MasterCard
Australasia
Level 8, 100 Arthur Street
North Sydney NSW 2060
Australia

tel +61 2 9466 3700
fax +61 2 9959 3296

www.mastercard.com.au

MasterCard

Dr Kathleen Dermody
Committee Secretary
Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

06 August 2015

Via e-mail: ***mailto:economics.sen@aph.gov.au***

Re: Economics References Committee Inquiry into Matters Relating to Credit Card Interest Rates

Dear Dr Dermody,

Thank you for the invitation to provide a submission to the Economics References Committee (the Committee) Inquiry into Matters Relating to Credit Card Interest Rates (the Inquiry).

MasterCard welcomes the opportunity to participate in the Inquiry, which we believe will play a valuable role in ensuring a balanced regulatory regime exists to enable Australians to have access to affordable credit, protection from fraud and its costs and product choice.

We note that much of the focus of this Inquiry relates to credit card interest rates. Whilst MasterCard does not play any role in determining interest rates and does not receive revenue from interest rates, we are very pleased to comment on those Terms of Reference which do have a direct relationship with our business.

This Inquiry is timely given the Reserve Bank of Australia's (RBA) current plans to further intervene in the regulation of the domestic payments system, which evidence shows is likely to adversely impact consumers through increased interest rates, reduced access to low-cost credit cards and higher banking fees. MasterCard's submission focuses primarily on two key issues:

- Interchange fees – specifically, the benefits they provide within the payment system and adverse consumer impact arising from regulation of these fees. This requires the Committee's urgent attention given the threat the RBA's regulation poses to low-cost cards and forecast increases in interest rates and card fees for consumers; and
- Competitive Neutrality – specifically, the lack of it and the resulting market distortion caused by the current regulatory regime, which discriminates between industry participants and, as a result, adversely affects small businesses and consumers.

To ensure these potential impacts are fully understood and to highlight the options available to correct them, MasterCard has made many submissions to the various inquiries on related issues over the years – most recently, the Commonwealth Government's Financial Systems Inquiry

(FSI)[1] and the Reserve Bank of Australia's *Review of Card Payments Regulation – Issues Paper*[2]. Copies of these latest submissions are attached.

Given the significant value of electronic payments to the Australian economy and to consumers and merchants in particular, MasterCard contends that Government and regulators should agree to a regulatory framework that advances the ongoing development of the payments system over cash payments and mitigates unnecessary risk and costs to consumers.

MasterCard would welcome an opportunity to have an ongoing dialogue with the Committee to help ensure Australians continue to have access to affordable credit, fraud protection and product choice.

Yours sincerely,

Eddie Grobler
Division President, Australasia

[1] MasterCard's submission in response to Financial Systems Inquiry, 31 March 2014, viewed online at: <http://fsi.gov.au/files/2014/04/MasterCard.pdf>
MasterCard's submission in response to Financial Systems Inquiry, 26 August 2014, viewed online at: <http://fsi.gov.au/files/2014/08/MasterCard.pdf>
MasterCard's submission in response to Financial Systems Inquiry, 31 March 2015, viewed online at: <http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Financial%20System%20Inquiry%20Final%20Report/Submissions/PDF/MasterCard.ashx>

[2] MasterCard's submission in response to Financial Systems Inquiry 24 April 2015, viewed online at: <http://www.rba.gov.au/payments-system/reforms/submissions/review-of-card-payments-regulation/mastercard.pdf>

About MasterCard

MasterCard is 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.

