Review of the Impact of Australian Payments Reforms

Reference: Federal Reserve System Docket No. R-1404

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1. Introduction

1.1 Background

As a result of the "Durbin Amendment" (Section 1075 of the Dodd-Frank Act), the Federal Reserve System has issued its draft regulations relating to debit card interchange fees and routing (Docket No. R-1404). The purpose of this document is to provide a review of the impact of the Australian payments reforms on the payments market, particularly with respect to those issues relevant to the proposed Federal Reserve regulations implementing the Durbin Amendment.

TransAction Resources is an independent consulting firm established in 1994 and based in Australia. We provide independent advice and support in the area of payments, card marketing and processing, the card regulatory environment and loyalty programs.

TransAction Resources has been involved in regulatory and competition reforms relating to payment cards around the world since 2001, including Australia, Europe, UK, New Zealand and the USA.

1.2 Scope

The main focus of this paper is on the impact of regulatory reforms relating to debit cards in the Australian market. However, there is also discussion of the impact of reforms to credit cards, particularly with regard to interchange regulations, as many of the outcomes of credit card interchange reform are relevant to debit card interchange fees. There is also some discussion about regulatory reforms elsewhere in the world which are relevant to the issues being considered by the Federal Reserve.

1.3 Limitations

This paper is not intended to be a comprehensive review of the Australian payments reforms, but is focused on those issues of particular relevance to the Durbin amendment.

1.4 Terminology

Card Scheme	A card association or an entity that manages the rules, procedures and the brand of a card payment system (e.g. American Express, Discover, Visa, MasterCard and Star)
Debit card	Where the term "debit card" is used in this document it refers to all debit cards in the market (i.e. EFTPOS + scheme debit cards) unless specified otherwise
EFTPOS	Australian domestic PIN debit card system
EFTPOS terminal	A card terminal at the point of sale with a PIN pad. All Australian card terminals have PIN pads
Scheme debit card	A debit card operated by one of the international card schemes (Visa, MasterCard) where the transaction is routed via the Visa or MasterCard network and is typically authorised by a signature (although PIN authorisation is also now an option in Australia). Commonly called signature debit in the USA.

2. Key Findings

The key findings of this paper which are directly relevant to the Federal Reserve's rulemaking process are briefly summarized below.

- Issuers on balance receive no revenue from debit card interchange in Australia.
- While fees on scheme debit (essentially signature debit in U.S. terms) are limited to a maximum of a weighted average of 12 cents, the fees paid are actually much lower because merchants have competitive routing options on these transactions.
- EFTPOS transactions (essentially PIN debit in U.S. terms) have interchange that runs from issuers to acquirers (and merchants) and which balances the fees on scheme debit such that issuers on all debit transactions combined pay and receive about the same total interchange.
- Since the reforms of debit interchange, payment by debit has grown faster in Australia than payment by credit.
- Over the past decade, debit card transactions have increased by 290% and spend on debit cards by 380%.
- There has been stronger growth in new debit accounts since the reforms than there was prior to the reforms.
- Although there is no regular data published on cardholder fees for debit cards, it appears they have declined steadily over the past decade.
- The fact that issuers receive no interchange income from debit cards has not led to any attempt to generate additional income from cardholder fees since the debit interchange reforms were implemented.
- Credit card usage has continued to increase strongly since Australia's reforms of credit interchange.
- Card issuer profitability has not been harmed by the reforms. Issuers have reduced costs and increased efficiency.
- Credit cardholder fees were increasing at a faster rate prior to the reforms than they have since the reforms.
- The Reserve Bank of Australia has concluded that merchants' lower costs are flowing through into lower prices due to the competitive environment in which most merchants operate.
- There are a number of debit card payment systems in the world with no interchange fee which have successfully operated for many years, generally with impressive growth and usage.
- The Directorate General Competition of the European Commission found that card issuing would generate positive profits in 20 out of 25 countries studied even without interchange fee income.
- The trend around the world has been to unbundle the governance and branding functions of card schemes (often called networks or card associations in the U.S.) from processing and routing functions so that merchants/acquirers have free choice in how to route and settle card transactions.

3. Australian Card Payment Reforms

3.1 Reform Process

The payments system reforms in Australia have been progressively implemented over the past decade. The first study, on which the reform process was based, was the Joint Study by the Reserve Bank of Australia (RBA) and the Australian Competition and Consumer Commission (ACCC) of interchange fees and access related to Australia's card payment systems conducted in 2000[1].

A number of important initiatives have been introduced since then, with the two major reforms being that for credit cards (published in 2002) and that for debit card interchange fees (published in 2006). It is not intended to provide a detailed review of these reforms, but a timeline is provided below and a brief summary of the key reforms is provided in an extract from an RBA document in Appendix 3. Further details can be found in "*Reform Of Australia's Payments System - Conclusions of the 2007/08 Review*" published by the Reserve Bank of Australia, September 2008.

The credit card reforms were announced in August 2002 and mandated three key reforms:

- a cost based methodology for setting interchange fees (from November 2003),
- merchant surcharging of credit cards to be allowed (from January 2003), and
- access to card schemes was opened to non-financial organisations, including the ability for merchants to self-acquire their own transactions (from April 2004).

The debit card reforms were first announced in a consultation document in 2005 and were introduced in November 2006. The major reforms were:

- revised interchange fees for both scheme debit and EFTPOS designed to bring the difference between the interchange fees of these two debit systems closer together
- abolition of the Honour All Cards Rule as it applied to scheme debit and scheme credit (i.e. merchants would be allowed to accept scheme credit cards without being forced to accept scheme debit cards and vice versa)
- a new access regime to make entry to the bilateral EFTPOS PIN debit system for new participants, particularly acquirers, easier.

It is now 8 years since the first reforms were put into operation, which has provided solid data over a sufficiently long time span to reasonably evaluate the impact of the reforms.

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1 *Debit and Credit Card Schemes in Australia - A Study of Interchange Fees and Access*, Joint Study by the RBA and ACCC, October 2000.

Milestone	Date
Financial System Inquiry final report (Wallis Report)	March 1997
Payment Systems (Regulation) Act	1998
RBA & ACCC Joint Study	October 2000
Credit card reform Consultation Document	December 2001
Debit reform process commences	July 2002
Credit card reforms finalised & published	August 2002
Merchant surcharging allowed	January 2003
Regulated credit interchange method comes into force	November 2003
New credit card Access Regime comes into force	April 2004
Debit consultation document	February 2005
Revised credit interchange benchmark	November 2006
Regulated debit interchange & HACR	November 2006
Review of Payment Systems Reforms commences	May 2007
Consultation document	April 2008
Findings of review published	September 2008
Revised standard for EFTPOS interchange fees	January 2010

Timeline of Australian Payment System Reforms

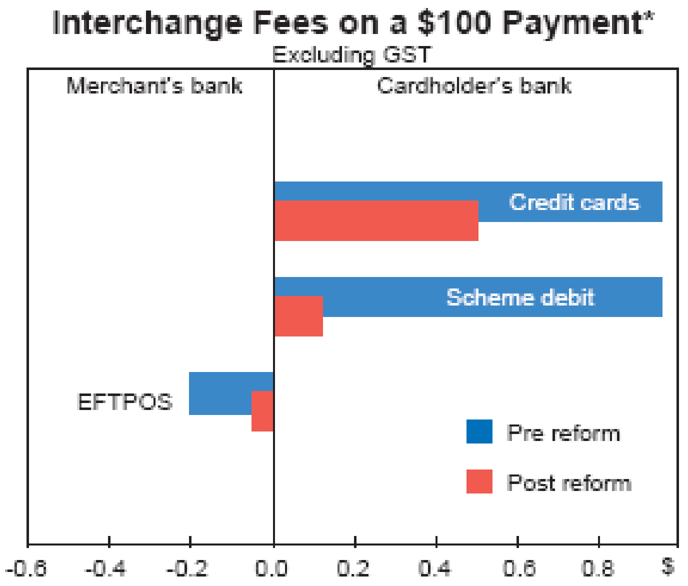
3.2 Interchange Fees

There have been two major phases of interchange reform in Australia - one for credit cards followed 3 years later by one for debit cards.

