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MasterCard

Hon. Joe Hockey MP
Treasurer of Australia
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

31 March 2015

By Post and Email: ***fsi@treasury.gov.au***

Dear Treasurer,

Thank you for the opportunity to respond to the Final Recommendations of the Financial System Inquiry (FSI). We appreciate the engagement we have had with the FSI Chair, David Murray, the Panel, the secretariat, Treasury and your office during the development phase of the final recommendations. We look forward to ongoing engagement as those recommendations are considered.

MasterCard supports the Government's policy agenda to remove 'red tape' through deregulation. As you are aware, the payments system has been regulated in Australia for over a decade. The FSI process and the Government consultation on the recommendations provide the opportunity to assess and address issues which have been created by over-regulation. Since 2003, payments regulations have led to negative, unintended consequences for Australian consumers.

MasterCard has consistently held the position that the Australian Government should consider whether the current (and future) regulation of the payments system is appropriate, considering the payments system and its participants have changed considerably since regulation was implemented in 2003. Significantly, the MasterCard governance and commercial structures have changed from being a membership association to a publicly listed company with an independent board. The RBA has made this point itself in its review of the regulations governing the Access Regime:

> *"The environment has now changed significantly. Most importantly, MasterCard and Visa have both changed corporate structure to become publicly listed companies rather than member associations of banks."*

In addition, there have been many significant developments including new market entrants such as American Express companion cards, China UnionPay, PayPal, as well as the introduction of new technologies including crypto-currencies like Bitcoin. Meanwhile, a broader array of card issuers and acquirers are operating in the payments system.

While the total FSI scope was broad, the key focus for MasterCard was Recommendation 17 which relates to the payments system in Australia, encompassing interchange regulation and surcharging. We note the objectives the panel has tried to achieve through its recommendations. In relation to Recommendation 17 these objectives include:

- Addressing unreasonably high and increasing surcharging costs for consumers;

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- Reducing the cost disparity for large and small merchants, which has been one of the unintended consequences of the current regulation; and
- Applying regulation to all payment system providers in the payments system so to achieve a level playing field.

However we have serious concerns over some of the suggested mechanisms to achieve these objectives and note that there are better options to ensure fairness, efficiency and competition in the payments system whilst minimising harm to consumers. We encourage the Government to fully investigate and consider alternate policy mechanisms to achieve the objectives of the FSI.

MasterCard's goal in participating in the FSI process to date has been to help develop an environment which recognises and accounts for the importance and success of electronic payments as an efficient, convenient, safe and cost-effective means of transacting for Australians, and one that facilitates competition and continued investment in innovation.

The attached document outlines MasterCard's formal response to the FSI Final Report and Recommendations. In addition we consider that it would be highly appropriate for an industry roundtable to be convened, to explore alternative solutions in an open and constructive environment. MasterCard would certainly be willing to play an active and constructive role in such a forum, and we are confident that there would also be broad goodwill and participation from across the industry.

We look forward to working with you and your team to achieve the objectives of the FSI Report and to find alternative, practical and achievable solutions to address the issues in the payments system regulation.

Yours sincerely,

Eddie Grobler
President, Australasian Division
MasterCard

About this Submission

This submission builds upon MasterCard's two previous submissions to the FSI, which can be accessed through the following links:

- Submission prior to the FSI's Interim Report (http://fsi.gov.au/files/2014/04/MasterCard.pdf)
- Submission following the FSI's Interim Report (http://fsi.gov.au/files/2014/08/MasterCard.pdf)

This submission specifically addresses the FSI's Final Report, and in particular Recommendation 17.

About MasterCard

MasterCard has been a part of the Australian payments system since 1984. We are a technology company in the global payments industry that connects consumers, financial institutions, merchants, governments and businesses worldwide, enabling them to use electronic forms of payment instead of cash and cheques.

As the operator of what we believe is the world's fastest payments network, we facilitate the processing of payment transactions, including authorization, clearing and settlement, and deliver related products and services. We make payments easier and more efficient by creating a wide range of payment solutions and services using our family of well-known brands, including MasterCard®, Maestro® and Cirrus®. We also provide value-added offerings such as loyalty and reward programs, information services and consulting. Our network is designed to ensure safety and security for the global payments system.

A typical transaction on our network involves four participants in addition to us: cardholder, merchant, issuer (the cardholder's financial institution) and acquirer (the merchant's financial institution). We do not issue cards, extend credit, determine or receive revenue from interest rates or other fees charged to cardholders by issuers, or establish the rates charged by acquirers in connection with merchants' acceptance of our branded cards.

In most cases, cardholder relationships belong to, and are managed by, our financial institution customers.

We generate revenue by charging fees to issuers and acquirers for providing transaction processing and other payment-related products and services, as well as by assessing these customers based primarily on the dollar volume of activity, or gross dollar volume ("GDV"), on the cards and other devices that carry our brands.

Interchange fees represent a sharing of a portion of payments system costs among the issuers and acquirers participating in our four-party payments system. They reflect the value merchants receive from accepting our products and play a key role in balancing the costs consumers and merchants pay. Importantly, MasterCard does not earn revenues from interchange fees.

Generally, interchange fees are collected from acquirers and paid to issuers to reimburse the issuers for a portion of the costs incurred by them in providing services that benefit all participants in the system, including acquirers and merchants. In some circumstances, such as cash withdrawal transactions, this situation is reversed and interchange fees are paid by issuers to acquirers. In Australia we establish "default interchange fees" that apply when there are no other established settlement terms in place between an issuer and an acquirer.

We administer the collection and remittance of interchange fees through the settlement process. Interchange fees can be a significant component of the merchant service fee, and therefore of the costs that merchants pay to accept electronic payments. These fees are subject to regulation in Australia, the details of which will be outlined in the following chapters.

