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MasterCard International

2 May, 2006

Mr Stephen Boyd
Committee Secretary
House of Representatives Standing Committee on
Economics, Finance and Public Administration
Parliament House
CANBERRA ACT 2600

Email: Stephen.Boyd.reps@aph.gov.au

Dear Stephen,

Thank you for the Committee's invite to speak at the public hearing in Sydney on May 15. As requested we provide a brief written submission providing some background to MasterCard International's perspective on the current and proposed payments system regulations.

If you have any queries relating to the attached please do not hesitate to contact me on 02 9466 3722 or my colleague Albert Naffah on 02 9466 3713.

Yours sincerely,

Leigh Clapham
General Manager - Australasia

MasterCard International Submission
to House of Representatives Standing Committee on
Economics, Finance and Public Administration
1 May, 2005

> *The Reserve Bank's reforms …… will allow normal market mechanisms to work more effectively in the Australian payments system and reduce its overall costs to the community. This will be achieved through:*
>
> - *lower merchant service fees as a direct consequence of reduced interchange fees,* ***which will pass through to consumers in the general level of prices;*** (emphasis added)
> …
> - *more efficient and transparent pricing of credit card services to cardholders and merchants; and*
> - *greater competition in the provision of credit card services to cardholders and merchants from the entry of non-financial corporations of substance.*
>
> **IV Final Reforms and Regulation Impact Statement issued on 27 August 2002**
> **Reserve Bank of Australia**

The extract above comes from the regulation impact statement that accompanied the Reserve Bank of Australia's publication of the standards which started a process of winding back the deregulation of the Australian financial services sector. If Parliament were to develop a report card against which to mark the performance of the Payments System Board, this summary of the Reserve Bank's objectives would form the basis of that report card.

As can be seen from the quote above, the Reserve Bank promised consumers that the prices they face at the till would be lowered by these regulations, as well as a flood of new entrants "of substance" into the credit card industry.

Indeed these promises were repeated time and time again by the Reserve Bank in its public statements relating to its regulations. In the Payments System Board Annual report of 2004 the Bank stated,

> As noted above, merchants have gained significant savings in merchant service fees as a result of the lower interchange fees. Given the competitive environment in which most merchants operate, these lower fees are likely to eventually find their way into lower prices of goods and services than would have otherwise have been then case. When fully passed through, the reduction in fees would be expected to reduce the Consumer Price Index (CPI) by between 0.1 and 0.2 percentage points. While important, this change is difficult to observe in the overall CPI, which is increasing, on average , by around 2 ½ per cent per year.[1]

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[1] *Payments System Board Annual Report* 2004 at p 12 This claim was also repeated in the 2005 Annual Report at page 1

It is timely that the Committee undertakes a review of this world first intervention by a central bank into the operation of a ferociously competitive payment system. Now that almost three years have passed since the implementation of the Reserve Bank's regulations, it should be clear whether the Bank's objectives have indeed been achieved, or whether the Bank's lack of real consultation and cooperation with the industry and the community at large on the regulations has lead to consequences foreshadowed by some in the industry although dismissed at the time by the Bank.

1. No evidence of any impact on the general price levels

It is indisputable that the regulations have delivered a significant financial windfall to Australia's credit card accepting merchants. According to statistics available in the Reserve Bank's monthly bulletin, the average merchant fee payable for a MasterCard or Visa transaction was 0.98% for the December 2005 quarter, down from 1.45% in September 2003 (the period just before implementation of the regulations).

These reductions in merchant fees are directly attributable to the Reserve Bank's regulation of interchange fees, and amount to a total saving to merchants of more than $600 million per annum. That adds up to an almost $1.8 billion saving to merchants since the implementation of the regulations. A handful of Australia's largest retail/business conglomerates have received the vast bulk of these savings, although according to the Reserve Bank merchants of all sizes have benefited from these reductions.

The Reserve Bank consistently maintained in pressing for the introduction of regulations that a major benefit flowing from them would be that these savings to merchants would be passed on to consumers in the form of lower prices. In more recent times, however, this benefit has been somewhat downplayed with the Reserve Bank, given that it is unable to point to *any* evidence of a reduction in prices. Now it merely claims that, but for the regulations, inflation is expected to have been higher[2]. This claim is made by the Reserve Bank without a scintilla of supporting research or evidence, and is another example of the Reserve Bank failing to apply to itself the same standards of proof it applied to organisations taking the effort to make submissions during the so-called consultation period prior to implementation of the regulations.

2. Cardholders paying more

The supposed reduction in general level of prices promised by the Reserve Bank to follow from the regulations was supposed to provide comfort to the more than 5 million Australians that carry and use credit cards and who, following the introduction of the regulations, faced immediate increases in annual fees, the introduction of new fees such as over-limit and late payment fees, the introduction by some merchants of surcharges of credit cards transactions, and a reduction in credit card benefits such as rewards points and the number of interest free days.