Credit card interchange regulations were introduced in November 2003 and these reduced the weighted average credit card interchange fee from 0.95% to a benchmark of 0.55%. A subsequent amendment in November 2006 further reduced the weighted average benchmark to 0.5%.

Debit card interchange fee reforms were implemented in November 2006. The RBA was principally concerned with two issues. Firstly that scheme debit cards had the same interchange fees as scheme credit cards, which the RBA believed could not be justified. Secondly, the RBA was concerned about the differential between the interchange fees for scheme debit and EFTPOS PIN debit and the potential for this to incentivise issuers to move from issuing EFTPOS cards to the higher income (for issuers) scheme debit cards. Accordingly it reduced the interchange fees for scheme debit and increased them for EFTPOS, reducing the average differential between these cards from around 60 cents to between 16 and 17 cents per transaction.

For scheme debit cards, these reforms had the effect of reducing the interchange rate from an average 0.95% (around 40 cents) to a maximum weighted average of 12 cents. This change can be seen in the graph below. Debit card interchange fees are discussed in more detail later in this document.



Credit Card Spend and Transactions in Australia [2]

It should be noted that the interchange fee benchmarks for both scheme (signature) debit cards and credit cards are not a maximum fee for any given transaction but the weighted average that each card scheme is not allowed to exceed. Thus the card schemes are allowed to have individual categories at rates above the benchmark providing the weighted average does not exceed this value. The interchange fee for EFTPOS must be between a specified floor and a specified ceiling (between 4 and 5 cents per transaction paid by the issuer to the acquirer).

Both Visa and MasterCard predicted that the card payment system in Australia would suffer badly from the interchange reforms. In fact MasterCard stated in a submission to the RBA that the setting of interchange fees is such a delicate balance, that to interfere with it, including via regulatory reform, could lead to a "death spiral process".

> *"A self-reinforcing cycle could be set in motion that could eventually lead to the whole open system unravelling: interchange fees set too low, leading to issuers charging higher fees to cardholders, leading to diminishing cardholders network, leading to fewer merchants acquired, leading to the need to further lowering of the interchange fee, and so on. This could be characterised as a* ***death spiral*** *process."* [3]

As this paper sets out, this has clearly not happened.

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2 *Payment Systems Board - Annual Report 2008,* Reserve Bank of Australia, p.14.

3 *Submission to the Reserve Bank of Australia*, MasterCard International, 20 July 2001, p.10-11.

3.3 Debit Cards

There are two major debit card types in Australia:

- EFTPOS, which is an on-line PIN debit network, and
- scheme debit cards which are issued by Visa and MasterCard (commonly called "signature debit" cards in the USA).

EFTPOS is the major debit card in the market, accounting for 83% of debit card transactions and 75% of debit card spend in 2010[4]. EFTPOS consists of a series of bilateral physical network connections and bilateral interchange and commercial arrangements.

EFTPOS has traditionally operated simply as a payment network, and not as a scheme, with technical and security standards controlled by the Consumer Electronic Clearing System (CECS)[5]. However, at the instigation of the RBA, EFTPOS Australia Payments Limited (EPAL) was formed in 2009, effectively to run EFTPOS as a scheme in competition with Visa and MasterCard's debit programs.

Visa has had scheme debit cards in the market since 1982, two years before the introduction of EFTPOS. Visa has dominated the scheme debit market as MasterCard did not have a standalone debit product in the Australian market until 2005 when BankWest commenced issuing the first "MasterCard Debit" cards[6].

3.3.1 Debit Interchange Fees

EFTPOS interchange fees are negotiated between issuers and acquirers as a series of bilateral interchange fees. There is no multilateral interchange fee nor any default interchange fee. Prior to the reforms these fees averaged around 20 cents per transaction negative interchange (i.e. paid by the issuer to the acquirer). The regulated EFTPOS interchange fees introduced in November 2006, while still negotiated bilaterally, must be between 4 cents and 5 cents. Although actual figures are not published, our understanding is that these are typically negative 4.5 cents per transaction.

Effective from January 2010, the RBA amended the EFTPOS interchange fee Standard to make the regulation of EFTPOS interchange fees more consistent with that for scheme debit interchange fees. The amended Standard caps the weighted average of any multilateral interchange fees in the EFTPOS system, should they be introduced at some future point, at the same 12 cent level as for scheme debit. The regulation of bilateral interchange fees remains unchanged at between 4 and 5 cents paid by the issuer to the acquirer. At this stage, this amendment has had no impact at all on EFTPOS interchange fees as all fees have remained as bilateral fees.

It should be noted that merchants with their own switch can become EFTPOS acquirers. Australia's two largest retailers, Woolworths and Coles, are both EFTPOS self-acquirers and are both members of EPAL with Board representation.

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4 Based on RBA Payment Statistics - Table C5

5 CECS is the group within the Australian Payments Clearing Association (APCA) which has historically been responsible for Australia’s ATM and EFTPOS systems.

6 A number of EFTPOS issuers in Australia co-branded their cards with Maestro for many years to allow the cards to be used overseas. The card operated as an EFTPOS card in Australia but could be used as a Maestro debit card or ATM card in other countries, but not in Australia.

Prior to the November 2006 regulations, scheme (signature) debit card interchange fees were set at the same rate as for credit cards. Thus scheme debit interchange fees were averaging around 0.95% (the same as for credit cards) prior to the introduction of the regulated credit card interchange fee. This then dropped to a maximum weighted average of 0.55% (which equated to around 40 cents per transaction for scheme debit cards according to the RBA[7]) in line with the credit card interchange fee. Following the introduction of regulated debit card interchange fees in 2006, the weighted average interchange fee for scheme debit cards is now not allowed to exceed 12 cents per transaction.

The major interchange fee categories for scheme debit are[8]:

Visa Debit

Strategic Merchant Rate	4.4 cents
Service Station Rate	6.6 cents
Supermarket Rate	6.6 cents
Electronic Rate	8.8 cents

MasterCard Debit

Strategic Merchant Rate	4.0 cents
Service Station Rate	4.4 cents
Consumer Electronic Rate	6.6 cents

A full list of Visa Debit and MasterCard Debit Interchange Fees are shown in Appendices 1 and 2 respectively.

Thus, **while the weighted average for signature debit interchange fees cannot exceed 12 cents, most merchants pay considerably less than this amount**. In fact, neither Visa nor MasterCard charge the 12 cent cap for any card present transactions even though the RBA allows them to. **Merchants have competitive network routing options on signature debit transactions which have allowed them to achieve rates below the cap.**

The weighted average interchange fee across all debit cards in Australia (scheme debit + EFTPOS) is estimated at between negative 2 cents and negative 3 cents, although no figures are published. Based on current transaction volumes for EFTPOS and scheme debit, the maximum this figure could be currently is negative 1.7 cents[9]. In other words, when taken across all debit card transactions, **issuers earn no income from debit card interchange fees**.

Despite this fact, debit card usage has grown at a faster rate than for credit cards (which do provide issuers with interchange income) as can be seen in the graph below. This demonstrates that **the lack of interchange fee income for issuers has not inhibited the growth in debit card usage in any way**.