In our first FSI submission, MasterCard provided a detailed outline of the importance of the value of Interchange and we attached it as Appendix 1 in this document.

Impact of regulation in Australia

The payments system in Australia has been regulated by the RBA's Payments Systems Board since 2003, and we believe Australians have been negatively affected as a direct result. MasterCard has consistently argued that Government should step away from the regulation of payments so as to remove and correct those negative outcomes. Changes to regulation since 2003 have been primarily concerned with correcting damage done to the balance in the system, and they've done little to rectify consumer impact. We have consistently argued that the simplest and most appropriate way to return to a balanced, fair and equitable system – one which is not detrimental to consumers and allows the industry to deliver real value to merchants – is to remove regulation completely.

In our previous submissions to the FSI, and in subsequent meetings with both the RBA and the FSI panel and secretariat, MasterCard has outlined the ways that regulation has negatively affected innovation, increased costs for consumers and impacted the cost of acceptance for small business, creating the disparity that now exists. While the Australian payments system continues to be regulated, there will continue to be 'winners and losers'. It is clear that consumers have historically lost out and that they will continue to lose out under the type of regulation which is contemplated in the final recommendations.

In its current form, the designation system for regulation favours some participants (those payment system providers which are not regulated) and provides them with an unfair advantage over those which are regulated. Where regulation exists in the payments system, it must be applied fairly across all participants, must promote innovation instead of dis-incentivising it, and must be flexible enough to capture new market entrants.

Regulation by designation has created disparity in the costs for merchants to accept those systems which are subject to regulation (by designation) and those which are not. The Australian Retailer's Association (ARA) submission to the FSI Interim Report outlines this disparity where merchants are paying much higher costs to accept American Express and PayPal (http://fsi.gov.au/files/2014/09/Australian_Retailers_Association.pdf).

The FSI provides the Government with a unique opportunity to address the unintended consequences and disparities created by regulation. Nonetheless, the recommendations as they currently stand will not sufficiently address the issues created by the current regulation, and risk further exacerbating the problems that exist.

We encourage the Government to further investigate options for addressing the outcomes of the current regulation, given:

- That the impact of current surcharging regulation is costing Australian consumers around $4.4 million each day ($1.6 billion per year) [1]; and

[1] Galaxy consumer survey (August 2014), commissioned by MasterCard

- The negative impacts on innovation and the periods of regulatory uncertainty, particularly in relation to interchange.
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Response to FSI Recommendation 17

MasterCard's overarching position is that regulation of the payments system should be removed to address the issues which have been created. Evidence across the world demonstrates that market competition drives better outcomes than regulation in competitive industries such as payments. Harm as a result of a lack of competitive neutrality is particularly acute in Australia given the third largest player in the credit card market – American Express – falls outside the regulatory burden of payment systems regulation.

Foundationally, MasterCard asserts that any regulation should be applied to all participants in the payments system equally.

FSI Recommendation:
Publishing thresholds for determining which system providers will be regulated.

MasterCard supports the principle that payments system regulation should apply equally across the industry regardless of the size of a participant or their share of the market. However, should regulation apply only once a particular threshold has been met, that threshold should be set at a low number (if not at market entry) and it should be clear and objective. It should capture all payment system providers operating in Australia today, including those which are currently unregulated, such as American Express, China UnionPay and PayPal. This will establish fairness in the system for all, protect consumers and businesses from the uneven application of regulation and ensure that the regulatory objectives are being met by the maximum number of participants in the system.

Currently, those payment schemes which fall under the regulatory regime are identified through a designation system that has proven to lack transparency and certainty, and has led to unproductive and inequitable outcomes. Over the last decade undesignated schemes and payments system providers have substantially grown reach and market share at incremental cost to merchants and consumers.

Publishing low thresholds for determining the application of regulation would address disparities which have arisen in the designation system. Low thresholds would allow regulation to capture new entrants to the market and ensure that advances in technology in the payments system do not compromise safety for participants.

FSI Recommendation:
Broadening interchange fee caps to include all amounts paid to customer service providers in payment systems, including service fees in companion card systems.

As we have outlined above, the basic view of regulation is that if it is applied it should do so consistently and fairly to all participants. Equal treatment of all card payment systems is fundamental to an effective regulatory regime. This includes treatment of proprietary three-party payment systems such as American Express, and PayPal and the four-party "companion card" model which operates nearly identically to regulated four-party schemes.

American Express Global Network Services (GNS) cards (i.e. 'companion cards') are cards issued by a bank which utilise the American Express payments scheme. On average, merchant service fees (MSFs) charged by American Express to merchants when accepting

these companion cards are more than twice those charged for MasterCard payments[2]. An interchange-like component from these higher MSF, which flows through to card issuers, is then used by issuers to fund greater reward points for consumers.

The unregulated companion card model competes directly with regulated four-party payment scheme providers (including MasterCard). Because companion cards can generate higher fees for card issuers, American Express enjoys a distinct competitive advantage compared to designated payment systems. This competitive advantage is artificially generated by unfair application of regulation.

Issuers, including major banks, have issued American Express companion cards to a wide range of consumers seeking the higher return product offerings these cards provide. In Australia, as a result of the current regulatory environment, American Express and Diners' Club have increased their market share of Australia's credit card transactions from 13.8% in 2002 to 18.7% in 2015 (http://www.rba.gov.au/payments-system/resources/statistics/).

We note that the FSI Panel has recommended that companion card systems should be regulated as other four party systems are, moving at least some way towards a level playing field.

Whilst the FSI Final Report recognises the importance of this move, we are concerned that the proposed mechanism to achieve fairness in the regulatory system (that is, to broaden interchange fee caps) is misguided. Interchange fee cap regulation cannot be expanded because interchange is a specific payment 'charged by the financial institution on one side of the payment transaction to the financial institution on the other side of the transaction' (RBA Review of Card Payments Regulation: Issues Paper, March 2015). In other words, interchange is a payment made from a merchant service provider (acquirer) to a customer service provider (issuer).