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[2] *Payments System Board Annual Report* 2004 at p 12

According to research undertaken for MasterCard International by Ernst & Young and Roy Morgan, at least three-quarters of credit card holders saw an increase in the cost of owning and using their cards as a direct consequence of the regulations. In order to recover the $600 million in lost revenue, card issuers increased fees by up to 120% - a reaction that the Reserve Bank anticipated and even endorsed – but the benefit at the till cannot be shown to have materialised. Instead cardholders are now faced with surcharging. In many instances the surcharge greatly exceeds the actual fee paid by the merchant, indicating that it is an opportunistic gouge of the cardholder rather than a good faith attempt to recover costs.

As predicted by MasterCard prior to the implementation of the regulations, surcharging has only taken root in industry sectors that are not subject to a healthy level of competition. All that the abolition of the "no surcharge rule" has managed to achieve is to remove the protections cardholders had when dealing with merchants who have the power to extract surcharges.

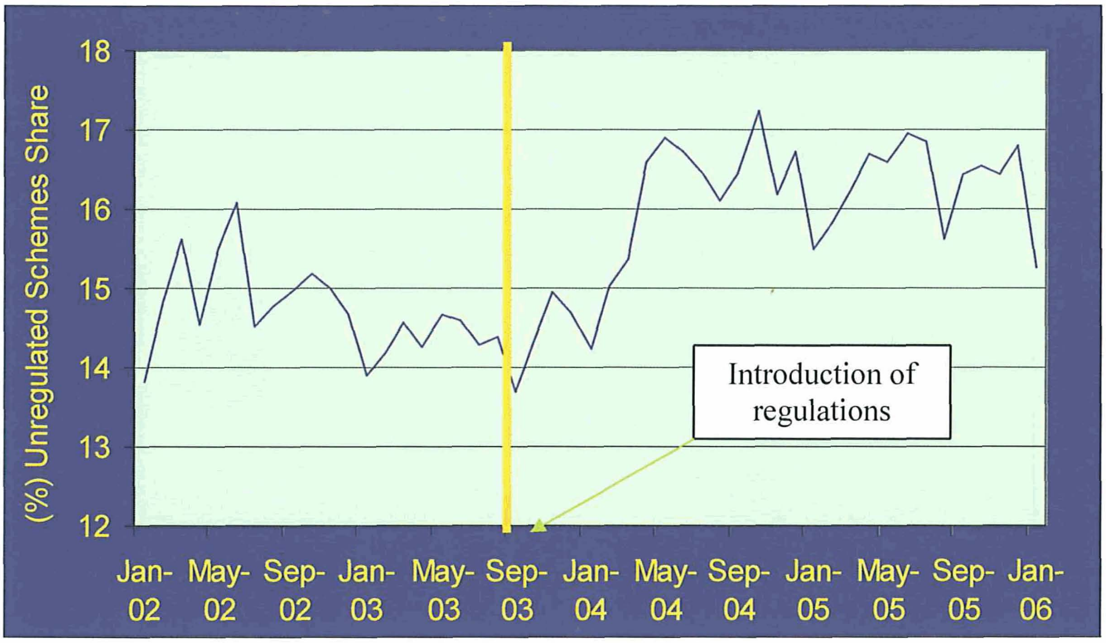
3. Three party schemes given unfair competitive advantage

In addition to the merchant community which is enjoying a $600 million annual windfall, the other major beneficiaries of the Reserve Bank's intervention are the "closed" three party schemes which were not subject to these regulations and, as a consequence, have been handed an enormous competitive advantage over MasterCard and Visa, which open their schemes to all eligible financial institutions. Despite the Reserve Bank's assertion that market forces would lead to a concomitant reduction in the merchant fees charged by the three party schemes[3], this has not happened. As set out above, the Reserve Bank Bulletin reports that the average merchant fee payable for a MasterCard or Visa transaction was 0.98% for the December 2005 quarter, down from 1.45% in September 2003 and 1.8% in 1999. In comparison the average merchant fee payable to the unregulated American Express was 2.33% for the same period, down from 2.7% in 1999. The gap between American Express merchant fees and those chargeable for MasterCard, Visa and Bankcard transactions has grown from 0.90% in 1999 to 1.35% in December 2005 or, expressed in a different way, American Express fees are now 138% higher than those applicable to regulated schemes.