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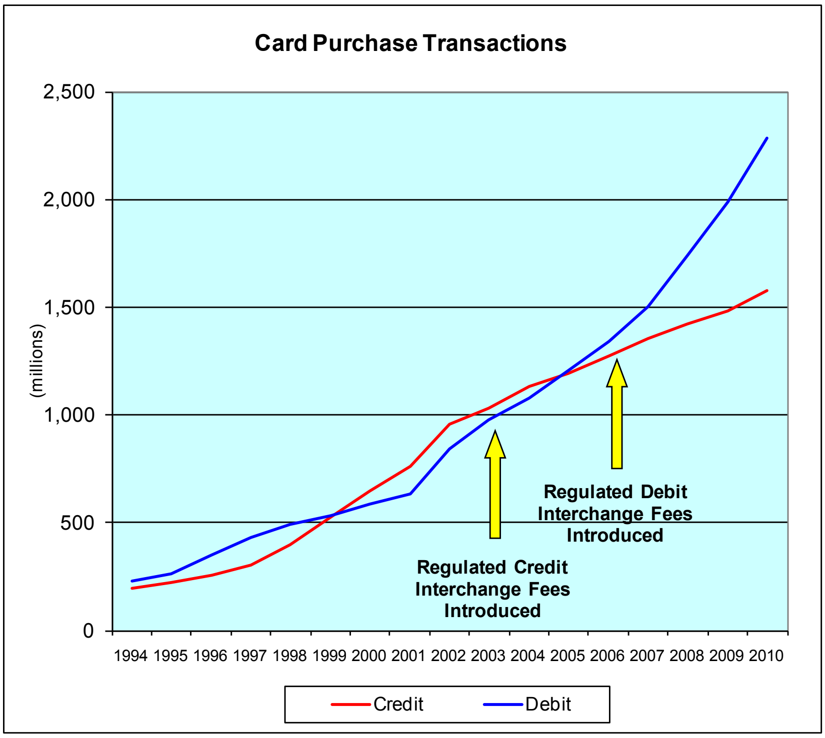
7 *Reform Of The EFTPOS and Visa Debit Systems in Australia - Final Reforms And Regulation Impact Statement*, Reserve bank of Australia, April 2006, p.9.

8 Please note all interchange fee rates include Goods and Services Tax (GST) of 10%. Thus, for example, the Visa Strategic Merchant Rate is 4 cents + 10% GST.

9 This is based on the current bilateral interchange fees for EFTPOS as no multilateral interchange fee has yet been implemented for EFTPOS.



Debit Card and Credit Card Transactions 1994 - 2010 [10]

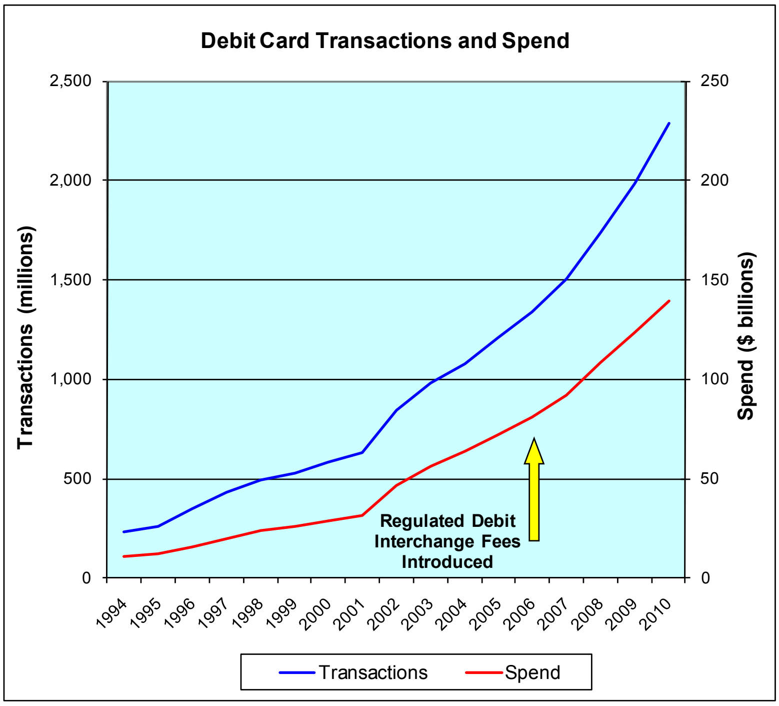
As discussed above, the difference in interchange income for issuers has reduced from a 60 cent per transaction advantage for scheme debit over EFTPOS prior to the reforms to a differential which is now less than 17 cents. However, scheme debit has continued to grow strongly with both transactions and spend increasing at a rate greater than that of EFTPOS, even though the incentive to issuers from interchange fees in choosing scheme debit over EFTPOS is significantly less than prior to the reforms. This supports the view that factors other than interchange fee income influence which debit program is chosen by issuers and cardholders.

3.3.2 Card Usage

The key indicators for both debit and credit cards (transactions, spend and cards on issue) have all shown healthy growth since the reforms. In all cases, there has been no negative impact from the reforms.

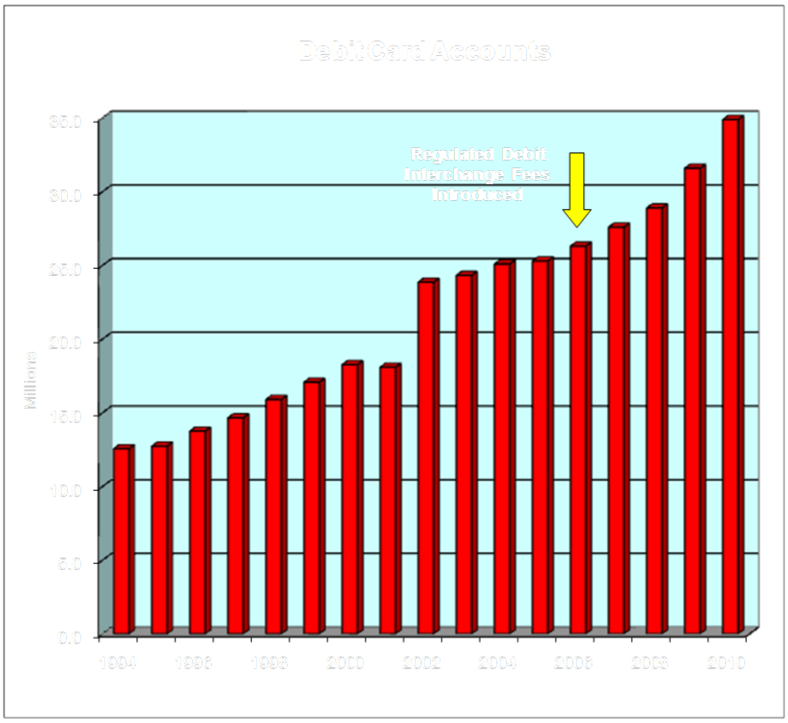
Debit card usage grew steadily up to 2001 when it took a strong upturn which has continued unabated until the present with no perceptible negative impact at all from the introduction of the regulated interchange fees. Over the past decade, debit card transactions have increased by 290% and spend on debit cards by 380%. The growth in transactions and spend can be seen in the following graph.

[10] Source: RBA Payment Statistics - Table C5. Debit card figures are for purchase transactions and exclude cash back only transactions and ATM withdrawals.



Debit Card Transactions and Spend 1994 - 2010 [11]

A similar trend can be seen in the number of debit card accounts. There has actually been stronger growth in new accounts since the interchange reform, although there is no evidence this increase in growth has occurred as a result of the interchange reforms. However, it is clear the reforms have had no negative effect on the on-going growth in the number of debit card accounts.



Debit Card Accounts 1994 - 2010 [12]

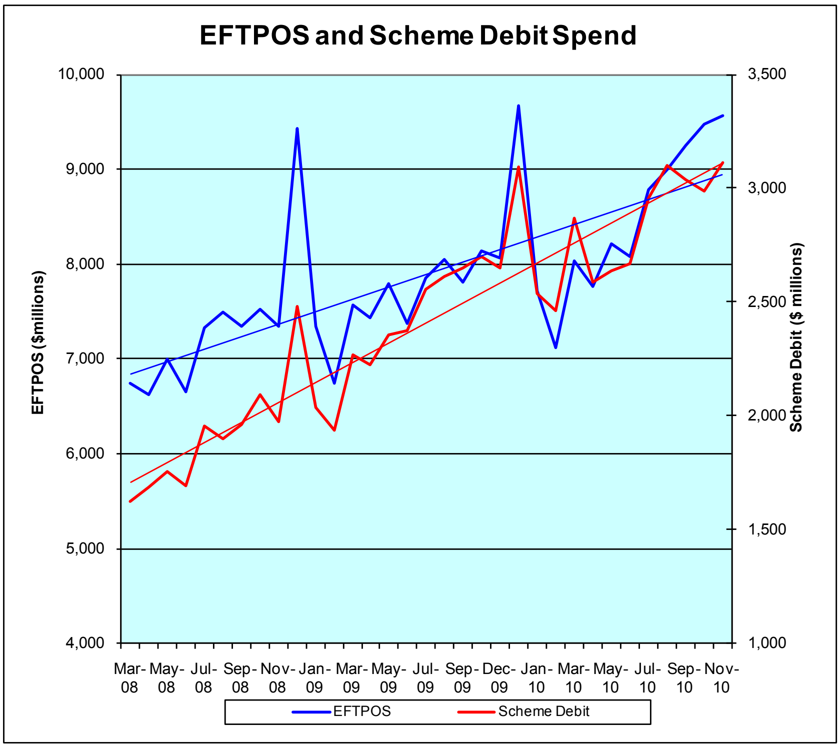
[11] Source: RBA Payment Statistics - Table C5. Figures are for purchase transactions and exclude cash back only transactions and ATM withdrawals.