The RBA describes in detail the costs associated with interchange fees at http://www.rba.gov.au/payments-system/reforms/cc-schemes/cc-fees-benchmark/guidance.html.

MasterCard asserts that *interchange-like* fees are applied in proprietary three-party payment schemes. These interchange-like fees functionally serve a similar purpose and cover similar costs as interchange, but are not subject to regulation because they fall outside the RBA's definition.

Consequently, we urge the Government to ensure that both companion cards and three-party scheme "proprietary" cards are included in any regulation which applies to MasterCard, Visa and Eftpos.

In order to capture companion cards within the current regulation, the RBA could monitor the total amount of compensation received by the partner on the issuing side from the three-party scheme (whether it comes from the scheme part or from the issuing or acquiring part of the business), over a certain period of time, with the total amount of the transactions done by the corresponding cards over the same amount of time.

To ensure that unregulated three-party payments system providers are captured in the regulation, an effective and simple way to control net compensation would be to require

[2] RBA *'Average Merchant Fees for Debit, Credit and Charge Cards'* Payments Data (http://www.rba.gov.au/payments-system/resources/statistics/index.html)

separate accounting (P&L) between the issuing and acquiring business of the three-party-scheme, so as to cap the flow of interchange-like payments.

The second step would be to ensure that any internal transfer received from the issuing part of the business is lower than the regulated interchange cap. Payment systems must be able to demonstrate that payments from merchant service providers to the customer service providers sit within the regulated level (i.e. 50 basis points weighted average). This would be analogous to monitoring transfer pricing.

This regulatory change would be popular among Australian businesses. A recent survey undertaken by IPSOS of 300 Australian businesses (October 2014) identified that 94% believe all payments systems should be regulated consistently (Appendix 2)[3]. In addition, only 4% of these businesses noted that the cost of accepting regulated cards such as MasterCard and Visa were 'very high' compared to 76% who noted that American Express was either 'very expensive' or 'expensive'. This reflects the RBA's own data on the average cost of acceptance of American Express (1.69%), Visa and MasterCard (0.83%) for businesses in Australia (Http://www.rba.gov.au/payments-system/resources/statistics/index.html).

FSI Recommendation:
Lowering interchange fees by reducing interchange fee caps.

As outlined in our previous submissions, the lack of consistency in how interchange and interchange-like fees is regulated across schemes has led to detrimental outcomes for consumers and for many businesses, particularly Small and Medium sized enterprises (SMEs). Lowering interchange fees further would lead to more consumer detriment, as well as further negative impacts for many merchants.

Any additional adjustment to the current regulatory environment also creates uncertainty, which can remove incentives for payment systems and financial institutions to continue to innovate in the payments space. There is some experience from around the globe that demonstrates this and provides quantitative evidence of consumer impact.

- In the United States, reductions in interchange on debit transactions as a result of the Durbin Amendment to the Dodd-Frank Act, left consumers paying more in banking costs and with no reduction in retail prices. Analysis by University of Chicago Law School economists David S. Evans, Howard Chang, and Steven Joyce found merchants collectively gained $7 billion yearly starting in 2011. At the same time, consumers began losing many money-saving banking benefits, (quantified at more than $22 billion) as a result. The estimated present discounted value of the losses for consumers as a result of the implementation of the Durbin amendment is between $22 and $25 billion. The Chicago Law School analysis explains that faulty economic theory assumed retailers would pass savings through to consumers[4].

- Research on interchange regulation in Spain has also demonstrated the link between lowering interchange rates and consumer detriment. A gradual reduction in interchange fees by more than 55% between 2006 and 2010 actually led to an increase in Spanish consumer costs by 50% (€2.35 billion in absolute figures).[5] This

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[3] IPSOS merchant survey (October 2014), commissioned by MasterCard

[4] Evans, David S. and Chang, Howard H. and Joyce, Steven, (October 23, 2013) *'The Impact of the U.S. Debit Card Interchange Fee Caps on Consumer Welfare: An Event Study* Analysis'. University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 658

[5] Juan, Iranzo and Pascual, Fernández and Gustavo, Matías and Manuel, Delgado (2012): *The effects of the mandatory decrease of interchange fees in Spain.* http://mpra.ub.uni-muenchen.de/43097/1/MPRA_paper_43097.pdf

report also showed the lowering of interchange rates "disturbed the necessary balance of the electronic payment system market and have damaged the majority of participants and society as a whole". These arrangements also "altered the four-party system, [and favour] other less participatory systems and reduces incentives to innovate to improve the quality and safety of the service."[6]

Many consumer groups globally have advocated against lowering interchange rates, because of the consumer detriment outlined above. In Europe for example a joint statement issued by six consumer groups in the United Kingdom stated that *'Retailers benefit from the use of credit cards through higher sales, lower costs of cash transportation and for securing cash on the premises, fewer losses from the use of cash, more efficient income management and a guarantee that they will receive payment. It seems unfair that the burden of paying for this service should be shifted from retailers to consumers'.*[7]

MasterCard acknowledges the challenge of the regulatory model as it currently operates, and in particular the disparity between the costs some small business are now paying in MSF compared with large businesses[8].

Currently schemes recalculate (and reset) interchange back to the weighted average every three years[9]. This period results in an upward drift in the average interchange yield per transaction as issuers change their consumer product offering.

A more regular reset requirement would see the average interchange yield remain closer to the weighted average and remove much of the upward drift that happens between resets. (There are some alternatives to this policy which also have potential to benefit smaller merchants including having a band so that a drift to a certain number (say 0.55% for credit or $0.14 for debit) would require a reset within three months.)

