts of retailers. It is therefore highly unlikely that issuers would seek to discourage EFTPOS usage due to current interchange fee levels; and
- EFTPOS acceptance and usage by consumers was growing very strongly in the early and mid1990's, outstripping credit card usage until early 1995. Graph 3 below illustrates this point. It was not until credit card loyalty schemes were introduced into the Australian market, that consumers switched from using debit cards in favour of credit. This clearly dispels the assertion by the EIWG that current interchange arrangements have the potential to shift consumer usage away from EFTPOS.

[68] Ibid. p. 4.

[69] Ibid. Footnote 4, p. 4.

[70] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' p. 5

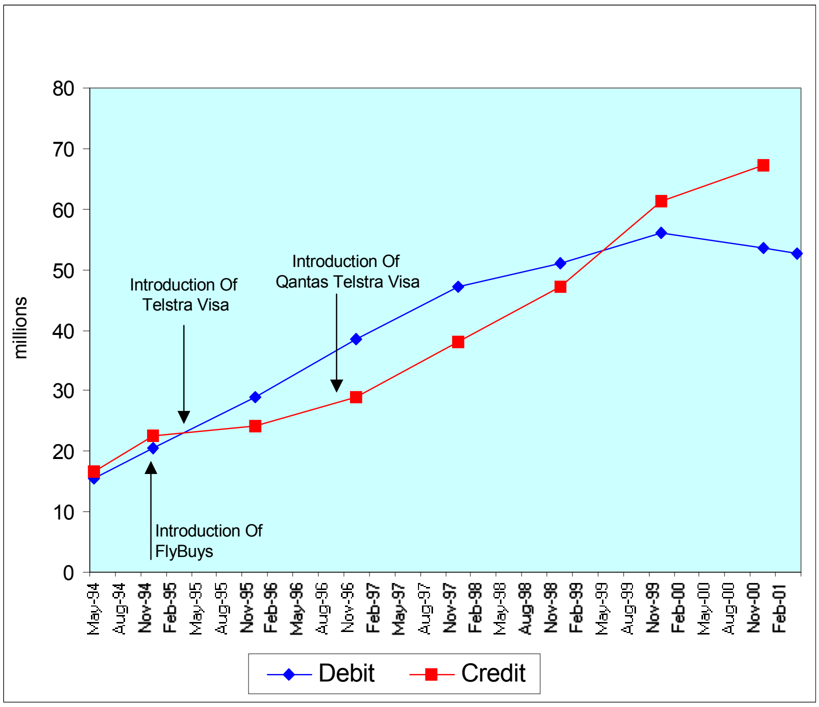
[71] ibid. p. 5.

Further, the RBA enquiry into credit cards[72] has found that credit card loyalty programs are sending the wrong signals to consumers. These loyalty programs have been at least partly funded by credit card interchange and they have resulted in growth of credit card usage at the expense of debit cards. The RBA has recommended that the cost of loyalty not be allowed as a legitimate cost in determining credit card interchange. This should rectify the incorrect signals and result in debit usage increasing.

The EIWG discussion paper argues that a further reason for seeking to alter current interchange arrangements is the inconsistency between EFTPOS interchange and other retail payment types. This is a completely invalid argument as the development of EFTPOS in Australia (as we have demonstrated in this paper) had and continues to have a unique set of characteristics. The EIWG appears to be seeking to establish a link between the positive interchange on credit cards and a desire for a positive interchange on debit!

The RBA / ACCC report states that "*in Australia, interchange fees are unique to card networks*".[73] Using the EIWG argument, does this mean they are in favour of zero interchange for credit cards to match the interchange arrangements for "*other retail payment types*" such as cash and cheques?

When a cardholder uses their EFTPOS debit card at an ATM, the interchange fee flows from the issuer to the acquirer. This fee flow should be identical when the same piece of plastic is used at an EFTPOS terminal – EFTPOS and ATM cards are one and the same in Australia. If an acquiring financial institution is entitled to receive a fee, having funded ATM infrastructure, why is the same logic not applicable to a retailer who has funded card terminal infrastructure?