Until 2008 only consolidated figures were available for debit cards which included both EFTPOS and scheme debit. However, from March 2008 the RBA has published individual transaction and spend data for each of these debit card systems. These figures show that EFTPOS continues to dominate debit card usage, currently accounting for 83% of the transactions and 75% of the spend.

	Transactions	Spend
2008	85.6%	79.3%
2009	83.2%	76.1%
2010	82.9%	75.0%

Percent of Debit Usage on EFTPOS [13]

The following graph shows the strong growth in both EFTPOS and scheme debit.



Purchase Value for Debit Cards 2008 - 2010 [14]

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12 Source: RBA Payment Statistics - Table C5. The large increase in debit card accounts in 2002 is due to the inclusion of a number of non-bank financial institutions for the first time, including building societies and credit unions. This was a one-off change in the reporting criteria in January 2002.

13 The 2008 figures are for 9 months only (March to December). 2010 figures are for 11 months only (January to November) as December figures have not yet been released.

14 Source: RBA Payment Statistics - Table C5.

3.3.3 Cardholder Fees

Although there is no regular data published on cardholder fees for debit cards, it appears they have declined steadily over the past decade. Unlike credit cards, a debit card is typically provided as a function of a savings or transaction account. Thus, monthly or annual debit card fees have not been charged in Australia, although monthly bank account fees are fairly common.

Historically, transaction fees were often charged on EFTPOS transactions, although frequently many accounts were provided with a monthly allocation of free transactions. For example, an account may have provided 8 free EFTPOS and ATM transactions per month and then charged 50 cents per transaction for every transaction above this threshold.

However, these transactions fees have largely disappeared. Even prior to the introduction of the debit card interchange fee reforms, the majority of debit card transactions attracted no fees.

In 2004 the Australian Competition Tribunal found that most consumers do not pay any EFTPOS fees.

> *"From this complicated picture however emerges the important fact that …. most consumers pay no EFTPOS fees today".*[15]

Also in 2004, as part of its review of debit card interchange fees, the RBA collected data from the five largest banks relating to EFTPOS cardholder fees to determine the frequency with which they were applied and the magnitude of these fees. This data showed that, at that time, 75% of EFTPOS transactions did not incur any fees[16].

In 2004, the ANZ Bank introduced a $5 per month bank account fee which covered all activities associated with that account, including, for example, provision of a check book, access to Internet banking, interest on savings, etc.. Following the introduction of this account fee, no debit card transaction fees were charged, irrespective of the number of transactions conducted on that account during the month. Subsequent to the RBA data collection in 2004, the other major banks have all followed suit, and accordingly the number of debit card transactions attracting fees has reduced even further.

This reduction in EFTPOS cardholder fees has been a gradual process which commenced before the introduction of the debit card interchange reforms and has continued completely independent of the reform process.

The fact that issuers receive no interchange income from debit cards has not led to any attempt to generate income from cardholder fees. As discussed below, there are many more important reasons why issuers want to see customers use debit cards than to simply generate income from debit card transactions.

Issuers do not charge transaction fees on scheme debit cards, and have not done so prior to or since the debit card reforms and reduction in interchange.

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15 *Determination re EFTPOS Interchange Fees Agreement [2004] ACompT 7*, Australian Competition Tribunal, 25 May 2004, para. 57.

16 *Reform of the EFTPOS And Visa Debit Systems In Australia - A Consultation Document*, Reserve Bank of Australia, February 2005, p.4.

> *"Institutions offering Visa Debit cards have typically not charged per-transaction fees for Visa Debit transactions."* [17]

3.3.4 Debit Cards and Bank Branches

The cost to an account-holding institution of an over-the-counter transaction or a paper check transaction far exceeds the cost of an electronic debit card transaction (by orders of magnitude) and therefore **the economics of debit cards for issuers do not rely upon either interchange or cardholder income**. In Australia this was critical to the introduction of debit cards, with EFTPOS being introduced as a cost reduction and branch replacement strategy for financial institutions. As the RBA stated in 1996:

> *"EFTPOS terminals are another partial substitute for access to a branch."* [18]

and

> *"While the number of bank branches has been declining over the past few years, access to the payment system and some other banking functions has expanded in a number of other ways, largely due to advances in electronic technology. In 1996, the number of ATMs has, for the first time, exceeded the number of bank branches, and the number of EFTPOS terminals continues to grow at a very high rate. Australia appears to continue to have a larger number of bank branches per head than countries with similar nationwide banking systems like the UK and Canada, but the number of branches is declining. This is in line with declines in a number of similar countries where banks are responding to pressures to reduce operating costs by substituting electronic access to banking services."* [19]

This saving in costs is demonstrated from figures provided at the time the regulatory reviews commenced. At that stage, estimates of the cost of an over-the-counter transaction at a branch ranged from \$3.50 - \$4.00 up to \$9[20] whereas an EFTPOS transaction had a cost to the issuing bank of under \$0.15 including overheads such as staff costs[21] but excluding interchange, or around \$0.35 including the interchange fee. It was this disparity in costs and the substantial savings from electronic transactions that largely drove the bank rationalisation program. The impact of debit card interchange fees has little bearing on these economics. As the RBA has stated:

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17 *Reform of the EFTPOS And Visa Debit Systems In Australia - A Consultation Document*, Reserve Bank of Australia, February 2005, p.5.

18 *Bank Branch Trends in Australia and Overseas*, Reserve Bank of Australia Bulletin, November 1996, p.5. Note that the terminology "EFTPOS terminals" in Australia refers to card terminals with PIN pads.

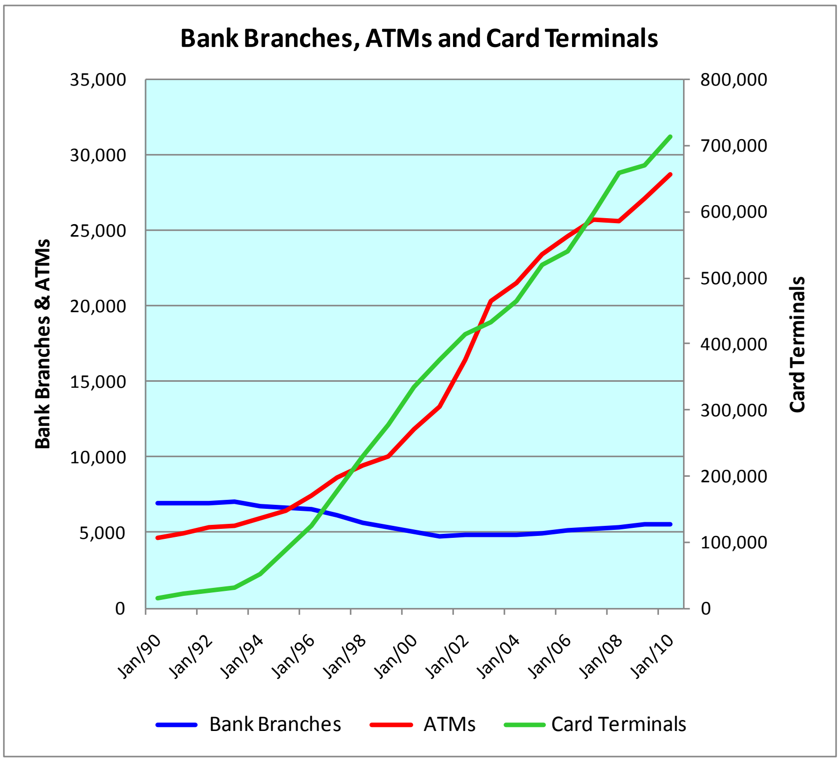
19 *Bank Branch Trends in Australia and Overseas*, Reserve Bank of Australia Bulletin, November 1996, p.6.