FSI Recommendation:
Replacing three-year weighted-average caps with hard caps, so every interchange fee falls below the interchange fee caps. This would also reduce differences in fees paid by small and large merchants.

MasterCard does not support the mechanism of a 'hard cap' to achieve lower interchange fees. Hard caps represent price setting and remove flexibility in the system – something that is vital to incentivise innovation.

The current interchange regulation in Australia allows for a weighted average of 0.50% for credit transactions (and $0.12 for debit) to be reset every three years, which provides for some flexibility in terms of an ability to provide a range of card products to meet the needs of different consumers whilst promoting innovation (such as adoption of contactless payments).

Implementation of hard caps is effectively price setting. It is a blunt policy tool, removing the flexibility within the system which has previously been used to introduce payments innovation including contactless and security measures where a lower interchange rate allows for incentives to be provided to merchants to invest in relevant infrastructure.

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[6] ibid

[7] UK Consumer Groups, (2013) 'Joint statement by consumer bodies expressing concerns about European Commission proposal to regulate interchange on card transactions' http://www.parliament.uk/documents/commons-committees/european-scrutiny/Consumer-bodies.pdf

[8] Reserve Bank of Australia (2013), Payment Systems Board Annual Report 2013, p 24

[9] Reserve Bank of Australia, Guidance Note, *'Implementation of the Standard on Interchange Fees'* http://www.rba.gov.au/payments-system/reforms/cc-schemes/cc-fees-benchmark/guidance.html

Hard caps would impact organisations that currently receive important social benefits from the weighted average mechanism. For example, MasterCard sets interchange at 0.00% for payments made to charities. It is likely this would be removed should there be implementation of hard cap interchange regulation.

Further, under the current regulatory model which is applied only to some participants in the payments system, application of hard caps would result in further disparity between the regulated and unregulated payment system providers.

Commercial Cards

If there is further regulation of interchange, there is international precedent for commercial cards to be excluded, given commercial cards deliver significant efficiency gains and cost savings when compared to the alternative payment processes (in particular invoicing). The main benefits include, but are not limited to:

- Better cash-flow management, since merchants receive money faster for cards transactions compared to payment terms following invoices process
- Working capital benefits (paying suppliers earlier/on time) by single future dated payment to the bank/issuer
- Better visibility of transactions
- Minimal administrative costs to recover/solicit late payments
- No risks of bad debt as issuer guarantees payment in case of cardholder/ company not paying
- Process efficiencies and lower administrative costs due to reduced processing time of card payments (vs. handling cash/cheques or recording and reconciling of invoices) and streamlined reporting
- Making e-commerce easier

Australian businesses significantly benefit from using commercial cards:

- Commercial "suppliers" are both receivers (merchants) and payers (card holders) in the commercial cards space. They acknowledge the advantages of paying (free) but not receiving (fees).
- Merchants reduce customer payment risk significantly by accepting card payments
- Merchants can remove debtors risk entirely by have a cards\-only policy (many examples exist in the travel management companies, distributor models etc.). This savings is usually between 1-1.5%.
- Commercial merchants participate in tenders and subsequent negotiated arrangements on the purchase/supply of products and services to entities – this includes payments terms, products, servicing and other KPI's – the price is set based on agreed deal parameters including payment timing and methodology
- Accounts receivables departments at commercial suppliers benefit significantly from streamlined receivables reconciliation facilitated by card payments – even more so where payment is at the invoice level as opposed to statement level
- Supply discounting (and dynamic discounting) is reduced through card acceptance, ensuring earlier payment, reduced administration and quicker funds flow
- There are significant cost advantages for merchants with card acceptance vis a vis debtors factoring (largely used by smaller/mid-market business to aid cash flow)
- E- commerce solutions are increasingly popular and can easily be introduced by taking advantage of online payments functionality of cards
- Supplier sales benefit (through increased volume and less leakage) from card "controls" that steer spend (per negotiated agreements)and prevent other non-preferred merchants from participating (when out of corporate policy) in the commodity category supply
- Data advantages, analytics and insights are provided from card spend to both merchants and buyers

It is essential that there is equal regulation of commercial cards between four party and three party systems. Without an exemption of both four and three party commercial cards three party schemes would be the only ones to benefit, in particular American Express given their already relevant market share in the commercial card sector.

Finally, commercial cards provide significant value to SMEs as a source of funding and working capital in the form of additional unsecured credit, as an instrument to grow commerce between SME's and governments. Should commercial cards be regulated, banks will have no option but to increase card fees and restrict access to credit to SMEs.

FSI Recommendation:
Applying caps as the lesser of a fixed amount and a fixed percentage of transaction values, instead of only one of these components. This would also increase the use of electronic payments for smaller-value transactions and ensure fees reflect costs for larger-value transactions.

MasterCard does not support the recommendation to apply the lesser of a fixed amount or a fixed percentage of the transaction value. While this recommendation purports to further reduce the costs for merchants, at present there is no technology that would support the implementation of this system and it would be technically difficult and costly to implement.

Surcharging

The regulation on surcharging has been problematic since its implementation and the FSI Panel and the Government (as referenced in the Treasurer's media comments) appear keen to address this issue. As noted in our previous submissions, Galaxy research from last year uncovered that Australian consumers are paying $1.6 billion in surcharges each year.

Over the last decade, we have seen surcharging negatively affect consumers, particularly in those industries where surcharges are excessive and implemented at much greater than the 'reasonable' cost of acceptance. The Australian public has also demonstrated their discontent with the current regulations on surcharging, with over 5,000 of the submissions to the FSI from the general public on surcharging.

As raised in the FSI final report, the challenge of the current surcharging policy is that there is no enforcement of a 'reasonable' level of surcharging and some merchants are able to continue to charge unreasonably high fees. In practice, the more complex surcharging policies become (e.g. through different tiers), the more difficult it will be enforce.

