



19 October 2009

Mrs Michele Bullock
Head of Payments Policy
Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Dear Mrs Bullock

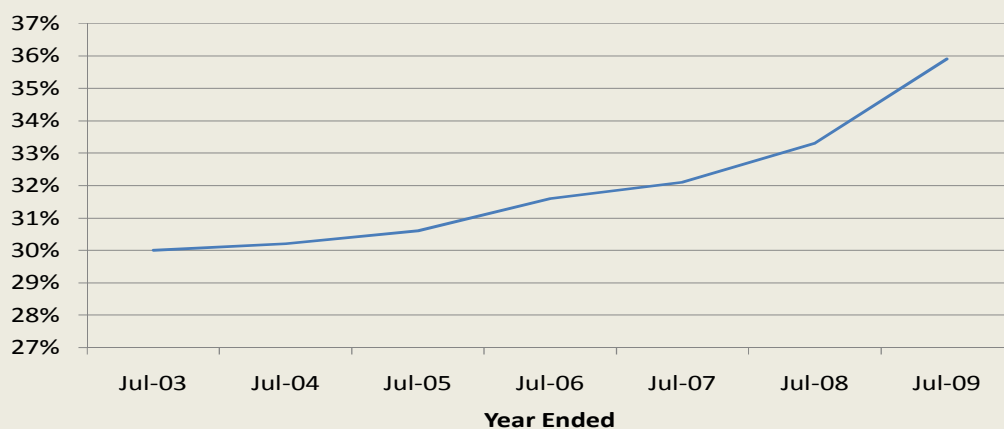
Australian Settlements Limited (ASL) delivers a cost-effective, convenient and secure entry to the Australian payments system for 16 Building Societies and Credit Unions. Our primary objective is to provide a competitive range of payment services to our members, enabling each of them to leverage the benefits of scale and expertise not possible on their own.

In seeking to ensure optimal results for our members, we are pleased to respond to your invitation for submissions on the proposed changes to the EFTPOS interchange standard.

Background

The role of debit in the Australian market is clearly undergoing a major change. After declining for many years, debit has recently been gaining share of purchases made with a card at the expense of credit and charge cards and other payment products. Refer graph 1.

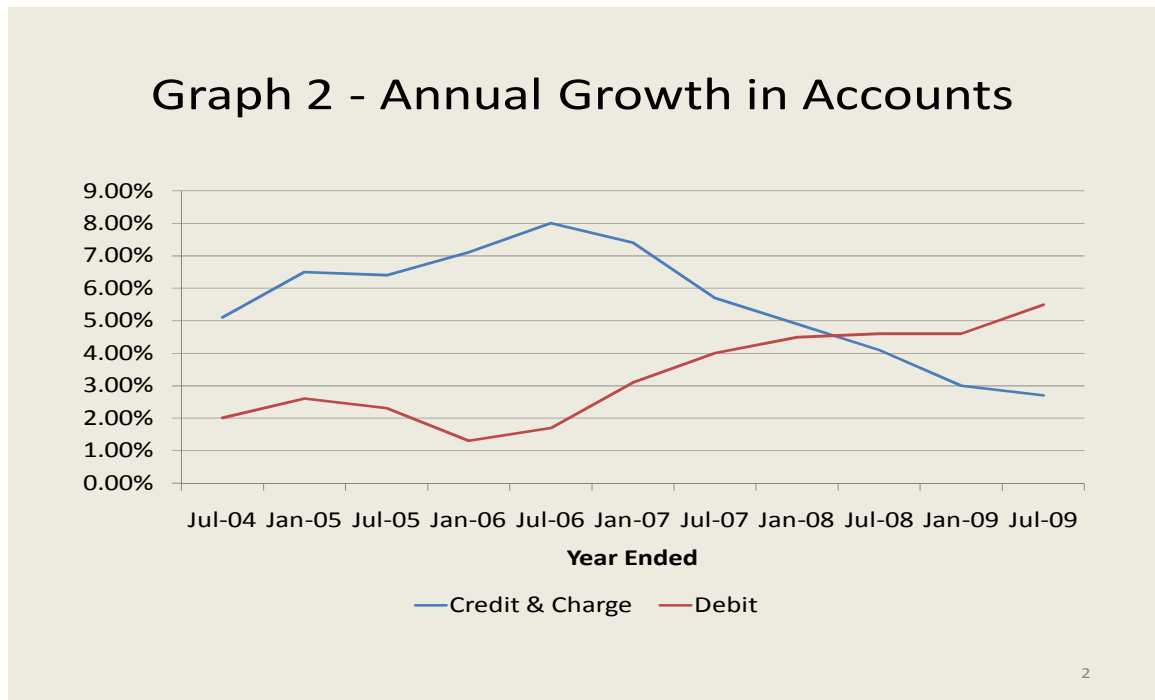
Graph 1 - Share of Value of Card Purchases on Debit