20 \$3.50 to \$4.00 is estimated to be at the lower end of the range for the cost of an over-the-counter transaction, based on industry knowledge. A cost of \$9 for over-the counter transactions is quoted in the *Report on Fees on Electronic and Telephone Banking* by the Joint Parliamentary Committee on Corporations and Securities (Labor Members Report, February 2001, p.1.)

21 *Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access*, Joint Study by the RBA and ACCC, October 2000, *p. 65*.

"Notwithstanding what the formal interchange methodologies might suggest, debit card issuers in Australia have been prepared to pay as much as $0.35 per transaction (if they use gateways) to participate in the debit card network. This is because issuing is regarded as an integral part of the provision of a transaction account, the costs of which can be recovered in various ways." [22]

The success of the banks' drive to move customers to transact electronically and change behaviour away from using branches is illustrated by the following graph and table.



Number of Bank Branches, ATMs and Card Terminals in Australia [23]

	Number (1990)	Number (2010)	Change 2010 vs 1990
Bank Branches	6,921	5,544	-20%
ATMs	4,636	28,764	+520%
Card Terminals	15,514	712,434	+4,492%

Relativity Between Bank Branches, ATMs and Card Terminals, 1990 to 2004[24]

In 1990 there were just over 2 card terminals for every bank branch in Australia – there are now 128 card terminals for every bank branch.

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[22] *Debit and Credit Card Schemes in Australia - A Study of Interchange Fees and Access*, Joint Study by the RBA and ACCC, October 2000, p.68.

[23] Source: RBA Payment Statistics - Table C8.

[24] Source: RBA Payment Statistics - Table C8.

3.3.5 Australian Debit Routing

The scheme debit cards issued in Australia may all be processed either via the scheme network or via the EFTPOS network. The choice is generally made by the cardholder at the point of sale by pressing an Account selection key on the PIN pad. The Account options are Cheque [CHQ], Savings [SAV] or Credit [CR]. If the cardholder selects either [CHQ] or [SAV] the transaction is processed via the EFTPOS PIN network. If the cardholder selects [CR] the transaction is processed via the card scheme network.

One Australian merchant (the largest by debit transaction volume) has elected to disable the [CR] account selection key on its PIN pads for scheme debit transactions and therefore effectively forces all scheme debit cards to be routed via the EFTPOS PIN debit network.

The Australian experience has been that increased merchant choice has increased competition and provided merchants with more leverage in price negotiations.

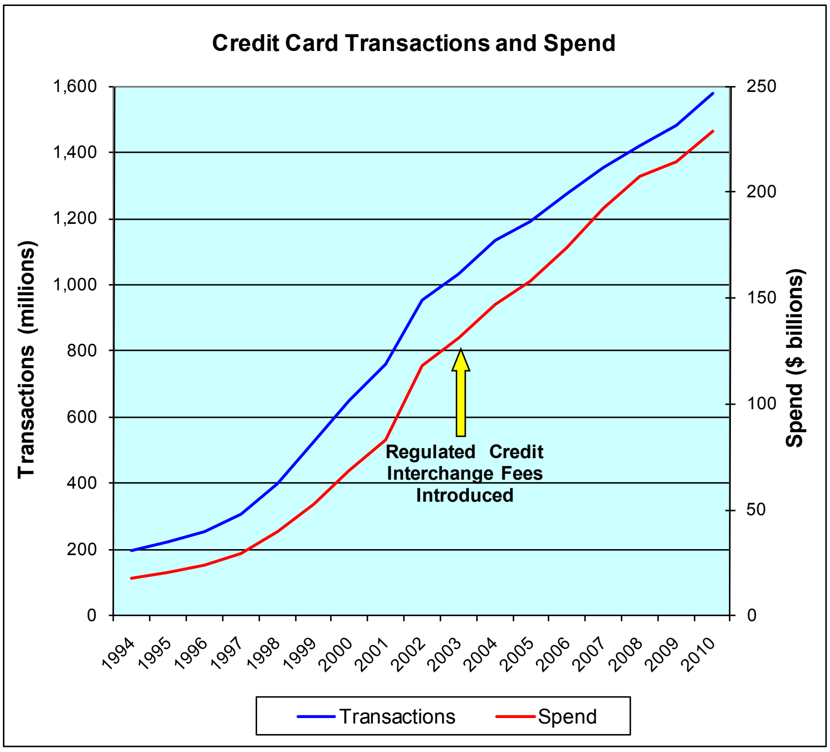
3.4 Credit Cards

While the draft regulations proposed by the Federal Reserve Bank relate specifically to debit cards and not credit cards, nonetheless the Australian experience in the regulation of credit cards is valuable and relevant to the proposed debit card reforms in the USA.

What the Australian experience demonstrates is that despite significant reductions in interchange fees, credit card usage has continued its strong growth. This reinforces similar outcomes that have occurred from the regulation of debit card interchange fees - that card payment systems can operate healthily and grow strongly despite regulated reductions in interchange income for issuers.

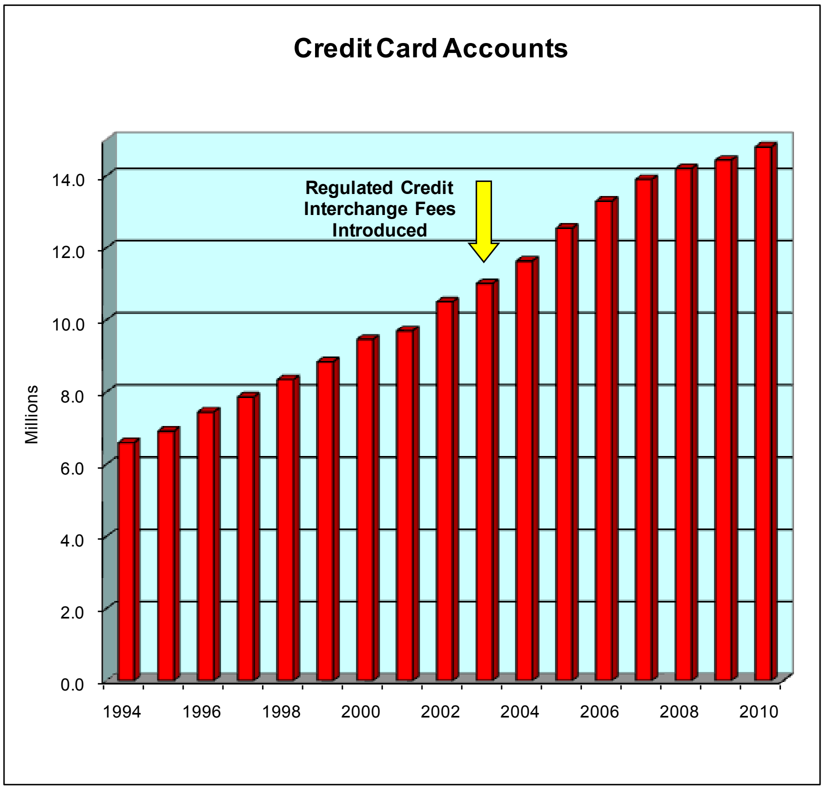
3.4.1 Card Usage

Credit card usage, with respect to both transactions and spend, has continued to increase strongly since the reforms. The regulated interchange reductions appear to have had no impact on usage or growth.



Credit Card Transactions and Spend 1994 - 2010 [25]

Similarly, the number of credit card accounts has continued to grow strongly with no perceptible slowing of the growth as a result of the interchange fee regulations.



Credit Card Accounts 1994 - 2010 [26]

[25] Source: RBA Payment Statistics - Table C1.

The growth in credit card transactions, spend and cards on issue following the credit card reforms echo the growth for debit cards following the debit card reforms.