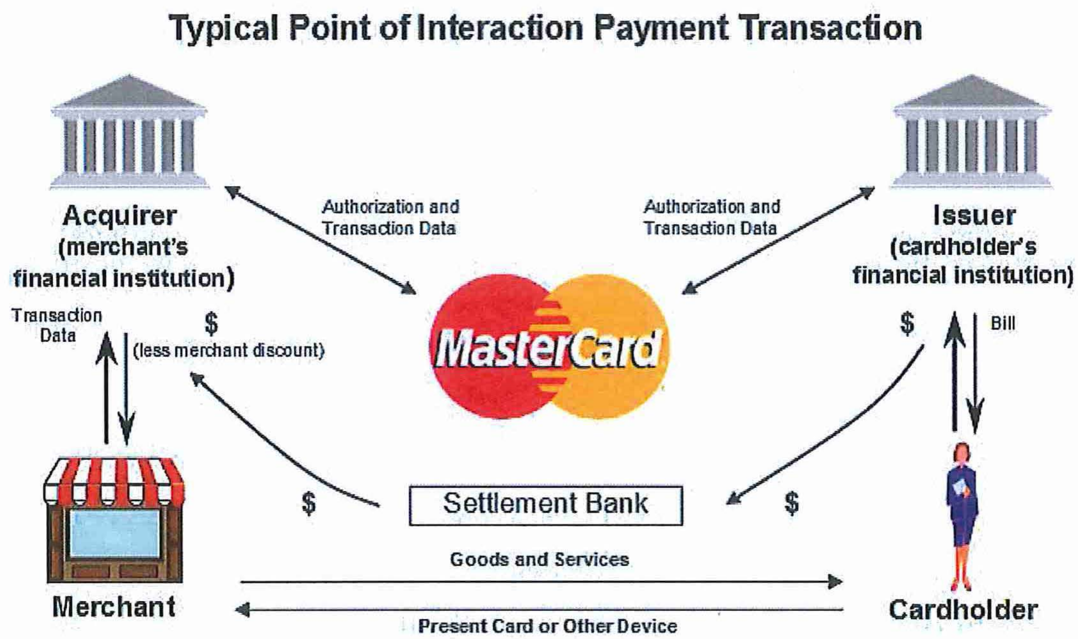
As the operator of what we believe is the world's fastest payments network, we facilitate the processing of payment transactions, including authorization, clearing and settlement, and deliver related products and services. We make payments easier and more efficient by creating a wide range of payment 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 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.

MasterCard Network – a typical transaction:

With a typical transaction involving four participants in addition to us, our network supports what is often referred to as a "four-party" payments network. The following diagram depicts a typical transaction on our network, and our role in that transaction:



In a typical transaction, a cardholder (or an account holder who may not be using a physical card) purchases goods or services from a merchant using a card or other payment device. After the transaction is authorized by the issuer, the issuer pays the acquirer an amount equal to the value of the transaction, minus the interchange fee (described below), and then posts the transaction to the cardholder's account. The acquirer pays the amount of the purchase, net of a discount (referred to as the "Merchant Service Fee", as further described below), to the merchant.

Fees, Charges and Cardholder Relationships

Interchange Fees
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.

We do 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. We or financial institutions 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.

In Australia, MasterCard is responsible for setting interchange fees, which facilitate the secure and efficient functioning of the Australian payments system. Interchange fees deliver major benefits to cardholders by:

- covering the cost of fraud protection
- allowing cardholders to be automatically repaid in the event of fraud
- paying for the interest free days on credit cards
- funding investments in innovation such as 'tap and go' technologies

Interchange fees deliver major benefits to merchants:

- allowing businesses to accept cards, which increase sales[3]
- guaranteeing payment and eradicating credit risk[4], and
- funding innovation such as tap and go

While MasterCard does not directly earn revenue from interchange, we do benefit when interchange is set at rates which are appropriate to drive higher volumes of electronic payments.

The interchange level can be deemed appropriate when it is set:

- Low enough for merchants to realise the economic benefits of accepting cards; and
- High enough to fairly compensate issuers for the costs involved in issuing cards to consumers, business and government employees.

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[3] According to the RBA, credit card sales at large merchants are on average about three times as large as cash transactions. Stewart, C., Chan, I., Ossolinski, C., Halperin, D., and Ryan, P., 'The Evolution of Payment Costs in Australia', RBA Research Discussion Paper, 2014-14, Table B2, p. 60.

[4] Every year, banks write off 2-4% of credit card balances as losses – a cost which would sit with merchants without interchange fees. Rodgers, D., 'Credit Losses at Australian Banks: 1980-2013', Reserve Bank of Australia Research Discussion Paper, May 2015, p. 21

In Australia, since 2003, interchange fees have been regulated by the Reserve Bank of Australia. As a result of that regulation, every three years, the weighted average for interchange on credit must be reset at 0.50%.

Additional Four-Party System Fees
The "Merchant Service Fee" is established by the acquirer to cover its costs of both participating in the four-party system and providing services to merchants. The rate takes into consideration the amount of the interchange fee which the acquirer generally pays to the issuer. Additionally, acquirers may charge merchants processing and related fees in addition to the merchant service fee, and issuers may also charge cardholders fees for the transaction, including, for example, fees for extending revolving credit.