1

After exhibiting a small gain in 2004, the trend strengthened a little but has demonstrated a significant upturn during the last two years. In a market that had been experiencing very strong growth in the use of credit cards, this was a significant alteration to what had been the underlying trend.

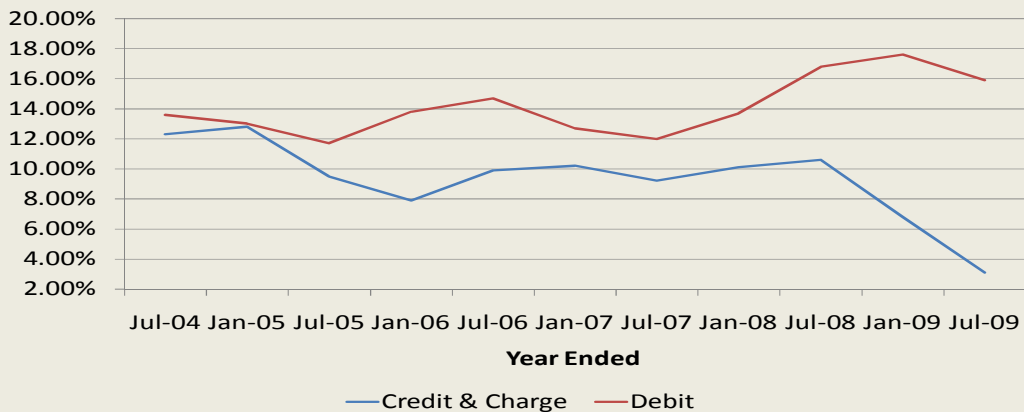
This shift is further shown by the relative growth rates in debit and credit accounts in recent years. Refer graph 2. Five years ago, credit and charge card accounts were increasing at two and a half times the rate of growth for debit card accounts. That position has now reversed and in the twelve months to July 2009, debit accounts grew at just over twice the rate for credit and charge.



When growth in card spend is reviewed, the divergence is even more dramatic. Refer graph 3. Five years ago, the annual growth in card spend was quite similar for both the debit and credit and charge segments. Following that, there was a softening of growth on credit and charge accompanied by a steady trend for debit. The last year however, has seen a very dramatic decrease in the rate at which purchases are increasing on credit and charge so that the value of purchases made with a debit card are now increasing at over five times the rate of growth on credit and charge.

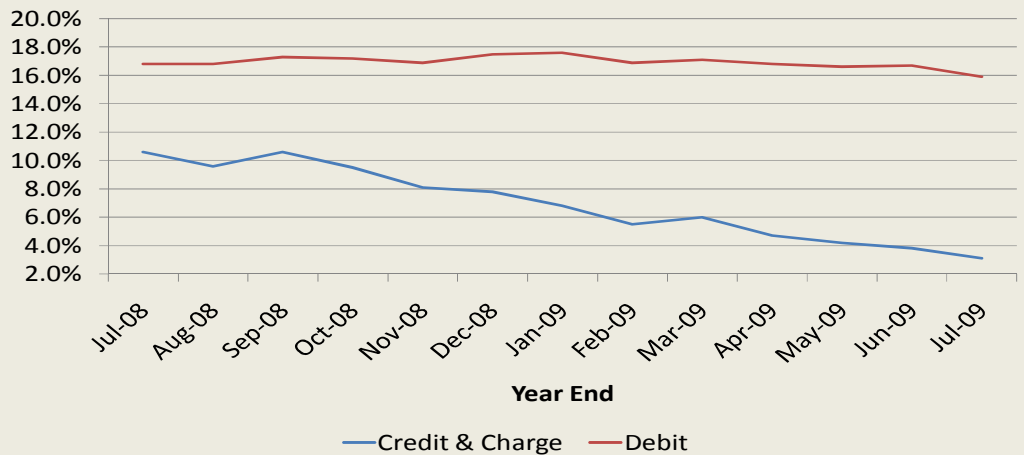
As graph 4 then shows, the volatility and uncertainty of the last year has had a profound impact on the rolling annual growth of credit and charge card use, with the annual growth rate dropping from 10.6% in the twelve months ended July 2008 to 3.1% in the twelve months to July 2009. Over this same period, the growth rate for purchases on debit was almost unaltered, moving from 16.8% at the outset to 15.9% at the end of the period.

