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EFTPOS INDUSTRY WORKING GROUP DISCUSSION PAPER

Options for EFTPOS Interchange Fee Reform

Comments on behalf of

Australian Permanent Building Societies

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1. INTRODUCTION

Interested parties have been invited to comment on the Discussion Paper "*Options for EFTPOS Interchange Fee Reform*" released in July by the EFTPOS Industry Working Group (EIWG) as part of an industry consultation process.

Australia Settlements Limited (ASL) has participated fully in the EIWG representing building societies and wholeheartedly supports the need for reform of debit card interchange arrangements. The objective of that reform should be simpler, more efficient and transparent pricing.

Debit card reform should also be seen in the context of the wider reform agenda instigated by the Reserve Bank of Australia (RBA). ASL has been a strong proponent of the need for concurrent and consistent reform across all card types¹.

This paper provides the views of Australian permanent building societies on the reform process and the preferred outcome of that reform.

2. BUILDING SOCIETIES IN AUSTRALIA

Building societies are well known in Australia. The modern building society offers a broad range of service which can be summarised as follows:

- providers of banking financial services to individuals and families with special skills in housing finance;
- suppliers of services to help meet the financial needs of many Australians; and
- being a community based institution.

The objectives of building societies are:

- to be an alternative to banks and money lenders in household financial services;
- to be businesses motivated by optimising the interests and needs of customers; and
- to serve the community in which they are located.

The following factors have assisted the development of building societies:

- the underlying strength of their balance sheet;
- compliance with the prudential standards of APRA in relation to capital structure, management policies and risk management;
- the benefits of comprehensive and uniform supervision through the APRA system;
- the acceptance by directors and management of prime responsibility for depositor protection;
- they are subject to the general laws and codes of conduct relating to prudentially supervised financial institutions; and

¹ See for example ASL's submission to the RBA on the credit card consultation document available on the RBA web site.

- their powerful affinity with their local community and customer base.

Building societies therefore operate at the retail end of the banking spectrum and customers are significant users of the payments system including EFTPOS in Australia.

3. THE NEED FOR REFORM

The Discussion Paper sets out clearly problems with the current EFTPOS interchange arrangements². In particular:

- fees set through bilateral contracts have been unchanged for a considerable period despite advances in computing and technology;
- access to networks requires negotiation of an interchange agreement with each issuer or acquirer; and
- a lack of consistency between EFTPOS interchange fees and those for other retail payment types.

It was instructive to read the Study of Interchange Fees and Access produced by the RBA and the Australian Competition and Consumer Commission (ACCC) on the disbursement fees paid by issuers and received by acquirers for debit card transactions³. The results are summarised in Figure 6.2 sourced from the Study.

While not at the most expensive end of interchange fees, building societies characterising smaller institutions are at a competitive disadvantage in negotiating interchange arrangements since they do not acquire EFTPOS transactions.

