APPENDIX A SUBMISSION

Visa's response to the RBA on debit issues

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Visa's response to the RBA on debit issues

1 This document sets out Visa's views with respect to issues raised by the RBA regarding Visa debit.

2 More specifically, Visa considers first the issues associated with the Honour All Cards rule; then discusses the appropriate setting of interchange fees for debit cards; and finally reviews the issues regarding surcharging.

3 Before turning to the substance of the issues raised by the RBA, Visa wants to stress its view that designation should be considered a last resort. More specifically, Visa believes that a regulatory solution, with all the costs it imposes, should only be relied on if it is clear that appropriate outcomes will not be obtained commercially or by discussion between the RBA and the parties. For the reasons set out below, Visa does not believe that this condition is met with respect to Visa debit. Rather, it is Visa's view that any substantive concerns the RBA may hold regarding Visa debit are being appropriately dealt with within the current arrangements.

1.1 The Honour All Cards Rule

4 The purpose of the Honour All Cards ("**HAC**") rule is to improve the efficiency and competitiveness of the Visa system.

Reduced transactions costs

5 The first substantive means by which the rule increases the efficiency and competitiveness of the Visa system is by reducing the transactions costs associated with using and accepting Visa-branded cards. In effect, as a result of the rule, consumers are assured that their card – regardless of its issuer or of its precise kind – will be honoured by merchants displaying the Visa acceptance logo. A consumer consequently does not need to inquire as to which Visa cards a merchant displaying the logo accepts; nor does a merchant need to catalogue or somehow communicate to consumers precisely which Visa cards it accepts. This makes it easier for consumers to rely on their cards and for merchants to secure value from their acceptance.

6 Visa submits that this benefit applies with equal force to all Visa branded cards. Were debit and credit acceptance distinguished, the value of the generic acceptance mark would be diminished. Either the Visa system would need to incur additional costs in developing distinctive acceptance marks that readily indicated which cards a merchant accepted, or

consumers and merchants would have to bear those costs in respectively seeking and providing the additional information required.

Reduced barriers to entry and expansion

7 The second substantive means by which the rule increases the efficiency and competitiveness of the Visa system is reducing entry and expansion barriers. This effect is especially marked with respect to issuing.

8 As a result of the rule, a Visa acquirer, when it contracts with a merchant, does so on behalf of all Visa issuers. This happens because an acquirer does not have the option of inducing a merchant to only accept particular cards; rather, the merchant must accept all cards bearing the acceptance mark. As a consequence, issuers do not need to enter into bilateral relationships with acquirers, nor do they need to be concerned that acquirers will favour particular issuers over others. Rather, as a result of the rule, the acquiring function is automatically carried out on a non-discriminatory basis on behalf of all issuers.

9 This reduces the costs involved in entry as an issuer and hence promotes intra-system issuing competition. It also reduces the scope for particular acquirers to obtain market power as a result of relationships with issuers. It therefore promotes competition in the acquiring side as well.

10 Visa submits that these effects are of great importance in Australia and are especially marked with respect to debit cards. This is for two reasons.

11 First, in Australia, there is a clear association between the nature of the issuing institution and the kind of Visa card that institution issues.

12 Historically, credit unions and building societies were not in a position to advance unsecured credit. As a result, when cards associated with the major acceptance marks became an important part of customer needs and expectations, these institutions responded *inter alia* by issuing Visa debit cards. Over time, they provided these debit cards with “credit like” functionalities by associating them with overdraft facilities. As these proved relatively popular, these institutions were able to compete successfully with credit card issuers without actually moving to the issuing of credit cards. Indeed, they would currently view a move into issuing Visa (or other) credit cards as unattractive, as it would “cannibalise” their Visa debit card base.

13 The major banks, in contrast, took the lead in issuing credit cards. As matters now stand, they would be unlikely to move into Visa debit on a substantial scale, as this could undermine their revenues from credit card issuing.