3.4.2 Impact of Reforms on Issuers

The profitability of credit card issuers appears to be, at worst, unchanged and in at least some cases improved. Although the issuers have suffered a drop in interchange income, they have rearranged their portfolios and restructured their operations to reduce costs and improve efficiency.

Of the four major national banks (which represent some 80% to 85% of the credit cards on issue), three (ANZ, Westpac and Commonwealth Bank) made public statements following the reforms which show their issuing business had not been negatively impacted by the regulations. The following statements demonstrate this point:

ANZ Bank

> *"ANZ appears to have easily sidestepped the expected profit-sapping impact of the Reserve Bank's credit card reforms, revealing that its consumer finance division, which runs the card products, was one of its best performers."* [27]

and

> *"Chief executive John McFarlane said ANZ had achieved better-than-expected results from the division despite the reforms … He said the interchange issues had been well managed and the bank had attracted a net 50,000 new customers in the half."* [28]

and

> *"Profit after tax increased by 16% with profit growth of 58% in Cards and Merchant Services, 22% in Banking Products and 6% in Personal Banking Distribution offsetting a 2% reduction in Mortgages.* [29]

Westpac

> *"Westpac has indicated that the reforms will have no negative effect on its results after it restructured its card operations."* [30]

Commonwealth Bank

> *"Spending on credit cards by customers increased by 17% during the year though this was partially offset by the impact of RBA interchange regulations."*[31]

and

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[26] Source: RBA Payment Statistics - Table C1.

[27] *ANZ Gets Cards To Cough Up*, Anthony Hughes, Sydney Morning Herald, 28 April 2004.

[28] *ANZ Annual Report 2004* , p.34

[29] *ANZ Annual Report 2004* , p.34.

[30] *ANZ Gets Cards To Cough Up*, Anthony Hughes, Sydney Morning Herald, 28 April 2004.

[31] *Commonwealth Bank of Australia Annual Report 2004*, p.11

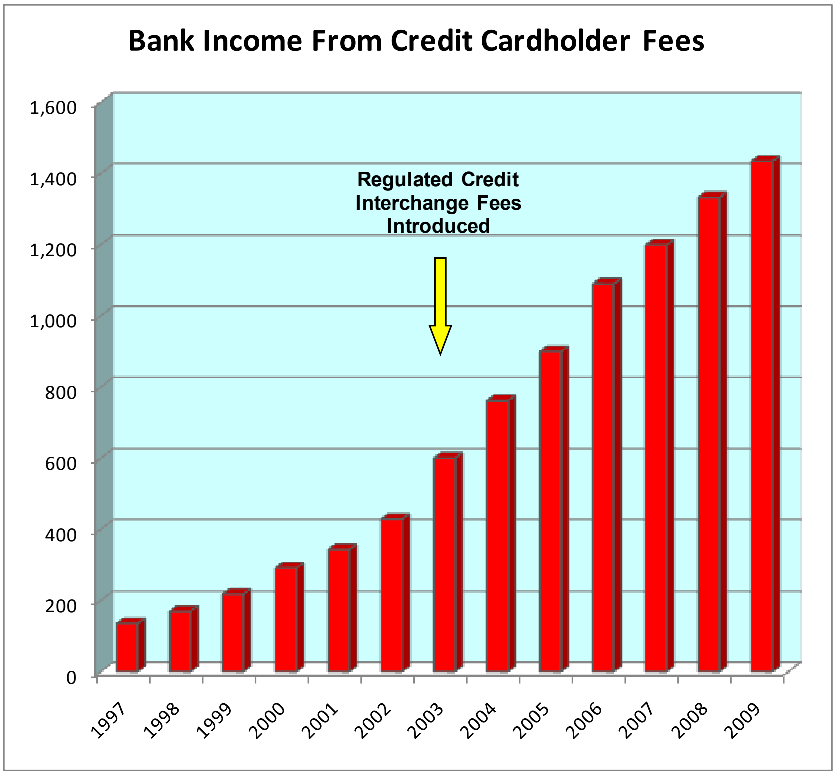
"Customer Reactions [to Credit card reforms] [32]

- *No reduction in use of credit cards*
- *Proliferation rather than a consolidation of credit cards per customer*
- *Customers more actively seeking the "right" card (High transactors seeking best rewards programmes / revolvers seeking cheaper rates)*
- *No discernible increase in debit transaction volumes"*

3.4.3 Cardholder Fees

Despite initial concerns from the banks that the reforms would have a significant impact on their income from cards, overall bank income from cards has continued to grow.

While some of the card schemes and banks have pointed to the introduction of the reforms as responsible for higher fees to cardholders, the following graph demonstrates that cardholder fees were already growing strongly well before the regulations were implemented in 2003.



Bank Income from Credit Cardholder Fees 1997 - 2009 [33]

In fact, credit cardholder fees were increasing at a greater rate prior to the reforms:

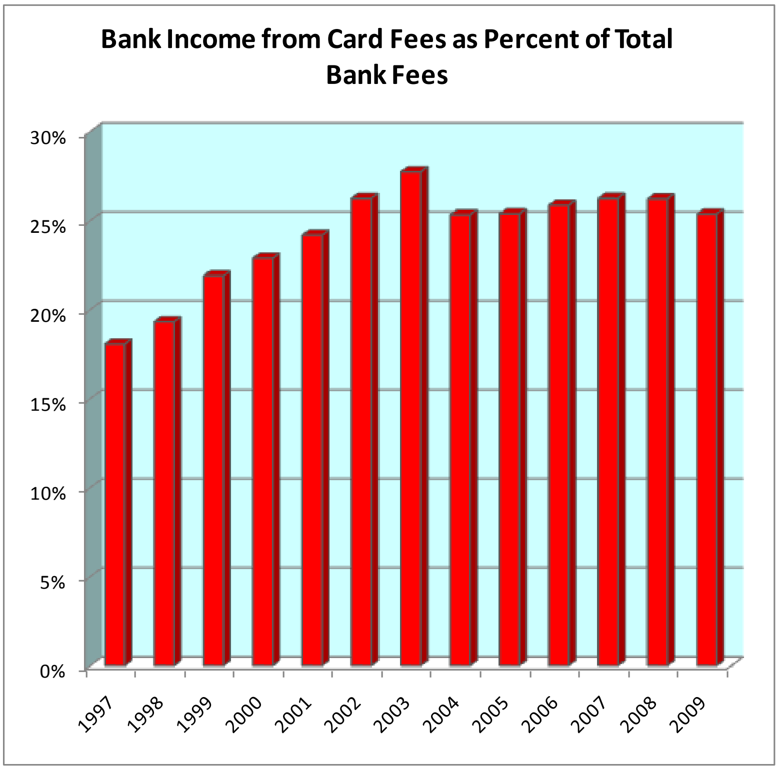
Increase in cardholder fees over 5 year prior to reforms (2002 vs 1997)	218%
Increase in cardholder fees over 5 year after reforms (2008 vs 2003)	122%

32 *Credit Card Reforms*, presentation by Stephen Morrow, Retail Banking Services, Commonwealth Bank of Australia, 6 April 2004.

33 Source: RBA Payment Statistics - Table F6.

The banks' claims that the reforms would increase the growth in cardholder fees proved not to be true.

Finally, bank income from card fees has stabilised at around 25% of all bank fees following the reforms, after increasing steadily up until 2003.



Bank Income From Card fees as Percent of Total bank Fee Income [34]

There has also been much discussion about whether the savings achieved by merchants as a result of the reforms have been passed on to consumers in the form of lower prices. While there is no hard evidence either way, the RBA has said:

> *"We are confident that the merchants' lower costs are flowing through into lower prices, given the competitive environment in which most merchants operate. Our estimate is that the cost savings will, over time, mean that the Consumer Price Index will be 0.1 to 0.2 percentage points lower than would have otherwise been the case. This may sound small, but it represents a significant benefit to consumers."* [35]

3.5 Impact of Reforms on Card Schemes

The card schemes appear to be in very healthy shape following the reforms. Usage of their cards, both credit and debit, have grown strongly, with scheme debit increasing its share of the overall debit market.