MasterCard does not earn revenue from interchange fees and does not issue cards; extend credit, determine interest rates or other fees charged to card holders by issuers. Nor do we establish the 'Merchant Service Fee' (MSF) charged in connection with the acceptance of cards and other payment devices that carry our brands.

MasterCard generates revenue by charging fees to issuers (the cardholder's financial institution) and acquirers (the merchant's financial institution) for providing transaction processing and other payment-related products and services.

Cardholder relationships belong to and are managed by the card issuers (our customers).

In addition to these services, MasterCard makes a concerted effort to educate consumers to make informed decisions about product choices, and to provide consumers with tools to assist in responsible budgeting and fraud protection. For further details of this, please see MasterCard's Consumer Education page on our Australian website: http://www.mastercard.com.au/education.html.

Interchange Fee Regulation – The Impacts

While many of the Terms of Reference to this Inquiry are outside MasterCard's remit for the reasons explained above, the first of two key issues of relevance is the negative impact on both consumers and innovation in the cards market from the regulation of interchange.

The second key issue is the uneven application of regulation to payment systems resulting in a distortion of the market, which will be addressed later in this submission.

There is clear evidence that intervention by the RBA to regulate interchange fees rather than allowing a competitive market to operate as occurred in Australia in 2003, has adversely affected consumers.

Where interchange has been regulated, both in Australia and overseas, costs to consumers have demonstrably increased. This is because the regulation broke the economic model whereby the beneficiary of a service paid a part of the cost of offering that service. Subsequently, for that benefit to continue to be provided the costs were passed to consumers who saw no benefit from merchants who, despite seeing reduced costs in accepting MasterCard cards, did not pass those cost savings on to consumers in the form of lower prices at the point of sale.

One such benefit received by merchants but paid for by issuers is credit losses. To explain, it is useful to consider an example. Think about the circumstances if a consumer purchases a new television for $2,000 with a MasterCard credit card, takes the television home, but then defaults on their credit card and never makes good on that purchase (that is, never repays their credit card issuer). In that case the merchant that sold the television will still retain the

$2,000 for the purchase, but the issuer (who provided the consumer with their credit card) has borne all of that credit risk and will suffer the $2,000 loss. The average MSF in Australia according to the RBA is 0.83% (for MasterCard and Visa) which means the merchant on average paid their acquirer $16.60 to accept that particular payment. The benefit they received was the full price of the $2,000 transaction. To further extend this real life example, credit losses in Australia according to the RBA are between 2% and 4%[5]. Given interchange for credit cards is capped at an average weighted 0.50%, merchants are receiving benefits well in excess of the interchange paid simply in the form of credit losses.

The reduction in interchange fees considerably harmed consumers by causing higher cardholder fees. Following interchange regulation, annual cardholder fees increased by 38% and 30% in 2003 and 2004 respectively. Evidence for these increases can be found in the Reserve Bank of Australia Bulletins of (May 2004 and May 2015). At the same time, no evidence exists that any reductions in Merchant Service Fees (MSF) were passed through to consumers. In fact, the RBA itself has made a slow, but consistent, retreat from specifically linking the regulations with savings passed through to consumers in the general level of prices.

- In 2002, the RBA said savings (as a result of regulation) would be passed "through to the community in the general level of prices"[6];
- In 2005, the RBA's Payment Systems Board (PSB) said they believed there had been "smaller price increases [for consumers] than otherwise would have occurred"[7] in the absence of regulation;
- In 2006, the RBA stated that the flow in savings for merchants on to consumer prices was "difficult to measure"[8];
- In 2007, the PSB acknowledged that merchants saved a considerable sum "which in the normal course, would be passed through into lower prices for goods and services"[9] but did not suggest there had been any savings for consumers;
- In 2010, the PSB said, since "the introduction of the reforms, decreases in merchant service fees across all four schemes are estimated to have produced cumulative savings to merchants of around $6 billion"[10], but again, did not mention any pass through of these savings to consumers nor specifically mentioned any consumer benefits from surcharging;
- In 2011 in their consultation acknowledging problems created by surcharging regulations, the RBA stated "merchants have increasingly been adopting a number of surcharging practices that have the potential to distort price signals and thereby reduce the effectiveness of the surcharging reforms."[11]

A report by CRA International produced in 2008 found there is no evidence that any savings to merchants as a result of regulatory intervention have been passed on to consumers.[12]