14 The overall outcome as far as the Visa system is concerned is that while the larger financial institutions primarily issue Visa credit cards, their smaller competitors overwhelmingly concentrate on Visa debit.

15 Second, in Australia, the major issuers also tend to be acquirers. Additionally, according to the ACCC[1]:

> "Merchant acquiring is highly concentrated with a small number of large institutions dominating. In particular, the four major banks provide about 85 per cent of merchant credit and debit card acquiring services, although according to RBA data this share has been falling gradually in recent years."

16 Given this concentration of the acquiring function among institutions that are also major issuers of Visa credit, the HAC rule has an especially important role in removing barriers that might otherwise prevent entry or expansion by smaller players. Specifically, absent the HAC rule, there would be a risk that acquirers could discriminate against smaller issuers, either by not promoting acceptance of their cards or by requiring higher payments for doing so. This would compromise one of the few alternatives consumers now have to the major financial institutions.

17 It might be thought that such behaviour would breach the Trade Practices Act, so that the smaller issuers would be protected in any event. However, there is no general obligation on a firm to assist its competitors and a substantial burden is involved in demonstrating that conduct breaches s.46 of the Act, especially in a relatively complex market such as that in which merchant acquiring services are provided. As a result, it is Visa's view that the HAC rule provides a relatively certain and low cost means of ensuring that discriminatory barriers to intra-system competition from smaller issuers do not emerge. Reliance solely on the Trade Practices Act would, Visa believes, be both costly and ineffectual.

18 It is worth noting that the risks associated with removing the HAC rule are substantially greater here than in the US. This is because the features that characterise the Australian market – specialisation of institutions in terms of the types of Visa cards they issue, and the pre-eminent role of the larger trading banks in both issuing and acquiring – do not apply in the United States.

19 With respect to specialisation by card type, U.S. deposit-taking financial institutions in the Visa system almost always issue both credit and debit cards. The only significant exception are the mono-liners, which are not depositary institutions. As a result, there is

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1 ACCC Determination: Applications for Authorisation .. in Relation to the Collective Setting of EFTPOS Interchange Fees, 11 December 2003 at ¶6.57.

not the same close relationship as there is in Australia between an institution's competitive position and the nature of the cards it issues.

20 Equally, the merchant acquiring service in the US is largely carried out by specialist providers. These providers have no incentive to discriminate among issuers.

Conclusions on Honour All Cards

21 Visa believes that the HAC rule, rather than reducing competition in any relevant market, serves to promote competition and enhance efficiency. In Visa's view, absent the rule, there is a real risk that smaller issuers – most notably credit unions and building societies – would ultimately have to strike bilateral deals with the larger acquirers, who could otherwise simply discourage merchants from accepting debit cards.

22 Visa notes that the ACCC, while accepting that competition in issuing has increased in recent years, indicates that the market remains highly concentrated.[2] Additionally, according to the ACCC:

> " .. the main barrier to direct access faced by new entrant card issuers appears to be the need to negotiate bilateral agreements covering technical and commercial arrangements with each merchant acquirer in the EFTPOS network. A new entrant may seek indirect access requiring only one bilateral agreement with the gateway provider. However gateway fees can make this an expensive option. The Commission understands that gateway services are predominantly utilised by the smaller card issuing institutions."[3]

23 In Visa's view, the HAC rule has provided, and should continue to provide, a simple and cost-effective way of guaranteeing to smaller Visa issuers access to merchants on predictable, non-discriminatory terms. This has allowed these smaller issuers to develop the Visa debit product as a close substitute for Visa credit, thereby increasing the competitive discipline on the larger banks.

24 Added to the savings in transactions costs that the rule provides to both consumers and merchants, these pro-competitive benefits make it highly desirable that the HAC rule be retained.

1.2 Appropriate interchange fees for Visa Debit

25 Visa believes that the Visa debit card differs greatly from the ATM/EFTPOS cards issued by depositary institutions.

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[2] Ibid, at ¶6.38.