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34 Source: RBA Payment Statistics - Table F6.

35 *Reform of the Payments System - Address to Visa International Australia and New Zealand Member Forum*, Philip Lowe - Assistant Governor (Financial System), Reserve Bank of Australia, 2 March 2005

In addition, both schemes have increased their scheme fees, thus generating increased income. The schemes themselves do not receive any of the interchange income and thus the reduction in interchange fees has not negatively impacted their earnings.

While both MasterCard and Visa were strongly opposed to surcharging, very few of their transactions actually attract a surcharge with many merchants surcharging only American Express and Diners Club transactions because of their higher merchant service fees.

On a negative note for the four party schemes, Visa and MasterCard have lost some credit card market share as some banks have started to issue American Express cards. However, this has been offset by Visa and MasterCard picking up additional business when the domestic Bankcard credit card exited the market in 2006[36].

4. Payments Reforms in Other Countries

This section is not intended to be a detailed analysis of reforms and activities happening in other parts of the world, but to focus on some issues relevant to the proposed reforms put forward by the Federal Reserve System.

4.1 Interchange

Interchange reform has taken place in a number of jurisdictions besides Australia. In Europe, interchange reform has occurred in a number of countries, including Spain, Switzerland and Poland as well as for cross-border interchange fees for both Visa and MasterCard. A number of other EU countries, such as the UK and Italy, are in the process of reviewing interchange fees and how they are set.

An important contribution to the discussion of interchange is the study undertaken by the Directorate General Competition of the European Commission (DG COMP) into Payment cards. This study has been extremely valuable because the findings are based on solid data rather than just academic argument. DG COMP sent a survey to a representative sample of 203 acquirers and issuers and 26 domestic and international payment card systems across the 25 EU countries.

The evidence collected showed that *"card issuing would generate positive profits in 20 out of 25 countries even without interchange fee income."*[37]

The final outcomes of the study were released in January 2007 and it concludes:

> *"Interchange fees appear to magnify the profits of card issuers. .... This exercise seems to partially invalidate explanations put forward by the industry that total system output would suffer if issuing were not subsidised through the transfer of revenues from acquirers."* [38]

In all these jurisdictions where interchange has been reduced, there are no signs of negative impact on card usage.

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36 Bankcard's demise was unrelated to the reform process and its usage had been steadily declining for many years prior to the reforms.

37 *Interim Report I - Payment Cards*, Competition DG, European Commission, 12 April 2006, p.11.

38 *Report on the Retail Banking Sector Inquiry - Commission Staff Working Document*, European Commission, Directorate-General for Competition, 31 January 2007, p.127.

There are a number of debit card payment systems in the world with no interchange fee which have successfully operated for many years, generally with impressive growth and usage. These include, among others, Canada's Interac network, The Netherlands "Pinnen" system (previously sometimes known as InterPay debit after the organisation which used to operate the network) and the majority of New Zealand's EFTPOS network[39]. There are also some debit card systems, such as Australia's EFTPOS, that operate very successfully on negative interchange, as do ATMs These examples demonstrate that the absence of interchange fee income for issuers has not hindered cardholder usage nor merchant acceptance. Equally, the lack of interchange income has not stopped card issuers from issuing these cards in large numbers.

It should also be noted that Visa has zero interchange on all transactions conducted on Visa Debit cards at the point of sale (POS) in New Zealand. These transactions are processed over the EFTPOS network.

4.2 Access / Routing

The current trend in many parts of the world is towards unbundling the processing elements of card schemes such as switching, authorisation and settlement from the governance and branding issues. Much work has been done on this in Europe under the auspices of SEPA for Cards.

An important element of the SEPA Cards Framework (SCF) is that card schemes will no longer be able to mandate that their networks be used for the processing and clearing of transactions.

> *"The separation between scheme management and processing must be effective and not just on paper. For example, contractual obligations between banks and card schemes requesting the use of a particular processing channel should be eliminated, and cross-subsidisation between card schemes and their processing units must also be avoided."*[40]

This view is repeated in the current version of the SCF:

> *"A SCF compliant card scheme is a scheme that allows unbundling of functions whilst applying the same pricing per card product to national Euro and SEPA transactions of the same type. Separation of SEPA card schemes' brand governance and management from the operations that have to be performed by service providers and infrastructures under these SEPA schemes is mandatory. A card scheme may offer additional services (e.g. processing services) but their usage cannot be mandated."*
>
> and
>
> *"Scheme rules may not require as a condition of participation that any particular provider of processing services (e.g. network management, authorisation, switching, clearing, settlement) be used."* [41]

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39 In New Zealand, EFTPOS negative interchange fees are paid between ANZ and the "ETSL" banks, but not for the majority of transactions. In all cases, issuers receive no income from EFTPOS interchange fees.

40 *The Eurosystem's View of a "SEPA For Cards"*, European Central Bank, November 2006, p.4.

41 SEPA Cards Framework, Version 2.1, European Payments Council, 16 December 2009, p.15

The most recent SEPA progress report by the European Central Bank restates this unbundling objective:

> *"The principle of the separation of scheme management functions from processing, which is one of the key requirements of the SEPA Cards Framework (SCF), is an important element in the creation of a competitive cards market in SEPA.* ***Card scheme participants should be free to choose their processors and clearing and settlement service providers****."* [42] *(emphasis added)*

[42] *SEPA Seventh Progress Report, Beyond Theory Into Practice*, October 2010, European Central Bank.

5. Appendices

5.1 Appendix 1 - Visa Debit Interchange Fees in Australia

Domestic Visa Debit and Prepaid Interchange Rates

Effective 30 June 2010, the following interchange rates apply to domestic transactions processed through Visa's National Net Settlement Service:

Description	Rate inclusive of GST*
Charity rate	0.0%
Large Ticket rate (exclude T&E)	A$11 + 0.11%
Strategic Merchant Rate	4.4 cents – 66 cents
Government rate	8.8 cents
Transit rate	6.6 cents
Utility rate	8.8 cents
Recurring Payment Transaction rate	8.8 cents
Service Station rate	6.6 cents
Supermarket rate	6.6 cents
Education rate	8.8 cents
Insurance rate	8.8 cents
Electronic rate	8.8 cents
Standard, Card Not Present and Paper rate	0.33%
Platinum rate	0.44%
Commercial rate	1.10%

** All fees are represented in Australian Dollars*

% = % of the transaction value
Cents = cents per transaction

Different fees apply when a Visa transaction involves either an overseas cardholder or an overseas merchant. Merchants should direct all questions relating to interchange fees to their Acquiring Institution.

There is a precedence in which interchange fee programs and rates are applied. Generally, acceptance based rates (e.g., utility, insurance, and recurring) take precedence over product-based rates (e.g., platinum and commercial). The following table provides a brief description of Visa's domestic interchange fee programs in Australia.

Interchange Fee Programs	Definition
Charity rate	Payable on Visa transactions for merchants who are non-political fundraising organisations (organisations engaged in soliciting contributions) and social service organisations engaged in social welfare services, including advocacy groups, community organisations, and health agencies. The charity must be registered with the Australian Tax Office. Acquirers are required to hold a copy of the Charity's ATO certification and ensure that the charity complies with the defined 'characteristics'. The characteristics of a charity are: 1. It is an entity which is also a trust fund or an institution 2. It is non-profit 3. It exists for the public benefit or the relief of poverty 4. Its purposes are charitable within the legal sense of that term 5. Its sole or dominant purpose is charitable
Large ticket rate (Excludes T&E)	Payable on a Visa transaction that is A$10,000 and above excluding travel and entertainment merchant categories.