Graph 3 - Credit & Debit Monthly Volumes 1994 ~ 2000 [74]

[72] "*Reform of Credit Card Schemes in Australia – A Consultation Document*", RBA December 2001.

[73] "*Debit and Credit Card Schemes in Australia*", joint study by the RBA and ACCC, October 200. p.i.

[74] Source: Reserve Bank Of Australia

11.3 Relationship To Other Interchange Reform Initiatives

The EIWG advises that credit card, ATM and scheme based debit card interchange reform has been initiated. At time of writing this process had in fact been completed, with the RBA having published its Final Reforms and Regulation Impact Statement. Other than the current credit and debit card reform processes the ARA is unaware of any proposed alterations to scheme based debit interchange. Our views on scheme based debit interchange are clearly stated in this paper – there needs to be a linking of any studies into domestic debit (EFTPOS) and scheme based debit card interchanges. This is necessary for two reasons:

- to remove the current Visa debit practice of charging retailers an ad valorem credit card merchant service fee for consumers accessing a cheque or savings account[75]; and
- to remove the possibility, once the current debit and credit card reform processes are concluded, of domestic debit issuers simply migrating all domestic debit cards to international credit card scheme debit products, and totally altering the interchange landscape. We have discussed the potential consequences of such an action elsewhere in this paper.

The ARA concurs with the EIWG statement that "*It is recognised that EFTPOS warrants a full consideration on its own merits. In addition, as with credit card interchange, any reform of EFTPOS interchange fees must allow for an appropriate degree of input and consultation with interested parties.*"[76] We would argue that in order to achieve the above aim two specific actions need to be taken:

- the conduct of a thorough, open and transparent investigation of the debit EFTPOS system with the process open to public comment, **over a reasonable timeframe**. The current debit reform process has been designed to meet a specific time constraint without consideration of the negative effects of this; and
- as the EIWG is keen to see input and consultation from all interested parties then the ARA as the representative of the Australian retailing community, which has a vital stake in the EFTPOS system, should be represented on any debit reform forum.

11.4 Overseas Experience

The EIWG presents brief commentary on the debit schemes of New Zealand, the UK, Canada, the USA and France but there has been no attempt to analyse the pros' and cons' of each system. Our detailed analysis of a number of overseas debit systems appears elsewhere in this document.

Of particular importance however, is the current change in the UK 'Switch' debit system, which is not commented on by the EIWG. Launched in 1987, the UK 'Switch' program has become the country's leading debit scheme and is carried on 28 million cards, accounting for nearly one in three card payments[77]. The member banks of Switch are to migrate their

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[75] This practice continues to be aggressively promoted by smaller financial institutions. Bendigo Bank has linked a loyalty program 'Bendigo Bank Rewards'. Refer www. bendigobank. com. au .

[76] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' p. 6

[77] Source: Guardian Unlimited (www. guardian. co. uk). Article August 2, 2002 by Jill Treanor '*Switch To Maestro Is On The Cards*'.

portfolios to a combination of MasterCard and Visa scheme debit products[78] (MasterCard Maestro and Visa Debit). This is the exact occurrence that the ARA wishes to avoid for the Australian EFTPOS system.

The UK 'Switch' system, once converted to the international scheme debit marks will see retailers most likely subjected to higher merchant fees in order for consumers to access cheque and savings accounts at retail points of sale.

11.5 EFTPOS Interchange Options

One of the ARA's principal concerns with the EIWG paper, as pointed out earlier, is the focus on interchange levels as the principal target of reform. The EIWG seeks to reform the '*the current EFTPOS interchange fee arrangements*'[79] and NOT the actual EFTPOS system! This focuses on interchange fees largely to the exclusion of other important aspects requiring reform, such as access and ongoing governance. The EIWG cites seven aims of EFTPOS interchange fee reform[80]. The ARA concurs with these aims, with the following provisos:

- that transparency is an important objective of any future reform process, and this is not included in the aims espoused by the EIWG;
- if the cost based model is to be used , then interchange fees should be set in accordance with the actual costs of all parties involved, not only issuers and acquirers. This would leave the way open for debit interchange to fall, be removed completely, stay at current levels or increase; and
- the issue of access is far more involved than simply seeking to establish an interchange position that is consistent with fair and open access. The level of interchange is independent of access.