MasterCard has long supported the removal of surcharging, particularly for regulated cards, where the cost of acceptance for merchants is considerably lower than that of unregulated cards. Should a surcharge ban be re-introduced, schemes and acquirers would be able to enforce the policy. This removes the need for a government regulator to monitor and enforce a 'reasonable' level of surcharging. Whilst the FSI recommendations for surcharging have merit, they would result in increased confusion for both merchants and their customers, and would present a technological challenge.

A number of different products exist within Australia's payments industry, so additional investments would be required for merchant point of sale systems so as to determine the surcharge to be applied to different products. Contactless payments, where the surcharge would be applied after the sale completion, adds a further level of complexity as the customer would likely not know the level of surcharge until after the sale.

Overall, the recommendations do not propose a viable option for how regulation would be enforced and monitored, which is already a major challenge of the current system.

FSI Recommendation:
Low-cost system providers, such as systems subject to debit interchange fee caps, to prevent merchants from surcharging. This would prevent customers from being surcharged for using low-cost payment mechanisms that involve minimal acceptance costs for merchants, relative to other payment methods.
MasterCard fully supports the removal of surcharging when a debit card is used to make a purchase and agrees with the rationale that has been provided in the FSI final report.

However, some merchants, particularly in an online environment where the card is not visually identifiable may not be able to distinguish between a debit and a credit card, and may have to invest significantly in systems that allow them to make the distinction between the different payment methods. This cost to merchants could outweigh the benefits of cost recovery to merchants.

FSI Recommendation:
Medium-cost system providers, such as systems subject to credit interchange fee caps, to apply surcharge limits set by the PSB. This would make it easier to prevent over-surcharging, while still allowing merchants to reflect their relative costs of accepting different payment methods.

MasterCard does not support the application of a 'fee cap' determined by the Payments System Board for 'regulated' systems. While a fee set as a cap would likely lower 'exorbitant' surcharges, it may result in more merchants applying a surcharge for card payments. This increased prevalence of surcharging would negatively affect more consumers as the average cost of all goods and services may increase across all industries, rather than the industries that currently surcharge at high levels – mainly taxis, airlines, hotels, utilities and online.

FSI Recommendation:
Higher-cost system providers to continue to apply reasonable cost-recovery rules. This would give merchants the flexibility to reflect the different costs of higher-cost payment methods.

MasterCard supports merchants being able to apply a surcharge on unregulated and high cost payment system providers. Payment System Providers that are unregulated are more expensive (around double) (http://www.rba.gov.au/payments-system/resources/statistics/index.html) for merchants to accept than those card systems that are regulated, and therefore we support the Australian Retail Association's position that they should be able to recover such high acceptance costs.

If these payment system providers remain unregulated, and their costs remain much higher, Australian businesses should be able to recover the costs for accepting that payment system.

Conclusion

The original circumstances surrounding regulatory interventions in the payments system no longer exist. MasterCard (and its main card competitor Visa) are now independent public companies, a substantial part of American Express now functions in effect as a four party scheme model, and there is increasing competition in the payments sector from both traditional providers as well as providers with new business models.

The unequal regulatory playing field, which impacts some market participants (notably MasterCard and Visa) with a substantial burden, while others (notably American Express, Diners Club, Union Pay and PayPal) are subject to little or no payments regulation burdens is fundamentally unfair and has resulted in unintended, negative consequences for end users of the system. Most notably, consumers are not getting accurate price signals about the costs of their choice of payment due to a distorted surcharging model, and small and medium businesses are paying more to accept MasterCard and Visa payments through the regulated interchange model. These challenges are most appropriately overcome, if not through the removal of regulation, then through policy changes which encourage flexibility and innovation, continued investment in the payments sector, and consumer benefits.

This FSI process provides an opportunity to seek industry and consumer solutions to problems created by payments regulation, and MasterCard welcomes the opportunity to participate in the process ahead, and to engage in a thoughtful and meaningful way with Government to address the current shortcomings of the regulatory system

MasterCard considers that it would be highly appropriate for an industry roundtable to be convened, to explore alternative solutions in an open and constructive environment. MasterCard would certainly be willing to play an active and constructive role in such a forum, and we are confident that there would also be broad goodwill and participation from across the industry.

Appendix 1 – Interchange (from MasterCard FSI Submission 1)

Arguably, the most controversial regulation from the RBA's Payments Systems Board was interchange regulation. But before we begin to analyse the regulatory impact, it is worthwhile providing some context.

The Value of Interchange
Electronic payments offer a wide range of benefits to all participants in the payments value chain – consumers and businesses who use our products to make payments; businesses that accept payments using our products; banks which issue and acquire MasterCard transactions; and governments. Like any valuable service with advanced technology behind it where innovation and development is vital, it comes at a cost. Businesses pay a Merchant Service Fee (MSF) to acquirers for acceptance and services.

What is Interchange?
As described earlier, interchange fees share a portion of payments system costs among the issuers and acquirers who participate in the four-party payments system. It is a small fee that reflects the value merchants receive from accepting our products. Under Australian regulation, it is capped on reset at an average of 0.50% for domestic credit card transactions and $0.12 for debit card transactions.

It is important to note that MasterCard derives no direct benefit from interchange fees and, accordingly, there is no incentive for MasterCard to set interchange at high rates which would negatively impact merchant acceptance or low rates – which would negatively impact card issuance.

In fact, the aim of setting the level of interchange fees at the optimal level is to ensure that issuers and acquirers are able to deliver services that optimise the output of our payment network and are in the best interest of the wider market.

