

7 April 2005

Dr John Veale
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Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear John,

CREDIT CARD INTERCHANGE FEES

Introduction

Visa International welcomes the invitation issued by the Reserve Bank of Australia (RBA) in its press release of 24 February 2005 for submissions on whether the credit card interchange standards for the Visa, MasterCard and Bankcard schemes should be amended so that the same benchmark applies in all schemes. For the reasons set out below, Visa International considers that this should be the case.

Visa International's Approach to Interchange

As a result of the extensive submissions Visa International has made to it in the past, the RBA is aware that Visa International does not consider that interchange fees should be set by reference to issuers' costs that are considered to be "eligible costs" within the meaning of the credit card interchange standards. Instead, Visa International views interchange as an essential mechanism for balancing the costs and revenues of the issuing and acquiring sides of the payment network. Its purpose is to encourage as many merchants as possible to accept VISA-branded cards, to encourage as many consumers as possible to use such cards and to encourage as many financial institutions as possible to participate and invest in the VISA payment network. Not only does a cost-based interchange rate have the opposite effect because it does not (except by chance) align the incentives network participants face with the wider impact of their actions on the network arising from network externalities, the RBA's regulatory scheme for credit cards:

- Puts four-party schemes that are open to many participants at a disadvantage to closed/three-party schemes, leading to inevitable migration by issuers to the higher cost three-party schemes and a consequent increase in the proportion of higher cost cards presented to merchants

- Ignores the precedent set by other two-sided markets where setting prices to reflect only costs would similarly result in products or services not being commercially viable – for example, Adobe Acrobat, newspapers, etc. - with a consequential negative impact on use of those products or services and reduction in welfare
- Provides no incentives for issuers to reduce costs – cost reductions merely flow into reduced future interchange rates, rather than increasing issuers' net revenue
- Provides no incentives for credit card associations to reduce fees charged to issuers and acquirers – fee reductions reduce the resources of the association without providing a commensurate benefit to issuers because the issuers' cost reductions again flow into reduced future interchange rates and not increased revenue
- Is subject to seemingly arbitrary decisions about what costs should be included and what costs should be excluded

Visa International does not resile from the above position, which has been expressed by it in detail in previous submissions to the RBA. The comments set out below should not be read as an abrogation of the position Visa International has previously expressed and continues to hold regarding the purpose of interchange and the manner in which it should be set.

Present Credit Standard: Lack of Fairness; Inhibition of Competition

Under the *Payment Systems (Regulation) Act 1998*, the RBA has introduced cost-based interchange regulation. The benchmark interchange fees under it differ among the Visa, MasterCard and Bankcard schemes as a result of differences in average eligible costs.

Visa International considers that any cost-based regulation should be fair and reasonable. It is not fair or reasonable if the more efficient competitor, with a lower cost-based interchange, is penalized by regulatory intervention and is handicapped in its ability to compete for issuing business.

This is the position Visa International currently finds itself in as against MasterCard International, with which it competes vigorously¹ for issuance business in Australia. Visa International is at a two basis points disadvantage against MasterCard International, which is an almost four percent pricing disadvantage – a significant margin in any large commercial enterprise. This means that:

- In negotiations with an issuer with higher than average eligible costs, the issuer *may* lose money in issuing MasterCard-branded cards – that is, if its eligible costs are higher than the relevant benchmark – but it *will* lose more money if it chooses to issue VISA-branded cards.
- In negotiations with an issuer with lower than average eligible costs, the issuer will earn a higher margin of revenue over costs if it issues MasterCard-branded cards, rather than VISA-branded cards.

¹ Bankcard is not considered in this context because, unlike Visa and MasterCard, it does not compete for issuing mandates.

Such an outcome of regulation seems perverse – and even more so if the position of the unregulated three-party schemes is taken into account, especially where they take on the appearance of the four-party schemes by partnering with a bank issuer.

Present Credit Standard: Increasing Costs to Merchants

The RBA has consistently said that higher interchange fees result in higher merchant service fees and, in turn, increases in the price of goods and services that are borne by all consumers. If this is correct, the current credit card interchange standards make the position worse because:

- If a credit card scheme can establish a higher cost base than a competitor its issuing banks are entitled by the regulations to higher interchange fees, often sourced from higher merchant service fees paid to acquirers.
- As described above, higher interchange fees make a credit card scheme more attractive to issuers. More cards will be issued under that scheme and presented to merchants, so a continually increasing proportion of transactions will attract the higher interchange rate. This will raise costs for acquirers and they, in turn, will increase the service fees they charge to merchants. Overall system costs will be increased by the higher incidence of higher cost cards.

Conversely, lower interchange fees do not in practice make a credit card scheme more attractive to acquirers. This is primarily because acquirers typically “blend” their pricing and charge each merchant one overall merchant service fee based on the projected proportionate volume of cards from each scheme. In effect, the lower cost scheme therefore subsidizes the higher cost scheme with the merchant receiving only perhaps some marginal benefit of the lower cost scheme’s interchange rates.

Again, such an outcome of regulation seems perverse – and even more perverse if the position of competing unregulated three-party schemes is taken into account. This is especially so where these schemes partner with a bank and, within those schemes, consumers are encouraged through rewards to substitute their three party scheme’s card for VISA and MasterCard cards.

Credit Standard Amendment – Single Interchange Benchmark for Credit Cards

So long as the Australian credit card market is subject to a regulated interchange setting model, it is clear that it must be adjusted to remove the unintended consequences of rewarding inefficient behavior. Therefore, a single interchange rate for all schemes’ credit cards should be adopted, which will mitigate the unfavorable outcomes described above.

Indeed a single interchange benchmark rate would encourage efficiency, as it would give credit card issuers with costs in excess of the benchmark an incentive to reduce their costs and, consequently, their losses resulting from the disparity. Currently, such issuers can mitigate their losses simply by their choice of scheme partner.

A single credit card interchange benchmark should be set by reference to the weighted average cost of Visa and MasterCard issuance. The position of Bankcard is somewhat anomalous and its costs should not be included in calculating a weighted average because Bankcard, which is apparently the lowest cost credit card scheme, is a legacy scheme in which no investment has been made for many years. It currently has only around five percent of credit card retail sales volume in Australia and this is in decline. Its costs are not reflective of those of a dynamic and growing network that must be innovative and invest in new products and technology. Its costs are likely not reflective of a truly international payment system given that it operates mostly as a domestic system, though with acceptance in New Zealand as well. Indeed, it seems that Bankcard has avoided needing to incur many legitimate costs by benefiting from investments made by Visa International and MasterCard International in areas such as fraud control, cardholder and merchant authentication and risk management relating to the fast growing internet channel. Thus to use Bankcard's costs would further reduce the capacity of all schemes to develop new products for the benefit of cardholders and merchants alike.

The use of a weighted average, preferably without including Bankcard's costs in the weightings (and leaving it to continue to use its own cost-based benchmark), would allow international and system development aspects to be taken into account. In addition, a weighted average would mean that total interchange fees on credit card transactions would be the same as under the present standards. The perverse incentives identified above as between Visa International and MasterCard International would, however, have been removed.

Summary

A single interchange benchmark rate for Visa International and MasterCard International would mitigate the issues discussed above as between the two card associations, although a solution that levels the playing field between the four-party schemes and their three-party competitors would prove a more complete solution to current problems and issues.

Visa International would be pleased to discuss any of the issues raised in this submission or in the course of the RBA's consideration of this matter.

Yours sincerely

A handwritten signature in black ink that reads "Bruce Mansfield," with a comma at the end.

Bruce Mansfield
General Manager, Australia & New Zealand
Visa International