4. CONCURRENT REFORM

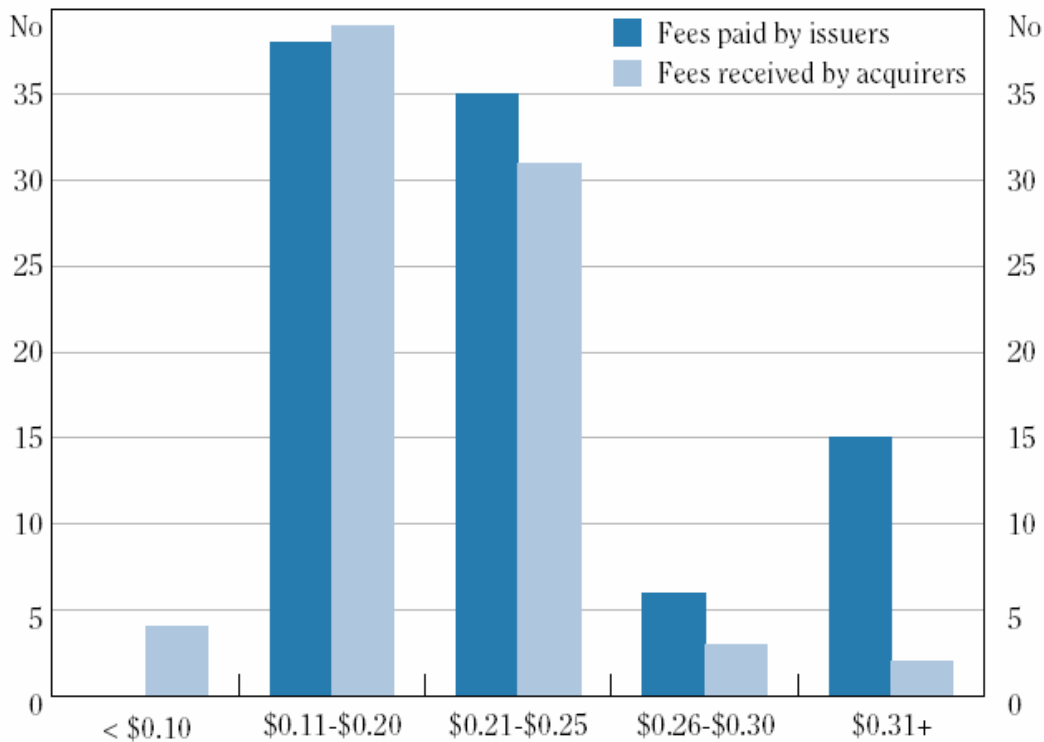
While clearly building societies will be directly and indirectly affected by the reform of credit card schemes in Australia, the greatest impact will be felt with changes to Visa debit interchange arrangements and reform of EFTPOS (debit card) interchange arrangements. The overriding principle frequently reiterated by the industry is that credit card reform must be closely linked to appropriate and consistent reform of all card based products.

Financial institutions typically offer a variety of card payment products. These include four party credit cards, three party charge cards for example AMEX and signature debit based cards such as Visa debit and EFTPOS. Some institutions are also significant acquirers and some such as building societies are not.

² EIWG, Section 1.2.

³ Reserve Bank of Australia and the Australian Competition and Consumer Commission, *Debit and Credit Card Schemes in Australia - a Study of Interchange Fees and Access*, October 2000, p. 62.

**Figure 6.2: Fees for debit card transactions
(taking into account gateway fees)
Number of agreements**



Reform of an individual card product is likely to have a different impact on a financial institution than would occur with simultaneous reform of all card products. Therefore, reforms anticipated or encouraged by the RBA (including credit cards, Visa debit and EFTPOS) should be implemented concurrently to avoid unnecessary market and institutional disruption. Costs for acquirers and merchants would also be reduced by one set of changes to interchanges.

5. PRINCIPLES TO BE FOLLOWED

Interchange fees should be set across all card types based on a set of common principles.

5.1 Background

In order to properly understand the principles, it is important to have a common foundation in the underlying economics of four party card payment schemes (whether credit cards, charge cards, deferred debit cards, signature debit cards or PIN based debit cards).

- At a minimum, a card scheme has three parties: the “merchant” who is providing a product or a service; a cardholder who is obtaining the product and service; and the “card company” that handles all relationships with the merchants and cardholders and provides the capabilities for the exchange of value between the merchant and the cardholder.
- In a three party scheme, all costs are incurred by the card company. The card company has two sources of revenue: the merchant and the cardholder. Therefore, if merchants set prices based on costs⁴, they must undertake an exercise to match what costs will be recovered from merchants and what costs will be recovered from cardholders.
- In four party card schemes there is a further dynamic in that the “card company” can actually be comprised of two different legal entities (the issuer and the acquirer) – one with the relationship with the cardholder and one with the relationship with the merchant⁵. Each entity incurs costs and each entity receives revenue but the revenue received may not be appropriately matched with the costs incurred. This is an example of a service that is jointly produced and jointly consumed.
- The core issue that evolves is how to match the costs of the issuer and the acquirer with the revenues received from the merchant and cardholder. The issue is paramount and is the rationale for the existence of interchange fees.