[3] Ibid, at ¶6.42.

26 To begin with, Visa debit offers a significantly wider range of functionalities than the banks' ATM/EFTPOS cards. For example, the Visa debit card can be used to pay bills over the telephone and to make transactions over the Internet.

27 Additionally, the Visa debit card has far wider acceptance than ATM/EFTPOS cards. Thus, even within Australia, the Visa debit card is accepted at locations such as restaurants which do not generally accept ATM/EFTPOS cards. Moreover, and for some consumers importantly, the Visa debit card can be used internationally while bank issued ATM/EFTPOS cards cannot.

28 These advantages the Visa debit card offers relative to ATM/EFTPOS cards means that it is not a close substitute, from an economic perspective, for ATM/EFTPOS cards.[4] Rather, in Visa's view, the closest substitute for a Visa debit card is a credit or charge card. This is consistent with the behaviour of Visa debit card issuers, for whom the ability to issue Visa debit cards has provided a viable and ongoing competitive alternative to issuing credit or charge cards.[5]

29 As the RBA knows, Visa takes the view that interchange fees should be set on the basis of achieving an economically efficient allocation of costs as between issuers and acquirers. In Visa's approach (which is based on the Baxter or "balancing" model of interchange), important elements in the determination of that efficient allocation include relative elasticities of demand and relative costs. The extent of any network externalities is also significant. Three points can be made in this respect:

Because accepting debit and credit and charge cards provides merchants with extra sales, some of which may be at the expense of those merchants who do not accept cards, each individual merchant will be particularly inelastic in its decision about whether to accept cards or not. Consumers, conversely, are likely to be relatively elastic with respect to the price of card use, since unlike merchants they face no strategic motivate to using cards.[6] As the RBA knows, Visa believes that this implies that

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4 From an economic perspective, two goods are substitutes if an increase in the price of one good, all other things being held constant, leads to an increase in the demand for the other. Goods are close substitutes when the extent of the shift from the good whose price has increased to the other would be sufficient to make it unprofitable for a hypothetical firm that was the sole supplier of the first good but faced effective competition in the supply of the second to increase its price slightly but durably above the competitive level.

5 Thus, although the credit unions had invested in the MyCard platform, which would have enabled them to issue credit cards, they did not proceed with that platform, which was recently sold to Citibank.

6 Moreover, because each individual merchant has a strong strategic motive to accept cards (in order not to lose sales to its rivals), there will generally be a greater proportion of merchant acceptance than existing active cardholders, which has the effect of further increasing the optimal interchange fee.

optimal interchange fees should be higher than a purely cost based approach would suggest.

Given the HAC rule, merchants' demand for Visa debit and credit cards has the same demand elasticity. According to the rule, merchants must either accept both types of transaction or neither. Going solely by demand side considerations, the optimal interchange fee for Visa debit under the HAC would seem to be the same as that for Visa credit. However, once the somewhat lower cost of servicing Visa debit transactions than Visa credit card transactions is taken into account, the optimal interchange fee would seem to be somewhat lower for Visa debit.

Putting aside the HAC rule, credit cards allow some additional sales due to the access to credit facilities, even above any overdraft facilities arranged on debit cards. Thus, merchants would be somewhat more inelastic with respect to accepting credit cards than debit cards. However, given the factors that differentiate Visa debit from ATM/EFTPOS cards, the gap in benefits (and hence in demand elasticities) between Visa debit and Visa credit is likely to be small. As a result, Visa debit may be efficiently provided by setting a common interchange fee with Visa credit, or by setting a fee for debit that is slightly below that for Visa credit (so as to reflect the slightly lower costs providing Visa debit involves).

30 Even putting aside the socially efficient interchange fees as determined from the balancing model, Visa does not believe that appropriate interchange fees for Visa debit are significantly below those for Visa credit. Thus, the RBA has adopted the approach that interchange fees should be based on those issuer-borne costs that it views as attributable to the acquiring function. Taking the indication the RBA has provided of those costs, there is, in practice, little difference in the relevant cost items as between Visa debit and credit.