The EIWG then proceeds to examine essentially three alternatives to the current interchange arrangements, while providing permutations of each alternative:

- retention of existing bilateral interchange arrangements, with various scenarios to reduce the level of interchange over time;
- introduction of multilateral interchange fees; and
- complete removal of debit interchange.

We will examine each of the EIWG alternatives.[81] **The ARA believes that the level of analysis and the supporting evidence for all of the options is completely unsatisfactory.**

Option 1A - Bilateral Interchange Agreements – Circuit Breaker

The EIWG, in proposing this option, is assuming that a problem exists with the current interchange arrangements, without presenting any evidence to support this. The option proposes an initial reduction in interchange with a movement over time to a zero interchange

[78] Ibid.

[79] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*' pp 9~10.

[80] Ibid. p. 8.

[81] ibid. p. 9.

position. No consideration or analysis of the effects on various parties is presented, including any impact on retailers and consumers. There is an assumption that the only direction interchange can move is downwards.

This option supports the ARA's view that the EIWG appears to have a predetermined view and is not seeking an unbiased and 'clean slate' review of the debit system.

Option 1B - Bilateral Interchange Agreements – Longer Term Approach

This option proposes the introduction of an agreed methodology for setting of interchange fees within a bilateral system. This appears a reasonable position provided that the methodology is agreed to by all affected parties and is administered by an independent body. In addition, the whole question of bilateral versus multilateral interchange fees needs to be the subject of independent evaluation.

The EIWG puts forward no strong arguments for changing current bilateral interchange arrangements. Indeed, the EIWG points out that there are probably Trade Practices implications in the suggestions they have made.

Option 2A – Multilateral Interchange Fees – Standard Multilateral Fee

This option by the EIWG proposes that a standard multilateral interchange fee be set across all issuers and acquirers. There are no proposals on:

- how such a fee would be fairly established;
- who would independently calculate such a fee, taking note of the effects on all parties; and
- what a governance model may look like, for the ongoing oversight and regular review of such an interchange fee arrangement.

Option 2B – Bilateral Fee Agreements With Multilateral Default Rate

This option proposes that bilateral arrangements be retained with a default multilateral rate in place, where bilateral agreement is not possible. It is further proposed that parties submit to binding arbitration where a bilateral fee could not be agreed to. The proposal goes on to propose two possible interchange level parameters:

- where there are no constraints on bilateral fee levels, and
- where upper and lower constraints were set with participants free to negotiate within a range.

There are a number of flaws with the option as proposed:

- as with all other options in this paper, this option lacks a rigorous analysis with inbuilt checks and balances to safeguard the interests of affected parties such as retailers; and
- the suggestion of an 'interchange negotiation range' raises further problems of independence. A totally open and transparent process would involve an independent assessment of the costs of affected parties and subsequent setting of debit interchange. The concept of upper and lower interchange limits in our view has no role within an independent, transparent and cost based process.

Option 3A – No Interchange Fees – Eliminate Interchange Fee Clauses

The reasons why the arbitrary removal of debit interchange, as proposed by this option is inappropriate have been canvassed throughout this paper. Arbitrary removal would simply be a process for transferring value from retailers and acquirers to issuers, with the ultimate result being a degradation of Australia's world-class debit system. The distribution of benefits would be completely inequitable with issuers realising large savings in their retail banking operating costs at the expense of retailers who have invested in secure card processing infrastructure – this is completely unacceptable to the ARA.

Option 3B – No Interchange Fees – Eliminate Bilateral Interchange Agreements

Our comments to 3A above, apply to this option too.

