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26 March 2004

Dr John Veale
Acting Assistant Governor (Financial System)
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001
By e-mail: vealej@rba.gov.au

Dear Dr Veale

RE: VISA DEBIT SUBMISSION TO RBA

Thank you for your letter to John Gilbert dated 23 February 2004, advising of the designation of Visa debit and inviting suggestions on addressing the areas of concern with Visa debit noted by the Reserve Bank of Australia (RBA).

Credit Union Services Corporation (Australia) Ltd (CUSCAL) welcomes the opportunity to propose reform of the debit card system operated in Australia by Visa International.

CUSCAL is the main industry body and service provider for credit unions. Australia's 177 credit unions have over 3.5 million members and total assets of \$29.4 billion. Credit unions are mutual Authorised Deposit-taking Institutions (ADIs), owned by their customers.

Credit unions are collectively the biggest issuer of Visa debit in Australia, with 1.2 million cards on issue or more than 30% per cent of the total number of Visa debit cards in Australia.

As noted in the RBA's 23 February 2004 announcement of the designation of Visa debit, Visa and its members (including CUSCAL) have been voluntarily considering reform proposals for Visa debit.

CUSCAL has consistently supported reform of Visa debit, and has engaged constructively and in good faith with the regulator and other parties through the voluntary reform process. You are aware of the importance of the Visa debit product in our sector, the significant impact that changes could have for credit unions and their members, and our firm view on the need for concurrent reforms across EFTPOS and Visa debit. We look forward to continuing to work closely with the RBA on this matter.

Please find attached our comments, which address the key areas identified by the RBA for suggestions.

CUSCAL would be pleased to provide more information if required. Please contact me on telephone (02) 8299-9046, or Luke Lawler, Senior Adviser, Policy & Public Affairs, on telephone (02) 6232-6666, with any queries or comments.

Yours sincerely

A handwritten signature in black ink, appearing to read "Louise Petschler", with a long horizontal flourish extending to the right.

Louise Petschler
Head of Public Affairs

EXECUTIVE SUMMARY

As the RBA is aware, CUSCAL has consistently supported payments system reform to increase efficiency and competition.

To ensure a fair and competitive result, and to deliver the RBA's stated policy objectives, the optimal outcome across the various payment instrument review processes would have been concurrent reform of interchange fee arrangements for credit cards, Visa debit and EFTPOS. CUSCAL has particularly emphasised the importance to credit unions of concurrent reform of Visa debit and EFTPOS.

Interchange fees for Visa debit have fallen in line with credit card interchange fees, providing benefits to merchants as acquirers have passed on the reductions, but merchants have been able to frustrate and delay implementation of reform to EFTPOS interchange fees.

This means that the RBA's reform agenda has, to date, delivered benefits to acquirers and merchants but nothing to EFTPOS cardholders. Interchange fee revenue to credit unions from Visa debit transactions has been reduced, without any reduction in EFTPOS interchange fee costs.

Set out below are CUSCAL's suggestions on practical approaches to the issues of concern raised by the RBA in its designation of Visa debit.

CUSCAL supports a Visa debit interchange fee standard based on the credit card interchange fee standard and introduced concurrently with reform of EFTPOS interchange fees.

While CUSCAL does not oppose separate recognition of Visa debit and Visa credit, nor removal of the 'no surcharge' rule, it is important that such proposals do not provide an avenue for predatory or discriminatory practices by other payments providers or large retailers. These issues are discussed below.

CUSCAL strongly supports the Honour All Cards (HAC) rule in relation to Visa debit. There are clear competitive and public benefits from retaining the HAC rule, and in our assessment, proposed reforms to other features of the Visa debit product substantively address any concerns the RBA may have about HAC.

Finally, as the RBA is aware, Visa debit is an important product for credit unions and credit union members. Credit unions and CUSCAL look forward to further close engagement and consultation on reform proposals through the designation process.

INTRODUCTION

Credit unions are collectively the biggest issuer of Visa debit in Australia, with 1.2 million cards on issue or 31.2 per cent of the total number of Visa debit cards in Australia.

The dynamics of our industry and scale of potential impact make Visa debit reform a major concern for credit unions.