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[5] Rodgers, David: "Credit Losses at Australian Banks: 1980-2013"; Reserve Bank of Australia Research Discussion Paper, May 2015. pp 21.
[6] RBA Media Release, 'Reform of Credit Card Schemes in Australia', 27 August 2002
[7] Payment Systems Board, Annual Report 2005
[8] Payment Systems Board, Annual Report 2006
[9] Payment Systems Board, Annual Report 2007
[10] Payment Systems Board Annual Report 2010
[11] RBA Consultation Paper, 'Review of Card Surcharging: A Consultation Document', June 2011
[12] Stillman, R., Bishop, W., Malcolm, K., Hildebrandt, N., 'Regulatory Intervention in the Payment Card Industry by the Reserve Bank of Australia'; CRA International, April 2008, p. 25.

Further, an IPSOS poll conducted in Australia between September and October 2014 (commissioned by MasterCard), found that up to 75% of business owners would not pass on any potential savings in interchange fees to customers by reducing prices.[13]

Evidence shows that as a result of the RBA's first intervention on interchange fees in 2003, cardholders are now paying approximately $480m each year in additional fees as costs were shifted onto them.[14] The RBA itself concedes that the costs to consumers of using cards are now higher.[15]

Despite this evidence, the RBA is now considering further regulation of interchange. This has prompted a number of banks and credit unions / societies which provide many low-cost cards to confirm they would find it difficult to continue offering low interest rate credit cards and would reduce their ability to fund innovation such as 'tap and go' which benefits consumers and merchants in many ways.[16]. Given the Committee's Terms of Reference, it is relevant that the RBA is actively considering a policy decision which would, by the industry's own admission, increase credit card interest rates.

By contrast, the RBA has not presented any evidence to suggest that consumers will not be charged more through other fees, for services which they currently receive as a result of interchange. Nor has the RBA presented any evidence to show that merchants will pass on any savings.

Impact of Interchange Fee Regulation Overseas
MasterCard's response to the Final Recommendations of the FSI dated 31 March 2015 outlines (at pages 7-8) some experience from around the globe which provide 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. This is supported by 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.

- 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). This 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

[13] MasterCard's submission in response to the RBA Issues Paper of March 2015, p. 4 and attachment on p.15
[14] Stillman, R., Bishop, W., Malcolm, K., Hildebrandt, N., 'Regulatory Intervention in the Payment Card Industry by the Reserve Bank of Australia'; CRA International, April 2008, p.13
[15] Chan, I., Chong, S., and Mitchell, S., 'The Personal Credit Card Market in Australia: Pricing over the Past Decade', Reserve Bank of Australia Bulletin, March 2012, p. 55
[16] Customer Owned Banking Association, Submission to the RBA Payment System Review, April 2015, p. 4

> system, [and favour] other less participatory systems and reduces incentives to innovate to improve the quality and safety of the service."[17]

That submission also outlined that 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'. This is supported by UK Consumer Groups, (2013) 'Joint statement by consumer bodies expressing concerns about European Commission proposal to regulate interchange on card transactions'.[18]

Further Impacts of Interchange Fee Regulation

Further interchange regulation will reduce innovation in payment, with major banks warning that if they are set too low, there will be insufficient incentive to trial and invest in new technologies.

Currently, issuers are able to implement new technology, funded in part by interchange revenue. Also, with the flexibility that the current weighted average model provides, there is an ability to promote the introduction of new technology through targeted, lower interchange rates. It should also be noted that, under the current flexible system, MasterCard is able to set the interchange rate for charities at zero. It would seem inappropriate to further remove flexibility and innovation revenue through further regulatory intervention.

While MasterCard recognises that increased costs for consumers and an impact on innovation are unintended consequences of regulation, they are proven consequences none the less. Given that banks and payment system participants have clearly stated that further regulation will have similar adverse consequences on consumers, it is incumbent on the RBA not to proceed with its current plans.

Conversely, the current process by which interchange fees are set at a weighted average of 50 basis points allows flexibility to support innovation and delivers significant benefits to both consumers and merchants.

Market Distortion

The second of the two key issues is the uneven application of regulation to Payment Systems resulting in a distortion of the market. Effectively, some payment systems are regulated and others are not, meaning that:

- Some cards and systems are significantly more expensive for merchants to accept
- There is uneven application of controls on interchange (or interchange-like) rates
- Higher costs for unregulated products have led to both surcharging and cross-subsidisation in order for merchants – particularly small businesses – to recoup the costs of accepting those products
- Banks are issuing – and seek greater customer take-up – of higher cost, unregulated products as they deliver the greatest level of revenue.