**Graph 3 - Annual Growth Rate of Value of Purchases
5 Year Period**



3

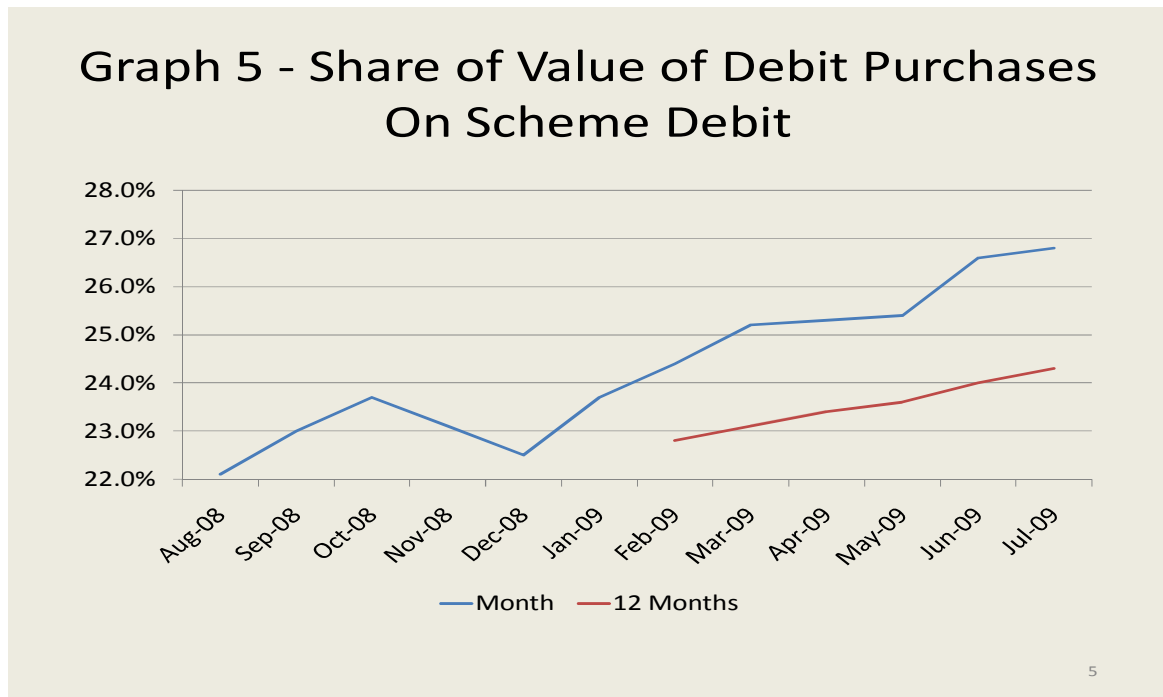
**Graph 4 - Annual Growth Rate of Value of Purchases
1 Year Period**



4

It appears that one of the primary factors resulting in the strong metrics for debit relative to credit and charge, was the emergence of scheme debit. For many years an exclusive product offering from Building Societies and Credit Unions, scheme debit began to feature in the product portfolios of the major banks in Australia over the last two years. With increasing distribution and strong marketing support, scheme debit has been achieving a significant gain in share. RBA data is only available from March 2008 but it is clear that scheme debit is outperforming EFTPOS. Refer graph 5. The value of scheme debit in July 2009 (the most recent data available) was 30.8% above July 2008 whereas EFTPOS increased by just 6.7%.

The underlying trend is that scheme debit represents a major cause for the strong growth metrics of debit relative to credit and charge. In addition to the monthly share of spend on scheme debit shown in graph 5, the share for the twelve month periods commencing in February 2009 (the first twelve month period in which data is available) is also illustrated. This share of value of purchases on scheme debit for the rolling twelve month periods starting in February 2009 has gone from 22.8% in that period to 24.3% in the twelve months to July 2009. The trend evident over the five months in which annualised data is available clearly shows the fact that growth in scheme debit is outstripping growth in EFTPOS.