Credit unions, as a consequence of size, diversity, mutual structure and bargaining position, are in a different position to other participants in providing a competitive alternative in financial services through their participation in Australia's payment systems.

These circumstances have contributed to a high issuance of Visa debit cards and a position in relation to EFTPOS where credit unions face a very substantial net out-flow of funds.

Credit unions, as ADIs, meet the same regulatory and prudential requirements as banks. However, a number of key factors distinguish us from other institutions in the retail banking sector.

Credit unions:

- are mutuals, where customers are owners;
- operate under a common set of principles and values, which explicitly place member benefit at the core of credit union operations;
- are not-for-profit, with a focus on delivering member benefit;
- range widely in customer base and asset size (from less than \$100,000 to more than \$2 billion);
- work cooperatively in offering member services, with institutions such as CUSCAL operating as service providers to individual credit unions; and
- have a strong customer focus, which is reflected in the high satisfaction ratings recorded by members of credit unions.¹

The scope and size of the credit union sector, combined with a diversity of operations and a non-profit driven revenue base, means that it is critical for regulators to carefully assess reform proposals that could have a major impact on the sector.

Unlike larger ADIs that operate as both card acquirers and issuers, credit unions are primarily issuers. The sector's focus on member benefit rather than shareholder return, and the nature of the mutual structure (with limited recourse to capital markets), means credit unions do not have the capacity to absorb regulatory shock with large impacts on margins. This makes transitional periods for reforms critical, and illustrates the importance of a balanced reform agenda that seeks to promote competitive neutrality in interchange arrangements.

Some relevant features of credit union participation in the payments system include:

- The use of aggregation (primarily through CUSCAL) to gain membership and access to key payments instruments and systems;
- the low issuance of credit cards by credit unions, and very low share of acquiring business compared with major banks;

¹ Market research commissioned by CUSCAL in 2003, through Eureka.

- the large net out-flow of funds faced by credit unions on EFTPOS transactions, where credit unions do not have significant acquiring business and operate as price takers under bilateral interchange arrangements;
- the adoption of Visa debit cards in response to difficulties accessing payment instruments, and to offer members greater functionality and access;
- the value of Visa debit as an access mechanism to credit union members, and the importance of balancing EFTPOS reform with Visa debit interchange; and
- a lower capacity to absorb any large ‘shock’ with significant reductions in margins, leading to a fall in competition in retail banking if credit unions are forced either from the market or to price products at uncompetitive levels.

As the RBA is aware, credit unions were early adopters of the Visa debit card, which was introduced into Australia in 1982 (for further detail, see attached September 2001 Discussion Paper *Visa Debit Australia*). Visa debit enabled smaller institutions in the retail banking sector to overcome barriers to participation in the payments systems.

Importantly, credit unions were able to provide members with widely accepted payment cards that did not rely on a credit facility. Credit unions have always been committed to responsible financial management by members, and are not motivated to maximize customer debt to drive returns for an external group of shareholders.

Visa debit is a payment card with the functionality of a credit card. Visa debit users are able to make purchases through all channels – online, over the telephone and through post – and are able to easily and efficiently access the global payments network. Like credit card users, Visa debit users are protected by scheme chargeback rights. These features do not apply to proprietary debit cards.

The main distinction between Visa debit and a credit card is that Visa debit users draw on their own funds. However, credit union Visa debit cards are attached to member accounts that may include a line of credit in addition to the members’ own funds. Interest rates on lines of credit on Visa debit generally are lower than credit card rates. (For example, NSW Teachers Credit Union’s Visa debit-linked line of credit rate is 11.5% compared to the Coles Myer Source MasterCard annual percentage rate of 17.5%.)

Consumers who are unable to afford a credit card, or who are averse to personal debt, can choose Visa debit to obtain credit card-like purchasing and access functionality.

EFFICIENCY AND COMPETITION

The RBA has identified four characteristics of Visa debit ‘which may affect the efficiency of, and competition in, the payments system’:

- the interchange fees charged between financial institutions for the processing of Visa debit transactions are the same as for Visa credit card transactions;
- Visa debit cards cannot be distinguished at the point of sale from Visa credit cards;
- the ‘honour all cards’ rule enforced by Visa requiring that merchants accepting Visa credit cards must also accept Visa debit cards; and
- Visa debit cards are subject to a ‘no surcharge’ rule.