31 Moreover, the main cost differential between Visa debit and Visa credit is due to the interest-free period. As the RBA has indicated that it believes the credit interchange should not cover the costs of the interest-free period, cost-based fee levels for Visa debit and Visa credit ought to be similar over the longer term.

32 The fact that the closest substitute for Visa debit is provided by credit and charge cards underscores this conclusion. More specifically, were Visa debit to become less attractive to issuers than credit and charge cards, it is likely that – rather than migrating customers to ATM/EFTPOS cards – they would shift to issuing credit and charge cards. Among other effects, this would, going by previous RBA statements, increase costs overall, including the costs borne by merchants. For this effect to be avoided, interchange fees for Visa debit need to be kept reasonably in line with those for credit.

33 More generally, given that Visa debit and credit and charge cards are close substitutes, any significant misalignment in the cost/interchange fee relativity between these would likely

lead to inefficient outcomes. More specifically, issuers would shift to the card type which had the highest ratio of the interchange fee to marginal issuing cost. This could and likely would increase costs overall, as demand shifted to a card type which might impose higher costs and yield lower net benefits.

34 As a result, Visa believes that both the balancing approach to setting the interchange fee and the more cost-oriented approach adopted by the RBA lead to the same conclusion: that there should be only a slight differential between interchange fees for Visa debit and Visa credit.

35 Visa has already emphasised to the RBA its concerns with respect to competitive neutrality. Since the reductions have been mooted and then effected in interchange fees for Visa credit cards, the closed credit card systems have made significant inroads into the customer base previously accounted for by, or which otherwise have tended to adopt, open credit card systems. In Visa's view, these shifts in market share are completely unrelated to relative costs and efficiency. They reflect a distortion of competition, rather than its promotion.

36 Visa believes that reducing the interchange fee for Visa debit materially below that for Visa credit would accentuate these distortions. Given the close similarity between the functions provided by Visa debit and those provided by charge cards, there would be a significant risk of substitution between these. This would occur with respect not only to the existing base of Visa debit but also to Visa debit's growth opportunities.

37 The risk of thus distorting competition does not arise for bank issued ATM/EFTPOS cards, as these do not provide the same range of functionalities as Visa debit. Moreover, banks will retain strong incentives to issue these cards as they provide owners of deposit accounts with a means of accessing their funds which, in terms of the issuing bank, is relatively low cost (for example, as compared to expanding the range of branch and teller services).

38 Finally, Visa notes it has done its utmost to address merchant concerns about the costs of accepting its card products through various initiatives aimed at reducing interchange fees.

1.3 Surcharging of Visa debit cards

39 Visa has already set out to the RBA its general views with respect to surcharging. No useful purpose would be served by repeating submissions Visa has already made at length elsewhere.

40 That said, Visa believes experience since the removal of the no-surcharge rule is consistent with the concerns it has raised. In particular, to the extent to which surcharging has occurred, it appears to bear little relation to underlying costs.

41 For example, Qantas has imposed a surcharge on the use of credit cards for on-line purchases of air travel. As Qantas itself has previously stated that it believes that on-line purchases avoid it significant costs, and as the only means by which these can occur is through the use of payment cards, it is difficult to believe that this surcharge is a cost-recovery mechanism. Rather, it appears to be a way of increasing fares without an explicit price rise.

42 Additionally, in Visa's view, an important claim made on behalf of allowing surcharging is that it removes or reduces the scope to impose too high interchange and merchant service fees. As interchange fees have been materially reduced, and are (or will soon be) at levels which could not be considered unreasonably high, Visa believes that a primary justification for allowing surcharging does not apply. Given the patchy nature of surcharging, and its lack of apparent relation to efficiency, Visa believes allowing surcharging for debit would yield no gains.