The need for interchange exists because payment networks such as MasterCard provide a "joint service" simultaneously to two different types of users – cardholders who use the products and business who accept them for payments (referred to in payments systems as 'merchants'). Given the market for payment services has two distinct types of end users, it is sometimes referred to as a "two-sided market". It is important to bear both of these concepts in mind when analysing any aspect of a payment network's operation, as they affect both efficiency and profitability.

Setting interchange at the appropriate level for the two types of end users is a complex process. Theoretically, the entire cost of a payment network could be borne either by the cardholders or by the merchants. But experience shows that a payment network achieves its greatest efficiency and scale if the end-users share the cost. This sharing is often referred to as "balancing" the network. Ultimately, MasterCard's methodology equitably balances the cost of the payment network services between users. MasterCard believes that an interchange setting methodology must:

- ensure that interchange fees are set:
  - independently of those who pay or receive them;
  - transparently, so it is consistent with legitimate competitive concerns; and
  - objectively, in order that there is a legitimate basis for each interchange fee;
- take into account all relevant considerations, including:
  - the nature of the particular payment stream;

    - the interchange fees or corresponding fees or costs of competitive payment systems (to the extent known by the payment network operator);
    - the costs of the recipients of the interchange fees;
    - the levels of cardholder usage and merchant acceptance; and
    - the impact of interchange fees and other fees on particular categories of users (i.e. cardholders) and acceptors (i.e. merchants);
- require that interchange fees are published in a form available to all stakeholders;
- allow for the integrity of the process to be verified through an appropriate level of independent audit and regulatory oversight; and
- create a level playing field and not disadvantage four-party payment networks when competing with three-party payment networks.

Globally, MasterCard's interchange methodology incorporates these principles and is aimed at promoting the widespread issuance and acceptance of MasterCard products, taking into account costs, competition, issuer and merchant behaviour, possible fraud losses, the business environment, the regulatory environment, systems implications and other relevant factors, in order to maximise the value of the MasterCard brand and business for the benefit of its customer banks, merchants and consumers. Under the fee structure matrix usually adopted by MasterCard, transaction criteria, product criteria, category criteria, and volume are all taken into account in determining the level of interchange. While MasterCard retains the sole authority to set and change default interchange rates (in Australia within the confines of regulated caps), issuing and acquiring financial institutions are free to negotiate individual terms of dealing, including setting interchange fees bilaterally. Throughout the world, periodic adjustments are considered to interchange fee rates and these are generally based on a range of factors including changes in market conditions, competitive environment, and/or other factors as outlined above.

In Australia as a direct result of regulation much of what is described above is delivered in a way that cannot maximise the balancing effects of interchange. MasterCard's ability to set rates in a way that incentivises innovation, facilitates efficiency and delivers growth is reduced as a result of a regulatory framework that fails to acknowledge competitive forces. This regulatory framework was implemented at a time when MasterCard was owned and operated in a different way, in a different environment and with very different competitive landscape. In Australia, interchange regulation has had the effect of benefiting one distinct party in the value chain (large merchants) at the cost of others (consumers and smaller merchants).

Flexible interchange rates are essential
Flexible rates ensure merchants and consumers receive maximum value for electronic payments at the lowest cost. Experience shows that when governments attempt to address merchant cost concerns by reducing interchange, consumers and small businesses (including smaller merchants) suffer cost increases and reduced benefits.

That said, it is essential that merchant concerns about interchange costs are examined and appropriately addressed. To this end, MasterCard is committed to continuing this dialogue through direct engagement with Australian merchants who play a vital role in the system. We believe this has actively addressed business concerns while at the same time protected consumers and merchants from the consequences of arbitrary interchange restrictions.

The following points provide an overview of the role of interchange and the importance of avoiding arbitrary limits.

Merchants receive enormous benefits from accepting cards
These include reducing the significant costs associated with counting, safeguarding and transporting cash and limiting the losses that occur when cash received is lost or stolen.

Merchants who accept cards also receive the most important commercial benefit: the ability to accept cards increases sales. Studies show that consumers spend more when they use cards and merchants make more money when they accept cards. This is not surprising since shoppers using cards are not limited to cash on hand but can access their funds on deposit or credit available from their banks when they make their purchasing decisions. These increases in spending (in a responsible way with appropriate consumer protections) are precisely the reason merchants began accepting cards and, with the increasing numbers of cards in Australia, these spending increases have become more valuable over time.

The benefits merchants receive are generated primarily by the card issuers
Card issuers incur all of the costs of attracting cardholders to the network, issuing the cards and servicing the accounts. Card issuers manage the accounts and extend all of the credit that enables consumers to purchase more from merchants than they could if purchases were limited to cash on hand. Card issuers also take all of the risk—the merchant gets paid by the card issuer even if the consumer never pays for the transaction.

While card issuers generate the bulk of the benefits merchants enjoy, they do not have a direct relationship with the merchant
In the MasterCard system, merchant relationships are handled by a second group of financial institutions (the acquirers). Acquirers connect merchants to our network but it is the issuers that create the benefits and take all the risk for the merchants. So the question is: How do issuers receive fair compensation for providing all of these benefits to merchants without having a direct relationship with those merchants? The answer is interchange. The acquirer then passes this interchange fee on to the merchant as part of the overall Merchant Service Fee (negotiated between a merchant and its acquirer).

When interchange is set based on market conditions, everyone benefits
That is because MasterCard sets the rates at levels that maximise the benefits issuers create for merchants, while keeping merchant costs low enough to maximise the value merchants receive from accepting our cards. By ensuring that merchants provide compensation for the value they receive, we are also able to ensure costs are kept down for consumers. The benefits of our approach can be seen when compared to other models. For example, when retailers extend credit themselves (such as store based credit), the interest rates charged to consumers are almost always higher than for a MasterCard credit card because in a retail credit program the consumer pays for all of the benefits the consumer receives as well as all of the benefits merchants receive. American Express operates a different model where the bulk of the costs are paid by merchants and, consequently merchants typically pay significantly more than they do for accepting MasterCard branded cards.