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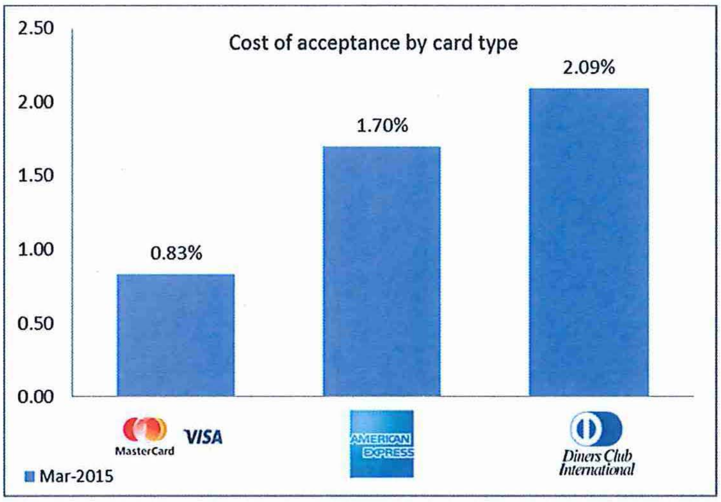
[17] This is supported by Iranzo, J., Fernández, P., and Matías, G., and Delgado, M., 'The Effects of the Mandatory Decrease of Interchange Fees in Spain', 2012, viewed online at: <http://mpra.ub.uni-muenchen.de/43097/1/MPRA_paper_43097.pdf>
[18] Joint statement by consumer bodies expressing concerns about the European Commission's proposal to regulate interchange on card transactions. Viewed online at: <http://www.parliament.uk/documents/commons-committees/european-scrutiny/Consumer-bodies.pdf>

Under the *Payment System (Regulation) Act,* Eftpos, Visa and MasterCard have been 'designated' and are interchange regulated. Those systems offered by American Express, Diners' Club, China Union Pay, JCP, PayPal and forms of digital currencies are not.

This outdated two-tiered system has resulted in many of the current complexities and increased costs in the payment system.

The most significant outcome of the regulatory disparity is a cost differential for Australian businesses. As published by the RBA[19] (in March 2015 Average Merchant Fees for Debit, Credit and Charge Cards) the average cost of accepting an unregulated card (American Express) is twice the average cost of accepting a regulated card (Visa and MasterCard).



The uneven application of regulation by the designation system as described above has also led to negative impacts for consumers, through higher costs for unregulated systems as promoted by banks and increased point of sale fees (either directly through surcharging or indirectly through cross-subsidisation to cover costs).

Conclusion and Recommendations

Following regulation in Australia in 2003, issuers responded by recovering costs they could no longer recover through interchange by increasing cardholder fees and charges. If interchange is to be further reduced as a result of the RBA's current regulatory interventions, then once again consumers (cardholders) will face increased fees and charges, including through increased credit card interest rates.

If the RBA again lowers interchange the costs for critical cardholder services such as interest free days, fraud protection and prevention as well as access to credit will undoubtedly shift from banks and retailers directly onto cardholders, including through higher credit card interest rates.

Additionally, some banks and credit unions / societies have confirmed they would find it difficult to continue offering low interest rate credit cards, which are one of the central planks to ensuring Australians have access to affordable credit.

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[19] RBA Statistical Tables: Average Merchant Fees for Debit, Credit and Charge Cards - C3
http://www.rba.gov.au/statistics/tables/

Based on evidence in Australia and from several jurisdictions around the world including the United States, the United Kingdom and Spain, it is apparent that if Australians are to have access to affordable credit, adequate credit fraud prevention and protection and product choice, three things need to occur:

1. The Committee should specifically consider the impact of RBA regulation of interchange fees on interest rates
2. The Reserve Bank of Australia should not further regulate interchange fees and exacerbate increased costs to consumers
3. At a minimum, any payments regulation needs to be fairly applied to all participants in the payment system

References

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RBA Statistical Tables: Average Merchant Fees for Debit, Credit and Charge Cards - C3 C3 - Data C3 - http://www.rba.gov.au/statistics/tables/

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