Given this change in the dynamics of the payment cards market, particularly over the last one to two years, ASL believes that the changes to EFTPOS now being considered by the RBA have gained an urgency that has the endorsement of our organisation and members.

The Proposed Approach

The RBA has been instrumental in modifying the interchange arrangements applying to debit in this country. Australia has the unusual practice of negative interchange for EFTPOS whilst scheme debit originally employed scheme credit interchange standards. In 2006, the RBA reduced the maximum interchange on EFTPOS and regulated the maximum interchange on scheme debit. This had the result of significantly reducing the differential between the two products.

The industry continues to work with negative interchange on EFTPOS transactions and positive interchange on Visa and MasterCard Debit transactions. The margin between the two has lessened to the current level of around \$0.17 per transaction but there does remain a clear financial incentive for issuers of scheme debit compared to EFTPOS.

The RBA is now proposing that the differential in interchange rates between the two products be removed, to be replaced with a standardised approach for both EFTPOS and

scheme debit. Given the degree of substitutability between the two, ASL believes that this is an eminently sound approach and we support the direction proposed by the RBA. We currently have some members who only issue scheme debit, some who only issue EFTPOS and some who issue both. In some cases, these are offered to consumers as discrete options or as alternatives as they both provide national ATM and EFTPOS network coverage in the domestic Australian market. It is true that scheme debit provides international functionality as well as on-line payment capability and in these capabilities, offer features not available on EFTPOS cards. But these functional attributes should be the determinants of what product is offered rather than the commercial results of diametrically opposed interchange revenue streams.

Our Rationale

Our position is unaltered from that described in our submission of June 2008 to the RBA when you requested responses to the “Reform of Australia’s Payments System, Preliminary Conclusions of the 2008/08 Review, April 2008”. We believe that the disparity between the EFTPOS and scheme debit interchange arrangements is an anomaly within the context of not only the Australian but the global payments system.

At present, there is a substantial financial disincentive for our members to offer EFTPOS. Negative interchange places a financial burden on them by requiring a payment to the acquirer whilst in the great majority of transactions (being card present and domestic), an EFTPOS card delivers exactly the same channel capabilities as a scheme debit card. We therefore fail to see why the interchange arrangements are so fundamentally different.

It does appear that commercial factors are driving what appears to be a strong move to scheme debit. It is true that the uncertainty and volatility of the economic conditions of the last year or so have underpinned a shift in consumer preferences away from credit and charge to debit. This has been driven by a growing consumer demand for certainty and control arising from the use of own funds. But within this broader shift, there is currently a strong commercial incentive for issuers to satisfy that consumer demand with scheme debit rather than EFTPOS.

There may well have been a sound rationale for negative interchange when EFTPOS was introduced into Australia in the 1980s. An electronic authorisation and capture network did not exist and acquirers required an incentive to develop the necessary infrastructure. This rationale extended to merchants who needed to upgrade their POS systems to accommodate the emerging debit card payment option. Twenty years later, the costs and benefits for all parties are very different and we would argue that the conditions that led to a negative interchange regime are no longer applicable.

There are essentially three basic options in determining EFTPOS interchange fees. These are:

1. An Issuer cost model based upon the premise that the benefits of payment guarantees from issuers are the dominant feature.
2. An Acquirer cost model in which the acquirer is considered to be providing access to secure funds.
3. A balanced model that factors in the costs and benefits of issuers and acquirers.

It is not possible for us to analyse the costs and benefits of each of these within the relatively limited timeframe available. But it is notable that the payments industry has globally embraced a positive interchange model for credit cards (reflecting option 1. above) and to the best of our knowledge, overwhelmingly adopted a similar arrangement for the management of EFTPOS interchange. We fail to see any rationale for arguing that the Australian EFTPOS infrastructure and process is fundamentally different to that which exists in international credit and debit markets today.

ASL is therefore supportive of the removal of negative interchange on EFTPOS as the first stage in providing a rational set of price signals to the payments industry and then to consumers.