CUSCAL’s comments on these matters are set out below.

Interchange Fees

CUSCAL supports a Visa debit interchange fee based on objective, transparent and cost-based methodology.

In our view, the RBA's considerations in setting a standard should include:

- an interchange cost methodology that is supported by sound economic principles;
- consistent application of reform principles and methodologies across card-based payments;
- the potential impact on all constituents, including the smaller institutions that issue this product and cardholders; and
- concurrency with the timing of reforms to EFTPOS interchange.

The RBA's credit card standard provides a benchmark for reform. Given the debates, public policy consultation processes and legal proceedings over interchange fees and calculation methodologies in recent years, there is no need to re-invent the wheel.

The credit card standard's 'eligible costs' are issuers' costs in processing transactions, fraud and fraud prevention costs, authorising costs, and costs incurred in funding the interest free period.

Funding the interest free period is likely to be a minor factor for Visa debit issuers and a Visa debit interchange fee standard.

As a cost-based methodology, the proposed standard should take as its base costs of Visa debit issuers.

This could require a new cost study or the initial interchange fee calculations could be based on cost data that has already been collated in the voluntary reform process. Given the large number of small issuers and the relatively small size of the card base compared to credit and proprietary debit, use of the existing data prepared during voluntary reform would be appropriate.

The Visa debit interchange fee should be an ad valorem rather than a flat fee. We understand that 'spend' per transaction on Visa debit is lower than on credit cards. A flat interchange fee would risk pricing out smaller transactions and inhibiting development of Visa debit in the future.

Distinguishing Debit from Credit

We do not oppose distinguishing Visa debit from Visa credit at the point of sale.

We assume the rationale for seeking to distinguish Visa debit from Visa credit at POS is to enable merchants choosing to impose a surcharge to set the surcharge to match the relevant merchant service fee (MSF).

If Visa debit is to be distinguishable at POS, it is arguable that Visa credit should be similarly distinguishable. For example, if the word 'debit' were to be visible on a Visa debit card then the word 'credit' should logically be visible on a Visa credit card.

In order to promote the right price signals, merchants choosing to recover from cardholders the costs of accepting a particular payment card would be able to set and impose their surcharges card by card.

Honour All Cards

We do not support removal of the Honour All Cards (HAC) rule. There are clear public benefits in maintaining the HAC rule.

The HAC rule facilitates access to card issuing, promotes product development and innovation, and guarantees consumer choice.

The HAC rule prevents discrimination by acquirers between issuers and card products within a card scheme. Without the HAC rule, acquirers would be free to act against the interests of competitors and competitor products.

In Australia, acquiring is dominated by the big four banks. The biggest acquirers do not issue Visa debit and, historically, have not been supporters of the product. Indeed, the Commonwealth Bank (CBA) in 2001 discontinued the Visa debit portfolio it had inherited in the takeover of Colonial Limited. CBA replaced the Visa debit cards with proprietary debit cards.²

Removal of the HAC rule, would enable Australia's largest retailer, Coles Myer (CML), a critic of Visa debit and promoter of a competitor product (Coles Myer Source MasterCard) to refuse to accept Visa debit while continuing to accept Visa credit cards.

Visa debit's viability would be under serious threat if it were not accepted by CML. The CML group includes Coles Supermarkets, Bi-Lo Supermarkets, Coles Online, Coles Express Shell Service Stations, Harris Technology, Kmart, Kmart Tyre & Auto Service, Liquorland, Liquorland Direct, Megamart, Myer Grace Bros, Officeworks, Shopfast, Target, Theo's Liquor and Vintage Cellars.

Similarly, abolition of the HAC rule would enable Woolworths to turn off Visa debit at Woolworths and Safeway supermarkets, Big W, BWS, Dan Murphy's, First Estate, Dick Smith Electronics, Dick Smith Electronics PowerHouse and Tandy.