The rationales for zero debit interchange are essentially given as:

- because the RBA and ACCC Joint Study[82] was not presented with convincing arguments for an interchange fee in the debit card network. It could be argued however that the study did not seek specific input on this matter and further the study's final comments on debit provided no detailed analysis or supporting arguments for the views put forward;
- that a number of overseas ATM and debit card networks have no or zero, interchange fee for EFTPOS transactions;
- that other payment instruments such as cheques and direct entry have no interchange; and
- that a no interchange option would raise the least Trade Practices concerns.

We would argue that the above rationales are not based on a detailed study of the full effects of zero debit interchange, neither are they based on a proposal for an independent evaluation and fee setting process. This option by the EIWG is a 'path of least resistance' and in our view completely inappropriate. Further, following this argument to its logical conclusion would also require the complete elimination of interchange for all credit card transactions, for consistency.

We do note however, that the EIWG cites the following as a drawback for a no interchange option:

"…lack of flexibility if it were to be determined either now or in the future that issuers or acquirers should be compensated through a non-zero interchange fee. This would have implications for the long term sustainability of the network, and the need for continued investment in the existing secure EFTPOS network" [83].

We would totally concur with this point. A logical approach would be the 'up front' independent determination of interchange methodology (bilateral versus multilateral) and fee levels, in conjunction with other issues such as access, barriers to entry and governance.

[82] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*'. p. 11.

[83] Ibid. p. 12.

11.6 Multilateral Pricing Methodologies

The EIWG conducts a rudimentary evaluation of the effects of a multilateral pricing methodology, with 'issuer costs only', 'acquirer costs only' and 'net of issuer and acquirer costs' models being examined[84].

We note that the analysis is very rudimentary and does not examine a considerable number of effects on participants in the debit EFTPOS system, nor does it acknowledge the full costs and benefits of all parties. We will deal in turn, with each of the EIWG's analyses of multilateral methodologies.

11.6.1 Pricing Models

In its discussion on pricing models the EIWG acknowledges that "*an explicit and transparent methodology for any multilateral interchange fees would seem desirable*"[85]. We would argue that such a methodology is critical to the retailer and public acceptance of any changes to the debit system.

11.6.2 Option A – Issuer Costs

The EIWG suggest in this proposed fee setting model that issuer costs only be taken into account in determining an appropriate debit interchange level. Interchange would therefore flow from the acquirer to the issuer. The argument is advanced that this would be "*consistent with various proposed credit card interchange fee methodologies…*" [86].

This option defies logic. There is no rationale whatsoever for the costs of a debit issuer solely, to be taken into account when setting a debit interchange fee. There is no acknowledgment of:

- the benefits which accrue to an issuer, as detailed elsewhere in this paper; and
- other party's costs, such as retailers and acquirers.

Quite simply, we see this option as having no place in any logical debate on the future of Australian debit interchange. Issuers have derived major benefits from the debit system without having their 'costs' being considered in isolation as the basis for debit interchange flows! Only a group dominated by issuers could conceive of such an option, in their own self-interest.

11.6.3 Option B – Acquirer Costs

The arguments which in our view, preclude an 'issuer only' interchange fee calculation are also valid when considering an acquirer only approach.

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[84] Ibid. p. 12.

[85] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*'. p. 12.

[86] Ibid.

11.6.4 Option C – Net Of Issuer And Acquirer Costs

Rather than netting only issuer and acquirer costs, it is logical to net the costs of **all** parties, including the capital investment and operating costs incurred by merchants.

There are however two provisos that need to be taken account of:

- all issuer benefits need to be factored into such a calculation. As discussed in this paper, issuers have derived and continue to derive, substantial benefits from the Australian EFTPOS system that must be factored into any interchange calculation. The ongoing transaction displacement / migration benefits which issuers have enjoyed, at the expense of acquirers and merchants must be acknowledged; and
- the capital investments made by merchants and the recurring costs incurred by them, in operating the debit network must be factored into any interchange calculation.

While 'net' approach to interchange level calculation has merit over the other options presented by the EIWG, there are still a large number of non-interchange related matters, which need to be addressed in any thorough review of the debit system.