43 At the same time, allowing surcharging for debit could remove a significant constraint on non-cost-based, excessive, surcharging. More specifically, if users of Visa have the option of shifting to debit cards which are protected from surcharging, the scope for merchants to durably impose excessive surcharges on credit cards is reduced. This provides a wider degree of protection to the card users in general.

1.4 Conclusions

44 Visa understands that the major issues the RBA has in respect of Visa debit relate to the Honour All Cards ("HAC") rule, the level of debit interchange and the scope for surcharging.

45 With respect to the HAC rule, the RBA has drawn a distinction between what might be referred to as the "Honour All Issuers" and the "Honour All Products" dimensions of that rule. The RBA has suggested to Visa that while it sees the rationale for the former, it does not see a clear rationale in respect of the latter.

46 Although the distinction drawn by the RBA is sound at an abstract level, Visa does not believe it captures the commercial realities of the Australian market. In Australia, giving efficacy to "Honour All Issuers" dimension of the rule requires an "Honour All Products" condition.

47 This reflects the fact that issuers are specialised by product: the larger banks tend to issue Visa credit, while the smaller banks and other issuing institutions generally issue Visa debit. Moreover, as a practical matter, the larger banks have a pre-eminent role in the supply of merchant acquiring services.

48 Absent an "Honour All Products" condition, there is a serious risk of discrimination against the cards issued by the smaller Visa issuers. Specifically, these smaller issuers, assuming they continued to issue Visa debit, could be forced to enter into bilateral arrangements with the larger acquirers to ensure that their cards were not disadvantaged in the provision of the acquiring service. Alternatively, they might need to themselves enter the merchant acquiring service. In Visa's view, either of these outcomes would diminish the competitive efficacy of the Visa debit card issuers and would harm consumers and competition.

49 Visa does not believe that reliance on the Trade Practices would provide a cost-effective means of avoiding this risk. The fact that the ACCC has identified the difficulties smaller issuers have in obtaining adequate access to the merchant acquiring service for ATM/EFTPOS cards as a substantial entry barrier underscores this point.

50 As a result, Visa believes a move away from the HAC rule would be contrary to the policy objectives the RBA is pursuing in respect of the payment system.

51 Turning to the issue of interchange fees, there are sound economic reasons for believing that the appropriate interchange fee for Visa debit is close to, and only slightly below, that for Visa credit. This emerges both from application of the Baxter, "balancing", methodology Visa adopts, and from the cost-based approach that has been adopted by the RBA. A key factor here is that Visa debit provides functionalities which are more similar to those of Visa credit than they are to the ATM/EFTPOS cards issued by depositary institutions.

52 Visa believes that departing from an arrangement in which Visa debit interchange fees were only slightly below those for Visa credit would have distorting consequences. Specifically, it would induce substitution away from Visa debit to alternative credit or charge cards. As this substitution would be unrelated to economic costs, it would reduce rather than enhance efficiency. This is all the more the case as one element of this substitution would be a further, unjustified, move away from the open and towards the closed card systems.

53 Further to discussions with the RBA, Visa has implemented, and has proposed to implement further, substantial reductions in interchange fees for Visa debit. Given these reductions, Visa does not believe that there are remaining issues in this area.

54 As regards the issue of surcharging, Visa believes the experience to date is consistent with the concerns it has previously expressed to the RBA. That said, Visa believes allowing surcharging of Visa debit would remove that degree of constraint which the threat of credit/debit substitution currently imposes on excessive surcharging. Overall, Visa sees no gain, and potential loss, from allowing surcharging of Visa debit cards.

55 Visa believes that the issues set out above can be, and are, being addressed in a constructive manner through its dialogue with the RBA. As a result, Visa does not see any benefit that would come from designation. At the same time, Visa is mindful of the costs designation imposes, including in terms of greater formality and hence more costly compliance. Visa therefore firmly believes the RBA should continue with the process successfully engaged to date, rather than relying on a costly and unnecessary regulatory solution.

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