Like CML, Woolworths is in the card business itself, promoting the Woolworths Ezy MasterCard (interest rate, 16%).

The Payments System Board said in its 2003 Annual Report that it was prompted by the US Wal-Mart case to raise the issue of the applicability of the HAC rule in Australia.

It is important to note that Visa and MasterCard did not change the HAC rule as a result of being persuaded about beneficial effects on efficiency and competition. The card schemes were forced to make the change to settle a massive, long-running class action by retailers and to avoid a potentially much worse outcome from a jury trial.

The Wal-Mart case, its origins, and its outcome are not directly relevant to Visa debit in Australia because:

- USA signature Visa debit interchange fees were twice as high as Australian Visa debit interchange fees³, *prior* to the RBA's intervention in Australia which has cut the Australian fees in half;
- transaction volumes on USA signature Visa debit cards in 2002 *exceeded* that of Visa's US credit cards, despite US consumers holding twice as many Visa credit cards as Visa debit cards⁴; and

² CBA submission to RBA, 3 July 2001.

³ Visa USA: average transaction amount \$38, average merchant interchange fee 60cents.

- in the USA, off-line (signature) debit cards accounted for about 60% of debit transactions in 2002 with PIN-based debit accounting for the remaining 40%.⁵

Visa debit interchange fees in Australia, already lower than USA fees, have been sharply reduced in line with the reduction in credit card interchange fees and may be subject to a further reduction in future under a new Visa debit standard. Visa debit transaction volumes in Australia are much lower than Visa credit transaction volumes and, in Australia, the proportion of Visa debit transactions is dwarfed by PIN-based (EFTPOS) transactions.

Merchants should have the capacity via surcharging to recover directly from the cardholder the costs of a particular card but merchants should *not* be able to dictate to customers what cards they carry in their wallet.

The HAC rule ensures customers can choose the payment card that suits their needs. Freedom to surcharge ensures merchants can keep pressure directly on merchant service fees and indirectly on interchange fees.

Removal of the HAC rule will put the future of Visa debit and Visa debit issuers – credit unions, building societies and regional banks – into the hands of the non-Visa debit issuing merchant-acquirer banks and their merchant partners, such as CML, Woolworths and big oil companies.

We can see no ‘efficiency and competition’ arguments to support an increase in the market power of the biggest banks and biggest retailers.

No Surcharge Rule

As indicated above, and consistent with our position on credit card reform, we do not oppose removal of the ‘no surcharge rule’ for Visa debit.

Freedom for merchants to surcharge to recover costs imposes greater market discipline on merchant service fees levied by acquirers and therefore on interchange fees paid by acquirers to issuers.

However, it is equally important that the freedom to surcharge is not abused by merchants by overcharging consumers or discriminating against particular cards. For illustration’s sake, a large merchant might be inclined to impose a heavy surcharge on Visa debit cardholders as a means of recruiting new customers for its own card.

According to *The Australian’s* Robert Gottlieb, the biggest retailers are expanding their credit card schemes to take advantage of the RBA’s reforms.

“It is ironic that one of the reasons Coles has an advantage over the Commonwealth Bank in credit cards is the Reserve Bank’s decision to change the card rules to favour retailers at the expense of banks. The discount war in airlines has lessened the popularity of frequent flyer points but they are still a powerful driver. GE, which operates the Coles Myer card, says the response in Australia to this type of card has been greater than anywhere else in the world. It could get a lot bigger because in coming years Coles Myer will use new technology to tailor in-store specials to their card holders.”⁶

⁴ *From minor to major*, European Card Review, March/April 2003, p23.

⁵ *From minor to major*, European Card Review, March/April 2003, p23.

⁶ *Appetite for growth*, The Australian, 20 March 2003, p41.

To date, surcharging has not been widespread. However, CUSCAL is concerned that the scope for surcharging is largely unregulated, with little regulatory oversight of the amounts charged by merchants and their relationship to cost. In viewing impacts on the market, potentially anti-competitive outcomes (such as discriminatory and selective surcharging of Visa debit, while credit cards – with higher interchange and therefore higher MSFs – are not surcharged) must be avoided.