11.6.5 Governance & Other Implementation Issues

The EIWG paper again touches on a number of important issues relating to governance, without providing a detailed analysis of available options relating to this issue as well as implementation. Certain issues relating to the implementation of multilateral interchange fees are very briefly touched upon, such as the need to establish a fee calculation methodology and a fee audit and review process. [87] There is however, no attempt to present options and the costs and benefits of each, along with a final set of recommendations. The issue of governance requires a much greater level of consideration. In the ARA's view, the Australian debit system is now a public utility and as such must be overseen via a representative body.

The EIWG also presents a rudimentary review of the impact on end users of changes to existing interchange fee arrangements. The EIWG acknowledges that '*merchants are not prohibited from charging a fee to cardholders for EFTPOS usage, but increased costs to merchants could also be passed on to all consumers indirectly*'.[88] This supports the ARA's contention that increased costs to merchants via lowering, removing or reversing current debit interchange arrangements would not be in the public interest in addition to delivering unwarranted benefits to one group – debit card issuers, particularly those who are not also acquirers.

On the matter of access, the EIWG continues to fuse the issue of debit interchange with the question of access to the debit network. As discussed earlier, it is entirely possible to reform access to the debit network without altering existing interchange levels. Simply lowering or removing interchange will not in itself result in a greater level of access. It may well make access for smaller existing financial institutions or non-bank financial institutions cheaper, but will not facilitate broader levels of access. While the two issues of access and cost of access (interchange) may well go hand-in-hand, they are not one and the same.

[87] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*'. p. 14.

[88] Ibid. p. 15.

11.6.6 Issues For Consideration

The ARA's responses to the EIWG invitation to provide input on 7 specific issues[89] relating to the EIWG paper are provided below. We would however predicate our comments by restating several key points:

- the Australian debit system is currently working very well and should not be put at risk by allowing a minority group to tamper with it to further their own aims. The ARA does however recognise that access needs to be improved for smaller organisations and new entrants – including retailers;
- the Australian debit system is already the lowest cost retail payment method available. As the RBA's key objective is efficiency of the payment system, then on this measure the EFTPOS network cannot be deemed as requiring major overhaul;
- one of the key reasons the Australian system has been so successful, has been that the current interchange arrangements have allowed retailers to make investments which have contributed significantly to this success; and
- any review of the current debit system should be done via an open and transparent public review process.

Our comments below are made in the context of the preceding four points.

Issue 1 - *Are the objectives for assessing options for reform appropriately defined? Are there other considerations that should be included in assessing the merits of any interchange fee options*?

Subject to our comments above we concur with the objectives defined by the EIWG:

- flexibility;
- customer acceptance;
- efficiency;
- competition;
- access;
- sustainability; and
- practicality of implementation.

We would again point out, that the reform process must be broader than simply focusing on the level of debit interchange. In addition, the process must be carried out by a more broadly constituted EIWG which then based its final conclusions on the costs and benefits for all parties.

Issue 2 – *Are the three general interchange fee options clearly and appropriately defined? Are there other options that should be considere*d?

The interchange options defined by the EIWG are just that – interchange fee options. A review of these in isolation, under the current review regime will not result in a more open, transparent and accessible debit system in Australia.

In addition, there is no "status quo" option listed. Although bilateral interchange is given as an option, it is only discussed in terms of reducing the current level of bilateral fees. As

[89] EFTPOS Industry Working Group '*Discussion Paper – Options For EFTPOS Interchange Fee Reform*'. p. 17.

discussed earlier, the current arrangements have led to a highly successful system that is efficient and has resulted in the widespread adoption of debit cards.

Issue 3 – *Are there advantages or disadvantages of the three options that should be taken into account*?

We would reiterate our views as expressed elsewhere in this paper, on the merits of multilateral versus no interchange options.

Issue 4 – *Are the three cost based models associated with a multilateral interchange fee appropriately defined? Are there other cost models that should be explored*?

The approach and content of bilateral versus multilateral interchange arrangements, should be the subject of independent assessment by a representative review body. A cost based approach which takes account of all parties' costs is preferred by the ARA. The 'issuer only' and 'acquirer only' models must be eliminated forthwith.