The market response to American Express is instructive — because it imposes higher costs on merchants, far fewer merchants accept Amex cards[10] and far fewer consumers have Amex cards in their wallets, making the overall utility of Amex to consumers and merchants lower than with MasterCard. By using interchange to balance the costs between consumers and merchants, we address both the store credit and the Amex problems. In our network, consumers and merchants receive the benefits of electronic payments at lower costs than they would incur if forced to absorb the costs on their own. This is a major reason why more consumers hold, and more merchants accept, our cards than store cards or American Express.

The impact of interchange caps on consumers is frequently discounted

[10] HSN Consultants Inc., (March 2014), *'The Nilson Report'* Issue 1036, pg's 1, 9

Because interchange is paid by merchants, there is a tendency to view it simply from the merchant perspective. For example, the European Commission has based its view of interchange on its so-called "merchant indifference test" and the limits are designed to ensure merchants are indifferent as to whether a consumer pays in cash or by debit or credit card. This test begs the question why the merchants' indifference should trump the consumers' and ignores the very significant consequences for consumers when interchange levels are set solely to achieve merchant indifference.

When the RBA looked at interchange over a decade ago, they focused too heavily on costs to merchants. For example, in its "Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access" report in October 2000, the RBA made 249 references to merchants, but only 33 references to consumers. Similarly, in its "Reform of Credit Card Schemes in Australia" consultation document in December 2001, the RBA made 626 references to merchants, but only 123 references to consumers.

Artificial limitations on interchange harm consumers
When interchange fees are artificially reduced through government intervention (as they have been in Australia) merchants no longer pay compensation for the benefits they receive from issuers . As a result, consumers end up paying higher costs and receive fewer services and benefits. The experiences here in Australia, as well as those in Spain and the US bear this out.

- In Australia, after the RBA reduced interchange fees benefiting large merchants (through lower acceptance costs), consumers paid the price, paying up to 50% more for their cards.
- In Spain, government intervention resulted in a €3.329 billion reduction in interchange over the five year period between 2005-2010. Again, while merchants received a significant cost reduction of almost €2.75 billion during that period, consumers paid the price and had to bear more than a 50% increase in annual fees for standard four-party payment cards. The additional cost to consumers amounts to €2.350 billion over the five year period. Other fees have also been increased, such as those charged to consumers for overdrafts and debt claims. Consumers saw their card rewards and promotions reduced in addition to paying more for these reduced benefits.
- In the US, consumers suffered similar consequences when debit interchange was regulated there. Many no-cost or low-cost bank accounts were eliminated and consumers now pay increased fees for basic deposit account services.

Artificial limits on interchange harm Small and Medium Enterprises (SMEs)
SMEs feel the effects of interchange limits in three ways.

First, many SMEs are cardholders who rely on their credit cards as an important source of credit to keep the business running when cash flow is insufficient to cover current expenses. These cards also simplify the process of purchasing inventory and supplies by replacing the cumbersome purchase order and cheque writing process traditionally used for these operations. While this may seem like a relatively modest benefit, it can be extremely important to small merchants because it allows them to focus on the business rather than administrative tasks. Artificial reductions in interchange have precisely the same impact on SMEs as they have on other cardholders – the costs of their cards go up when merchants who accept cards no longer pay for the benefits those merchants receive.

Second, many SMEs also accept cards. While they may view interchange reductions as potentially beneficial, experience shows otherwise. For example, the RBA's most recent PSB Annual Report (October 2013) showed that, as a result of interchange regulation Australian SMEs are more likely to pay much more (up to ten times more) to accept card payments than large merchants. Similar results were found in the US. This is because of the

natural disparity in bargaining position between large and small merchants – larger merchants are able to negotiate to obtain the full cost reduction from interchange fee reductions while SMEs find that negotiation more difficult. This results in widening disparity in costs between large and small merchants, which causes SMEs to fall further behind in their efforts to compete with larger merchants.

Third, artificial interchange reductions can have an even more painful impact on SME's in the form of a reduction of credit availability. The flow of interchange enables issuers to take more credit risk and extend more credit than is possible when relying entirely on cardholders to compensate for that risk. When interchange is artificially reduced, issuers can be forced to considerably reduce risk to reduce costs in an effort to offset the reduction in interchange revenue. Reduced risk means reduced credit availability which harms SMEs as both cardholders and acceptors of cards. Reduced credit availability means less credit extended to SMEs to run their businesses. Given the relatively sluggish lending to SMEs from other sources, reductions in credit card lending is particularly painful. Reduced credit availability also means that the cardholders who purchase from SMEs will have less credit available to spend in their shops.

Artificial reductions in interchange impede innovation
When interchange regulation began, the reduction in revenue significantly changed the business case for issuing payment cards of all types. Just to get back to pre-regulation levels of profitability, card issuers needed to impose higher fees on cardholders and/or reduce credit availability and other services to reduce costs. This has an adverse impact on investment in innovation at precisely the same time as innovation is increasingly demanded by consumers and merchants alike. For example, as issuers seek to offset interchange reductions, they likely will be in a weaker position to invest in costly but vital security innovations like the move to EMV cards which was delayed as a result of interchange regulation. In a 2008 CRA International report on the effects of regulation in Australia, they made this precise point:

> *"The RBA intended that its interventions would reduce the profitability of issuing four-party cards, and this reduction in profitability naturally reduces issuers' incentives to invest in new types of four-party cards. Our interviews with the major Australian banks confirmed these views. Each of the banks in Australia we interviewed told us that the interventions have made it more difficult to develop a "business case" for investments related to four-party cards. Banks cited the introduction of EMV/Chip and PIN and the provision of prepaid cards to commercial clients as examples of projects that have been adversely affected by the RBA's interventions."*[11]

While interchange regulation is not the answer, merchant concerns about the costs of accepting electronic payments must be addressed
As electronic payments increasingly replace cash and cheques, merchants understandably are focused on the costs of those payments. MasterCard is committed to engaging with merchants to address their concerns and to ensure that interchange rates in our system are set at levels that maximise the value they receive while controlling their costs. Through commercial negotiations, we believe these issues can be resolved in a way that protects the interests of consumers and merchants alike without the need for regulation.