5.2 Principles

Establishing principles is difficult in part because of the need to draw lines between assumptions, economic principles, commercial principles, commercial practices and precedents and so forth. It is likely that the correct set of principles will (1) follow sound economic theory for obtaining the highest public benefit and (2) reflect common practices across payment products to ensure commercial viability and consistency.

The RBA Consultation Document⁶ considered 6 principles that would be required for any methodology determining credit card interchange arrangements. The principles should be consistent across clearings and are therefore applicable to EFTPOS. They are incorporated in Section 5.2.2 below although reworded.

The list represents a set of principles that could form the basis for the determination of EFTPOS interchange fees (or the decision to have no interchange fees which is a different outcome). Interchange fees should be based on the following assumptions, principles and practices:

⁴ There are of course other methods to set prices (e.g. comparable product analysis, loss leaders and so forth). But at a minimum over the longer term a card company must recover their economic costs.

⁵ In four party schemes, some transactions are “on-us” in that the same entity acquires a transaction from a merchant generated by use of a card issued by the same entity. Other transactions are “not-on-us” in that different entities acquire the transaction and issue the card.

⁶ The Reserve Bank of Australia, “Reform of Credit Card Schemes in Australia”, *Vol 1 A Consultation Document*, December 2001, pp 42, 3.

5.2.1 Assumptions

1. EFTPOS used at merchants provides payment and cash withdrawal services that are jointly provided and jointly consumed.
2. The closest payment product substitutes to EFTPOS are cash (in terms of average transaction value) and cheque (in terms of being a transaction account access device). The closest cash withdrawal service is an ATM machine.
3. EFTPOS interchange fees are wholesale prices.

5.2.2 Principles

1. Interchange fees should be based on efficient pricing principles.
2. Interchange fees should be cost justified in that the calculation of the fee should be based on actual costs incurred by issuers, acquirers or both (RBA Principle (i)). Costs should include both operations related and capital investment related costs.
3. End user pricing principles (i.e. the end user should pay the full cost of the services / benefits they are provided) drive interchange fees; interchange fees do not drive end user pricing.
4. Relevant interchange costs should relate to specific services (benefits) provided to cardholders and merchants (RBA Principle (ii)).
5. Relevant costs should only include costs related to affecting the transfer of value between the merchant and the cardholder (RBA Principle (iii)).

5.2.3 Practices

1. The methodology used to calculate the interchange fee should be transparent to interested parties:
 - a. The details of the calculations should be available for review, in commercial confidence, by appropriate regulatory agencies.
 - b. The details of the calculations do not need to be made public as they are wholesale prices. The aggregate wholesale costs and wholesale price should not be publicly disclosed.
2. There will be different interchange fees for different transaction types as determined by differences in relevant services provided and costs incurred (RBA Principle (iv)).
3. The calculation of the interchange fee will be independently determined and / or validated (RBA Principle (v)).

4. The level of interchange fees will be periodically reviewed (RBA Principle (vi)). As warranted by economic, commercial and participant conditions, cost components of the interchange fee will be reviewed more frequently and the interchange fee will be adjusted as warranted.
5. Implementation of a revised methodology (and potentially revised fees) for EFTPOS interchange should be done in a way that takes into account the impact on all participants. These impacts would include market disruption, implementation costs, unrecovered past investment and so forth.
6. Interchange fees will serve as the means to balance the economics of the EFTPOS product between the issuers and acquirers. The RBA Consultation Document notes that this principle has been rejected by Cruickshank in the UK and the European Commission as a principle for the determination of interchange fees⁷.

5.3 Eligible Costs for Credit Card Schemes

Under the Reserve Bank's Standard on Interchange Fees, eligible costs for inclusion in the calculation of the cost-based benchmark are limited to:

- (i) issuer's costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;
- (ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;
- (iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and
- (iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the Reserve Bank over the three financial years prior to the date by which the cost-based benchmark must be calculated⁸.