Issue 5 – *Are there advantages or disadvantages to the cost models that should be taken into account?*

The cost models presented are superficial and incomplete.

Issue 6 – *What other issues involving access to the EFTPOS network should be considered? What options should be considered to address these issues?*

As we have noted elsewhere in this paper, any review of the EFTPOS system must fully address the question of access. This must be on a broader basis than simply seeking to provide for easier access for smaller financial institutions.

Issue 7 - *Are there other implementation issues that need to be considered?*

Any review of the EFTPOS system that resulted in retailers paying higher fees for debit transactions, must also consider the question of debit transaction cost recovery. Large or small retailers faced with debit fee increases (or network access fee removal in certain cases) must be allowed to explicitly recover the payment mechanism cost. This principle has been upheld by the RBA in its proposed reforms of the credit card system. The issue of uniform technical standards must also be addressed to reduce the costs of entering and operating in the national debit system. High technical costs are a very effective barrier to entry.

12. Governance

12.1 Multilateral vs Bilateral Agreements

The current debit card interchange model in Australia is based on a series of bilaterally negotiated interchange agreements between card issuers and acquirers on the terms, conditions and fees surrounding the exchange of EFTPOS transactions. The interchange agreement terms and conditions are bound by APCA's '*CECS Regulations Manual*',[90] which

[90] Australian Payment Clearing Association's Consumer Electronic Clearing System (CS3).

members (issuers, acquirers and merchant principals[91]) are obliged to adhere to when participating in any interchange activity.

The bilateral interchange fee however, is negotiated commercially. Interchange fees agreed between two parties will be normally somewhere in the range of $0.18 to $0.25 [26].

The alternative interchange / agreement models proposed by the EIWG are:

- a standardised multilateral interchange fee across all card issuers and acquirers through a common bilateral interchange agreement. These interchange fees could vary according to the transaction type (if appropriate) and based an agreed pricing methodology; and
- the retention of existing bilateral interchange fee agreements but introduction of a multilateral "default" interchange fee that would be enforced if no agreement could be achieved on a bilateral basis. This multilateral interchange fee could also be used as an "interim" fee while parties were in the process of negotiation.

The current interchange model has, as discussed below, a number of benefits. Any proposed changes should be considered as part of a representative EIWG process.

12.1.1 Bilateral Arrangements – For & Against

As discussed, the current bilateral interchange model involves the negotiation of fees between card issuers & acquirers and to a large extent is determined on the basis of a card issuer's market share and the number of cardholder transactions processed. This commercial arrangement therefore enables larger issuers to negotiate (due to volume) a lower interchange fee with an acquirer.

Bilateral arrangements have three positive features, which should be retained in any modification of current arrangements:

- they allow market forces to operate in their purest form, with buyers and sellers negotiating on a 'user pays' basis;
- there is a greater likelihood that issuers will fairly compensate acquirers (and as a result, those retailers qualifying for a network access fee) for the significant investment in establishing and maintaining their EFTPOS systems and communication networks; and
- acquirers are able to allocate resources in the most efficient manner. That is, faced with negotiating several bilateral arrangements, an acquirer will prioritise these in order of economic benefit.

The current concern however, with bilateral interchange arrangements is that it is necessary for new EFTPOS network entrants to undertake a process of negotiating bilateral interchange agreements with each existing member. This may impact the viability of entering the debit issuing and/or acquiring market. Further, smaller financial institutions do not enjoy negotiating parity when negotiating bilateral interchange fees with larger existing members. This has resulted in such organisations being 'price takers'. While these points may be valid, it must be remembered that smaller financial institutions have not made significant investments in acquiring infrastructure, but have certainly maximised issuing benefits for themselves.

[91] Merchant principals are merchants that switch transactions direct to card issuers rather than through an acquirer.

12.1.2 Multilateral – For & Against

The methodology of setting interchange fees multilaterally has the potential to provide all EFTPOS network stakeholders with transparent and open commercial arrangements. However, for this methodology to be agreeable to all parties concerned, it is important that it be administered and regulated in an independent manner.