Strategic Merchant Program	Payable on Visa transactions for merchants designated by Visa to be strategic in which they meet certain volume and/or growth thresholds. The range of interchange rates available to this program is displayed.
Government rate	Payable on Visa transactions initiated at any merchant defined as a Government entity (meeting Visa's merchant classification requirements).
Transit rate	Payable on Visa transactions for local and suburban mass passenger transportation over regular routes and on regular schedules, and does not include taxicabs, limousines, and bus lines. Included in this category is railway commuter transportation.
Utility rate	Payable on Visa transactions initiated at any merchant providing electric, gas, water or sanitary utility services (meeting Visa's merchant classification requirements).
Recurring Payment rate	Payable on Visa transactions initiated at a merchant who has entered into an agreement with their Acquiring Institution to participate in the Recurring Payment Transaction Service, where the cardholder has signed an agreement with the merchant to authorize the merchant to bill their Visa card for recurring payments, the transaction details are sent to the Issuing Institution, the Issuing Institution authorizes the transaction and the merchant sends the transaction to its Acquiring Institution for clearing and settlement with the Issuing Institution within four days.
Service Station rate	Payable on Visa transactions for retail sellers of automotive gasoline and receive payment either at the counter through signing a sales slip or through the use of an Automated Fuel Dispenser (AFD). Automated Fuel Dispensers enable cardholders to purchase fuel by completing the transaction at the pump.
Supermarket rate	Payable on Visa transactions for merchants that sell a complete, full line of food merchandise for home consumption. Most of the food merchandise is perishable, including self-service groceries, meat, produce and dairy products. In addition, they also sell canned, frozen, prepackaged, dry foods, a limited selection of house wares, cleaning and polishing products, personal hygiene products, cosmetics, greeting cards, books, magazines, household items, and dry goods. These merchants may also operate specialized departments such as an in store deli counter, meat counter, pharmacy, or floral department. NOTE: Merchants typically known as a convenience stores and sell a limited selection of products or specialty items are not eligible for this rate.
Education rate	Payable on Visa transactions for designated schools that accept Visa for payment. Schools include elementary, secondary, universities, correspondence schools, business and secretarial schools and vocational and trade schools.
Insurance rate	Payable on Visa transactions for merchants that sell all types of personal or business insurance polices. This includes merchants that provide the following types of insurance: automobile, life, health, hospital, medical, and dental insurance, homeowners and renters insurance, real estate title insurance, pet health insurance and flood, fire or earthquake insurance. This also include direct marketing insurance services e.g., accidental death, travel insurance, etc.
Electronic rate	Payable on Visa transactions initiated at any merchant where a cardholder presents a consumer magnetic stripe card or a chip card, the card is used at an electronic terminal, all data on the card is successfully transmitted to the Issuing Institution, the Issuing Institution authorizes the transaction and the merchant sends the transaction to its Acquiring Institution for clearing and settlement with the Issuing Institution within four days.
Standard, Card Not Present and Paper rate	Applicable to all transactions on a standard consumer card that do not qualify for any other rate detailed. Typically these are transactions on Visa Classic and Gold cards that are used in a card not present environment (e.g., internet) or a non-electronic transaction (paper based). An electronic Classic or Gold transaction that is not settled within 4 days would receive a standard interchange rate.

5.2 Appendix 2 - MasterCard Debit Interchange Fees in Australia

Debit MasterCard Transactions

Interchange Category Name	Priorit y	Interchange Fee inc GST
Charities	1	0.000%
Strategic Merchants	2	$0.04
Government & Utilities	3	$0.077
Micropayments	4	$0.044
Petroleum	4	$0.044
Recurring Payments	5	$0.10
Quick Payment Service	5	$0.044
EMV Commercial	6	1.628%
EMV Consumer Electronic	6	$0.132
Commercial	7	1.397%
Consumer Premium	7	0.550%
Consumer Electronic	8	$0.066
Consumer Standard	9	$0.209

MasterCard Cash

Interchange Category Name	Priorit y	Interchange Fee inc GST
Transit	1	A$0.04

Debit MasterCard Interchange Fee Qualifying Criteria

Interchange Category	Description
Charities	Available to merchants set up with MCC 8398 that are recognized by the Australian Taxation Office as charitable organisations and only for donations/payments that may be claimed as a tax deduction.
Strategic Merchants	Available to particular merchants or merchant groups as determined by MasterCard from time to time and that meet performance requirements specified by MasterCard.
Government and Utilities	Available to the following MCCs: 9211, 9222, 9223, 9311, 9399, 9402, 9405, 4812, 4813, 4814, 4816, 4821, 4899, 4900
Micro-payments	For transactions only to the value of A$20 or below. Does not apply to Charities, Strategic Merchants or Government & Utilities.
Petroleum	Available to the following MCCs: 5541, 5542
Recurring Payments	Available for transactions containing the Recurring Payment indicator other than transactions qualifying for Charities, Strategic Merchants, Government & Utilities, and Petroleum.
QPS (registration required)	Available for transactions containing the QPS indicator other than transactions qualifying for Charities, Strategic Merchants, Government & Utilities, and Petroleum.
EMV Commercial (EMV card, non-EMV terminal)	Available for all commercial payment cards containing an EMV compliant chip, other than for Charities, Strategic Merchants, Government & Utilities, Petroleum, and QPS.
EMV Consumer (EMV card, non-EMV terminal)	Available for all consumer cards containing an EMV compliant chip, other than for Charities, Strategic Merchants, Government & Utilities, Petroleum, and QPS.
Commercial	Available for non-EMV commercial payment card transactions, other than for Charities, Strategic Merchants, Government & Utilities, Petroleum, Recurring Payments, and QPS.
Consumer Premium	Available for all consumer premium payment card transactions, other than for Charities, Strategic Merchants, Government and Utilities, Petroleum, and QPS.
Consumer Electronic	Available for consumer debit card transactions(excluding consumer premium) conducted at an electronic data capture terminal and authorised by the issuer other than for Charities, Strategic Merchants, Government & Utilities, Petroleum, and QPS.
Consumer Standard	Available to all domestic Debit MasterCard transactions not qualifying for any other interchange category.

5.3 Appendix 3 - Summary of RBA Payment Reforms (2008)

The following is an extract from "*Reform Of Australia's Payments System - Conclusions of the 2007/08 Review"* published by the Reserve Bank of Australia, September 2008.

Table 1: Payments System Reforms

Standards	
Interchange fees	
Credit cards	Weighted-average interchange fees in the MasterCard and Visa schemes must not exceed 0.50 per cent of the value of transactions. MasterCard and Visa must publish their actual credit card interchange fees.
Visa Debit	The weighted-average interchange fee for Visa Debit transactions must not exceed 12 cents per transaction. Visa must publish its actual debit card interchange fees.
EFTPOS	EFTPOS interchange fees for transactions that do not involve a cash-out component must be between 4 and 5 cents per transaction.
Merchant restrictions	
Honour-all-cards	Visa is not permitted to require a merchant to accept Visa Debit cards as a condition of accepting Visa credit cards, or *vice versa*. Visa Debit cards must be visually and electronically identifiable as debit cards, and acquirers must provide merchants with information required to electronically distinguish Visa Debit and Visa credit card transactions.
Surcharges	The card schemes must not prohibit a merchant from imposing a surcharge for MasterCard or Visa credit card transactions, or for Visa Debit card transactions.
Access Regimes	
Credit cards and Visa Debit	Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit-taking institutions (ADIs). A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or *vice versa*. Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.
EFTPOS	The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently $78 000 (ex GST). An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).

Voluntary Undertakings	
American Express and Diners Club	American Express and Diners Club have provided the Bank with written undertakings to remove restrictions in their credit and charge card schemes preventing merchants from charging any fee or surcharge for the use of a card.
American Express	American Express has provided the Bank with a commitment to modify provisions in its merchant contracts that would otherwise prevent a merchant from 'steering' a customer's choice of payment instrument. Also, in the event that American Express introduces a debit card in Australia, the merchant agreements and pricing for that product will be separate to those for credit and charge cards.
MasterCard	MasterCard has provided the Bank with a written undertaking to voluntarily comply with the Visa Debit interchange Standard and the honour-all-cards Standard as they apply to credit and debit card transactions, as well as the Standard on surcharging as it applies to debit card transactions.
Other	
EFTPOS Access Code	Under the EFTPOS Access Code developed by the Australian Payments Clearing Association, new and existing EFTPOS participants have specific rights to establish direct connections with other participants within a set time frame.
Scheme data	Since August 2005 the Bank has published aggregated data on the average merchant fee for each of the schemes as well as data on market shares.