Eligible costs included in setting the credit card interchange rate relate only to the issuer. This is in contrast to results of a Joint Study by the RBA and the ACCC which concluded that the study did not find a convincing case for an interchange fee in the debit card network in Australia, in either direction⁹.

However, the Joint Study considered that debit cards were a potentially strong competitor for credit cards. "From the viewpoint of the merchant, a debit card also provides a guaranteed,

⁷ RBA 2001, pp 41, 2.

⁸ Reserve Bank of Australia, "Reform of Credit Card Schemes in Australia", *Vol IV Final Reforms and Regulation Impact Statement*, 2002, pp. 61, 2.

⁹ RBA & ACCC, p. 68.

pre-authorised payment; for cardholders who do not face a cash constraint, a debit card is a close substitute for a credit card."¹⁰

5.4 Comment

The above is a discussion of the principles that should be applied to the determination of interchange fees. The actual application of the principles would determine the direction and the magnitude of the fees. However, consistency across card schemes and overseas experience would suggest that the direction of interchange fee should be from the acquirer to the issuer.

6. OPTIONS FOR EFTPOS INTERCHANGE FEE REFORM

Three broad options were identified for reform of interchange fee arrangements¹¹:

- Option 1 – retaining or modifying existing bilaterally negotiated interchange fees as a short-term circuit breaker;
- Option 2 – in common with most major overseas networks, implementation of one or more standard interchange fees applied on a multilateral basis; and
- Option 3 – no interchange fee by eliminating the interchange fee clauses of current bilateral contracts or eliminating bilateral interchange agreements altogether.

One particular issue addressed by the EIWG was the impact of the Trade Practices Act (TPA) on a more standardised interchange fee structure and the potential for requiring authorisation by the ACCC. The impact of the TPA could possibly vary depending upon the option chosen and therefore consideration may need to be given to a short-term solution if an option with a potentially longer lead time is chosen.

7. ASSESSMENT OF OPTIONS

Concurrent and consistent reform across all card payment types leads ASL to conclude that the interchange fee for debit cards must be set by reference to the credit card model with a multilateral approach to determining the appropriate fee. This will require an analysis of costs of issuers in order to set the appropriate interchange fee or fees. ASL would accept this fee being a "default" rate with parties arrive in fact other arrangements bilaterally if they desire.

Any other option results in an arbitrary setting of interchange fees and is without a firm basis other than expediency. It does not provide consistency across card transaction types.

¹⁰ RBA & ACCC, p. 38.

¹¹ EIWG, pp. 8-14.

Should a detailed cost study indicate that the interchange fee would be close to zero, then ASL would accept a zero interchange fee subject to revision of the setting of the fee within a reasonable period of time, say two to three years. However, it is noted that the zero interchange fee set in this method is different to adopting a no interchange fee regime.

We acknowledge that this option is likely to impose a requirement for ACCC authorisation. Therefore, action would need to be taken to expedite implementation of this option in order to comply with the timetable set by the RBA for credit card reform. Should the timetable not be achievable, ASL would support the elimination of interchange fees under Option 3 subject to:

- implementation of Option 3 being achievable concurrently with credit card reform; and
- work continuing with implementation of Option 2 for implementation within a two year period.

8. VISA DEBIT

While Visa debit is not part of the EFTPOS study, ASL represents building societies in a Visa debit working group. We recognise the interest of all participants in the EFTPOS study in any reform of the Visa debit arrangements.

The same approach to reform of credit card interchange fees should also apply to Visa debit. With ASL's proposal for reform of EFTPOS, we would then see consistency of reform across all card types.

9. CONCLUSION

ASL on behalf of building societies submits that the current EFTPOS interchange arrangements are anti-competitive and lead to distortions in card based transactions. EFTPOS reform must be implemented concurrently with reforms to all card types to avoid market distortion and unnecessary costs.

ASL supports either of the multilateral options under Option 2 using the approach specified in the RBA's Standard No. 1, The Setting of Wholesale ("Interchange") Fees.