Going Forward

Having indicated our support for the standardised approach as drafted by the RBA, we also support the process in which the RBA has described this step as a further stage along the payments system review. It is important that participants in the payments system have a sound logic in which interchange rates are determined, with this facilitating a stable environment in which to plan and operate. ASL does not believe that such an environment is possible without a disciplined cost-based approach methodology in place. We strongly support moving to such a process as the next stage in the determination of on-going debit interchange rates.

In our June 2008 submission, we stated in our comments on your Option 2 that , “...if this option is implemented, members believe that the interchange fees should be set at 11 or 12 cents per transaction for both EFTPOS and scheme debit, flowing from acquirer to issuer..” We support the maintenance therefore of the current scheme debit interchange rate as well as the proposed alterations to the EFTPOS rate. Going forward though, we do not necessarily see that both rates must necessarily be identical. Nor does it follow that the proposed benchmark for EFTPOS and scheme debit will necessarily be the most appropriate. On balance however, it is our view that the issuer cost model as used in almost all global debit and credit scenarios is the most likely and appropriate model.

Whilst we share the concerns of the RBA that in the present scenario EFTPOS is at a competitive disadvantage, we do not conclude that the interchange rates for both payment products need or should be identical in the longer term. As we indicated in our June 2008 submission, the setting of the same interchange rates for EFTPOS and scheme debit suggests that the products have the same costs and benefits. Whilst similar, they are not in fact the same.

Draft Standard

We note in the RBA paper accompanying the Draft Standard for EFTPOS interchange, that the objective of the RBA is to change the interchange rate for EFTPOS to be consistent with that applying to scheme debit. As indicated earlier in this letter, ASL supports this move as a transitional step before a final determination is made.

We are not sure however, that the drafting of the proposed standard will necessarily achieve the stated objective. Notwithstanding that there are two possible means of establishing a revised EFTPOS interchange rate (multilateral and bilateral), the wording of

each states that the new EFTPOS interchange rate must not exceed the benchmark rate now in force for Visa Debit. In theory therefore, the EFTPOS rate could be \$0.12 or \$0.11 or \$0.09 or (\$0.05) or (\$0.04). Each of these rates appears to meet the wording of the draft and yet the last two examples would in fact result in no change to the status quo.

We would therefore suggest that just as the current EFTPOS standard provides a minimum (\$0.04) and maximum (\$0.05) rate, the proposed draft should do the same so that the required objective of removing or substantially removing the differential between EFTPOS and scheme debit is achieved.

We note that your draft allows for the establishment of either a multilateral weighted interchange rate by EFTPOS Payments Australia or bilaterally negotiated rates as occurs at present. Your paper accompanying the draft standard states "The draft standard also proposes that the benchmark would apply differently to interchange fees depending on whether they are set multilaterally or bilaterally. If the EFTPOS scheme sets multilateral interchange fees then the cap would apply to the *weighted average* of those fees. If, however, EFTPOS interchange fees remain bilaterally negotiated, the *actual* fees would be required to be below the cap:..."

Again, we are unsure that the current draft would necessarily achieve this objective, given that the wording of both a multilateral and bilateral interchange rate requires only that they do not exceed the benchmark, being the rate applicable to Visa Debit.

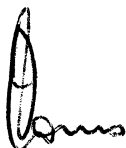
ASL does not hold a particularly strong view about whether the EFTPOS rate is best set multilaterally or bilaterally although we do favour the former. Given that there is now an industry body in EFTPOS Payments Australia and given further that bilaterally determined rates provide at least some deterrent to competition, we believe that on balance, multilaterally determined rates are the preferred way forward.

Summary

To summarise the views of ASL:

- We support the standardisation of EFTPOS and scheme debit interchange.
- The longer term should see rates based upon an agreed cost based model.
- The longer term may see similar rather than identical interchange rates for EFTPOS and scheme debit.
- The draft standard may need tightening to ensure the desired results

Yours sincerely



JOHN TOMS
CHIEF EXECUTIVE OFFICER

Reference Sources

The data used in the preparation of the graphs included in our submission are the following Payment Tables issued by the RBA:

Graph 1.

C1 Credit and Charge Card Statistics
Additional Credit Card Statistics
C5 Debit Card Statistics

Graphs 2, 3 and 4.

C1 Credit and Charge Card Statistics
C5 Debit Card Statistics

Graph 5.

C5 Debit Card Statistics