CONCURRENCY WITH EFTPOS REFORM

CUSCAL has consistently called for reform of Visa debit to be implemented concurrently with reform of EFTPOS or proprietary debit. This will minimize transition costs for cardholders, issuers, acquirers and merchants.

But most significantly it will balance the impacts on cardholders and issuers of the loss of Visa debit interchange fee revenue and the reduction in EFTPOS interchange fee costs.

CUSCAL-affiliated credit unions' revenue from Visa debit interchange fees is forecast to be slashed this financial year to \$27 million from \$40 million in the previous financial year. This reduction in revenue is equal to 7% of the credit union sector's total profit last financial year.

The reduction in revenue will become even starker over a full year commencing at the end of the September quarter 2003 when the cut to credit and Visa debit interchange fees took effect.

This is the effect of payments system reform on Visa debit *before* the outcome of the current designation process.

At the same time, CUSCAL-affiliated credit unions' proprietary debit interchange costs are forecast to be \$19 million this financial year.

If EFTPOS reform is not implemented, credit unions will be simultaneously hit by growing EFTPOS costs and plunging Visa debit revenue.

Problems with EFTPOS, or proprietary debit, interchange fee arrangements have been obvious for some time, and were discussed in the Prices Surveillance Authority's June 1995 Inquiry into bank fees.⁷

Almost a full decade ago, the PSA found that EFTPOS interchange fees had not changed over time and were not based on costs. Nothing has changed since then.

“The strong growth in the number of EFTPOS transactions over recent years, and the relatively high incidence of fixed costs in the system, suggest that unit costs would have fallen over time and that incremental costs are very low.

“Consequently, the retention of interchange fees negotiated in the late 1980s has meant that the cost burden of system operations has tended to fall increasingly on the institutions that are predominantly card issuers.

“Those financial institutions which have not established an EFTPOS network, but issue cards to customers, are clearly losers.”

⁷ Report No.65 by the Prices Surveillance Authority *Inquiry Fees and charges imposed on retail accounts by banks and other financial institutions and by retailers on EFTPOS transactions* June 1995, p268.

The PSA identified this class of ‘losers’ as including regional banks, building societies and credit unions.

Large retailers have been winners from the EFTPOS arrangements. The magazine *European Card Review* commented in 1996 that powerful retail groups had taken control of the payments supply chain in Australia.

“Banking relationships in Australia have been managed in such a way that the retailers are the dominant partners in the plastic card payment systems supply chain, largely thanks to their superior negotiating skills.

“Past absence of strategic vision among their acquirers about the increasingly cardcentric delivery of financial services and the lack of recognition within bank hierarchies for the payment card managers, have provided a ‘corridor of indifference’ to plastic payment cards, which the large Australian retailers have been able to exploit.”⁸

The impact of the RBA’s payments system reforms to date has been to benefit acquirers and merchants and penalise card issuers, particularly smaller card issuers who are not significantly involved in acquiring.

We urge the RBA to approach Visa debit reform and EFTPOS reform as a package and to ensure that the benefits of reform are balanced in their impact on cardholders, retailers, issuers, acquirers and consumers generally.

CONCLUSION

Credit unions play an important role in providing choice and competition in retail banking. Credit unions and their members are spread across metropolitan and regional Australia.

Visa debit is an important credit union product, highly valued by credit union members. Visa debit provides benefits to cardholders and merchants. A Visa debit card has exactly the same functionality as a credit card except that it does not automatically involve the provision of credit to the cardholder.

CUSCAL has always supported payments system reform. We believe we are in substantial agreement with the RBA on many of the issues that have been identified as demanding a response.

We look forward to working with the RBA on reform of Visa debit but we warn that if Visa debit is pushed out of the market by ill-considered regulatory intervention, the outcome will be:

- more credit cards;
- more personal debt;
- loss of access to merchants and the global payments network by some consumers;
- loss of some customers by some merchants;
- harm to the competitive position of credit unions in the retail banking market; and
- no improvement to competition and efficiency in the Australian payments system.

Attachments: Visa Debit Discussion Paper: September 2001

⁸ *Role Reversal*, *European Card Review*, May/June 1996, p25.