Assuming multilateral interchange fees were set appropriately, this may then have a positive impact, with improved access for new entrants. Specifically, the elimination of separately negotiated interchange fees (and if truly multilateral – commercial agreements) may simplify and speed up the implementation process for new entrants.

A further option may be the use of multilateral technical interchange standards, while retailing bilateral commercial arrangements. This matter should be dealt with by a reconstituted EIWG, as discussed above.

12.2 Current Governance & Public Interest

Governance of debit card technical interchange standards is currently under the jurisdiction of the Australian Payments Clearing Association Limited (APCA). Incorporated in 1992 as a public company, APCA is owned by the Australian banks, building societies and credit unions[92]. It is an autonomous, independent body, which is solely responsible for the management and implementation of system technical rules, policies and procedures relating to membership access for payment clearing and settlement systems.

In December 2000 APCA introduced the Consumer Electronic Clearing System (CECS) following a determination issued earlier by the Australian Competition and Consumer Commission (ACCC). Through the CECS management committee, it develops technical, operational and security standards to enhance the integrity and efficiency in the exchange of consumer electronic payment messages for the domestic ATM and EFTPOS networks[93].

Eligibility for membership to this management committee is limited to institutions that engage in interchange activities in the capacity of either an acquirer or issuer of cards, or represent one or more acquirers or issuers and effect settlement directly. In the case of acquirers this may also include the category of merchant principal.[94]

Presently, membership of this management committee comprises only financial institutions and one sole merchant principal (Coles Myer Limited). The committee does not have any jurisdiction over commercial and other arrangements between issuers and acquirers.

Given the current management committee's charter and membership, it is difficult to see how the public interest and the interests of other stakeholders, particularly retailers and consumers, are advocated. The ARA would suggest a broadening of the committees

[92] APCA is not listed on the Australian Stock Exchange, however is a company limited both by shares and guarantee.

[93] These policies and standards are detailed in two separate documents, which are both published by APCA – Regulations for Consumer Electronic Clearing System (CS3) and CECS Manual for Consumer Electronic Clearing System (CS3).

[94] "Merchant Principals" are organisations (such as major retailers) that able to electronically capture card transactions at the point of sale and switch them directly to card issuers. The category of "Merchant Principal" member was introduced during the formation of CECS. Coles Myer has been a member under this category since it's inception.

membership eligibility to include wider retailer representations and enhancing its charter, allowing it to play a greater role in the governance of debit in Australia.

12.3 Ongoing Supervision and Management

As discussed throughout this paper, the ARA is supportive of a representative and properly constituted EIWG undertaking EFTPOS reform in Australia. It is therefore possible, that such a forum could also be used for the ongoing supervision and management of a revised EFTPOS system.

An appeals process could be introduced to provide stakeholders of the EFTPOS network a vehicle to contest decisions made by the EIWG. Appeals may be able to be referred to the RBA or (less likely as this is a consumer forum) to the Banking Ombudsman.

13. Recommendations

We would emphasise that while we fully support the EIWG process, we believe that our five key recommendations emanating from our review of the EIWG paper, would significantly enhance the current process. We would recommend:

- that the EIWG be reconstituted under the auspices of the RBA, to ensure representation from ALL affected parties, particularly retailers – large and small;
- that such a reconstituted EIWG then be charged with determining an appropriate review timeframe, which allows for the proper evaluation of the Australian EFTPOS system and possible alternative access and processing arrangements;
- that the EIWG be asked to examine all aspects of debit cards in Australia, both the domestic debit (EFTPOS) and the international 'scheme' debit card products;
- that the EIWG be asked to establish one set of operating rules for all debit card products in the Australian market; and
- that the EIWG present such a comprehensive, transparent and representative review to the RBA for final ratification and adoption.

We would reiterate our earlier point that the Australian EFTPOS system is seen internationally, as an example of a highly efficient, low cost and successful payment system. It should not be tampered with lightly, and then only after due consideration by all affected parties.