Looking at regulation through the eyes of participants
For Australian consumers there have been more negatives than positives as a result of regulation, as the effective price to cardholders for using their credit cards has increased.

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[11] CRA International (April 2008) *'Regulatory intervention in the payment card industry by the Reserve Bank of Australia'*

Annual fees have grown; the value of reward programs has been diluted, surcharges on payment card transactions have been introduced by some merchants (often at rates that are substantially higher than the MSF's that they are paying) and the use of 'blended' surcharge rates further compounds this gouging of consumers. And, as described above, there is no evidence that prices paid by Australians at the point of sale have fallen as a result of the reduction in interchange fees. *"The Personal Credit Card Market in Australia: Pricing over the Past Decade"* report, written by Chan et al (2012) found that *"over the past decade it has become increasingly expensive for cardholders to earn reward points and other benefits by using their cards, while merchant service fees have fallen"*[12].

However, for large merchants there have been more positives than negatives. With the reduction in interchange fees, the MSF's that they pay have fallen and indeed have continued to fall; there is no evidence that these lower costs have been passed onto the consumer through lower prices and the removal of the restrictions on surcharging has given some merchants a 'double whammy' of benefits.
They are now allowed to directly charge consumers for using payment cards rather than building those card acceptance costs into the prices of their goods and services as they had been prior to the removal of the 'no-surcharge' rules. But at the same time, the use of 'blended' surcharges, which sees an average surcharge applied to all types of payment cards, no matter what their specific cost, has allowed merchants to gain extra income for every payment card transaction.

As we have indicated above, the shift away from costly and inefficient cash payments across to electronic payments has slowed in Australia. The continued use of cash does not add to the potential efficiency of the financial system, nor does it benefit any legal participants of the payments value chain. Speaking at the Institute of International Finance's conference in Sydney, ahead of the G20 meeting in February 2014, Daniel Mminele, deputy governor of the South African Reserve Bank claimed that every 1 per cent increase in payment card usage would increase consumption by 0.06 per cent and GDP by 0.03 per cent, as this would mobilise household savings and hence enhance productive opportunities.

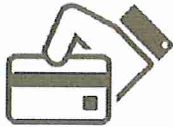
[12] Chan, Chong and Mitchell, Reserve Bank of Australia (March 2012), *'The Personal Credit Card Market in Australia: Pricing over the Past Decade'* http://www.rba.gov.au/publications/bulletin/2012/mar/pdf/bu-0312-7.pdf

Appendix 2 – IPSOS Merchant Survey (October 2014)

Survey: Australian business perspectives on Card Fees

Businesses in Australia believe American Express and Diners Club should be regulated in the same way as Visa and MasterCard.

In a recent survey conducted by Ipsos amongst Australian businesses, 59% were not aware that Visa and MasterCard are regulated for merchant related payment costs in Australia, but American Express and Diners' are not. A very large majority (94%) are in favour of all payment systems being regulated in a consistent way.



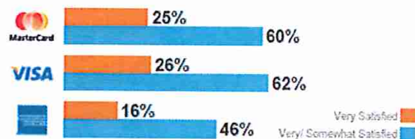
Business perspective on regulation of the costs of card acceptance

Know that currently Visa and MasterCard are regulated for merchant related payment costs in Australia, but American Express and Diners' are not.

Think that all payment systems should be regulated in the same way.

Satisfaction with Processes and Support

Businesses are more satisfied with the network processes and support received from MasterCard and Visa than from American Express.



Base: All accept American Express (164) MasterCard (291) or Visa (295)

Q. Currently, how satisfied or dissatisfied are you overall with the processes and support (such as call center support, problem resolution, and settlement terms) associated with accepting each of the following payment card types?

Up to 75% of businesses would not pass on any potential savings to consumers by reducing prices.

Would use the saved money…

25% To reduce the retail prices for my customers

24% To increase my revenue

43% To invest into/innovate my company

8% Don't Know

Q. If the costs of accepting payment cards were reduced, what would your business do with the money saved?

Fees Associated with Card Payment Types

	Don't know	Very Low	Fairly Low	Average	Fairly High	Very High
American Express	3%	2%	4%	15%	38%	38%
Diners Club	3%	4%	9%	31%	22%	31%
MasterCard	4%	4%	12%	56%	18%	4%
Visa	5%	4%	13%	57%	17%	4%

Q. Thinking specifically about the fee charged on card payment transactions, how would you rate the fees associated with using each of the following card payment types?

American Express is accepted by more than half of businesses (55%). Diners Club is accepted by a quarter (23%). Both American Express and Diners are correctly* perceived to have higher fees than other cards: Almost 40% of Australian businesses say American Express fees are *Very High*, compared with only 4% who say the same thing for MasterCard or Visa.

*http://www.rba.gov.au/statistics/tables/xls/c03hist.xls

Survey Methodology: This survey is based on 300 telephone interviews conducted by Ipsos Public Affairs on behalf of MasterCard with managers and owner/proprietors from a selection of business sectors across all Australian states and territories. Sectors were selected based on likelihood for having relatively high volume of credit card transactions and include: retail, healthcare, food, entertainment, accommodation, automotive, travel, transport, education, utilities, insurance and telecommunications. Fieldwork was conducted between 10 September and 3 October 2014. The survey has a confidence interval of ± 5.7%.

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