This significant gap in merchant fees has allowed American Express and Diners Club to develop extremely rewarding relationships with several of the larger banks, with whom it did not have relationships prior to the Reserve Bank's regulations. While still in their

[3] "If a standard for interchange fees resulted in lower merchant service fees in the designated credit card schemes, normal competitive processes would ensure that competitors would have to react. Merchants would have an even stronger preference than at present for cards of the four party schemes. They would be likely to seek to renegotiate merchant service fees charged by American Express and Diners Club; alternatively, if fees did not adjust, some might stop accepting the latter cards altogether, a viable option because merchants may not fear losing many sales in view of the relatively small network size of American Express and Diners Club. These schemes would therefore be under strong competitive pressure to respond by lowering their merchant service fees to protect their merchant base." *Reform of Credit Card Schemes in Australia - A Consultation Document*, **December 2001, Reserve Bank of Australia at p. 119**

formative years, these relationships have allowed the unregulated schemes to grow their collective share of the credit card business by more than 320 basis points over the last two and a half years. As the diagram below demonstrates, coinciding with the implementation of the regulations in October 2003, the combined share of unregulated schemes grew immediately from 13.7% to 16.9%. This represents a shift of more than $4.5 billion in spend from the regulated to the unregulated schemes – costing merchants an additional $63 million in merchant fees per annum (based on a differential of 1.4% between regulated and unregulated scheme merchant fees).



All indications are that the unregulated schemes will continue to grow their share of credit card spend well into the future. In recent months American Express has launched a series of new programs each with significantly richer cardholder rewards programs than is offered by any MasterCard or Visa branded programs. Westpac's new Altitude Platinum American Express program offers double the reward points of the MasterCard program on an ongoing basis, while four times the points for the first six months. In addition National Australia Bank's Velocity program (co-branded with Virgin Blue airlines) also offers double the reward points for American Express transactions compared to Visa branded transactions. There are several more examples which prove that the unregulated schemes are able to fund significantly richer rewards programs with their higher merchant fees and continue to grow their business at the expense of those MasterCard and Visa, which are shackled by the Reserve Bank's regulations.

As the share of spend enjoyed by American Express and Diners Club continues to increase, and merchants see more and more cards issued by the unregulated schemes which on average cost them more than double the price of a MasterCard or Visa card, we have a situation whereby the competitive imbalance slowly eats away at the $600 million reduction in merchant fees delivered to merchants by the RBA. Moreover, there has been no significant introduction of surcharges on the more costly three-party schemes, as the Reserve Bank predicted.

These actual results strongly refute the claims made by the Reserve Bank in introducing the regulations:

> The Reserve Bank does not accept that its reforms of the designated credit card schemes constitute a regulatory bias that favours the three party card schemes, American Express and Diners Club. ... The Reserve Bank has not been persuaded that competition in the payment card market, strengthened by its reform measures, will encourage the growth of the smaller, higher cost card schemes over the larger, lower cost schemes in Australia. On the contrary, the freedom of merchants to charge a "fee for service" for credit and charge card acceptance can be expected to put strong competitive pressure on the higher cost card schemes and ensure that these schemes also bear the impact of the Reserve Bank's reforms.[4]

4. No new entrants

The Reserve Bank's promise of new entrants "of substance" coming into the Australian market place as a result of the regulations, which would deliver great benefits, has also not materialised. While the Reserve Bank will argue that new co-brand programs such as those featuring Virgin Money and Aussie Home Loans are a result of its intervention, the fact that these major organisations decided to merely lend their brands to bank run and controlled programs, rather than become issuers and acquirers in their own right, is testament to the fact that the Australian marketplace is now an unattractive prospect for new market entrants. MasterCard is also aware that several large U.S. and U.K. issuers, which were considering entering the Australian credit card business before the Reserve Bank imposed its regulations, have decided not to enter at least for the time being.

The Reserve Bank has heralded the entry of Money Switch as a new acquirer. While MasterCard wishes Money Switch the best of success as its newest customer in Australia, it would be premature at this stage to label Money Switch a new entrant "of substance". The simple fact is that, after almost three years since the introduction of the regulations, there has not been one new entrant "of substance" into the Australian credit card industry despite the fact that entrants were touted by the Reserve Bank as being ready to enter on the back of its regulations. The absence of new entrants was not difficult to predict by anyone other than the Reserve Bank, given that Australian credit card interchange fees have been slashed to a rate that is substantially below those anywhere else in the world. Note, that Australia's credit card interchange fees were already the among lowest in the world prior to the regulations.

5. Simple solution being sought

[4] Regulation Impact Statement p34

A simple assessment of the Reserve Bank's track record against the report card set out in the opening paragraphs of this submission would lead an independent observer to conclude that the regulations have not scored a passing grade. They have introduced regulations in a piecemeal fashion and without any real understanding of the dynamics of competition between different payment platforms.

The banking industry has demonstrated for many years, and across many issues, its willingness to work with legislators and regulators towards achieving mutually beneficial outcomes. However, the industry was not provided with such an opportunity in this instance. No sooner had the Reserve Bank identified some concerns with the way in which some aspects of the credit card industry operated, that it announced draconian new regulations which manifested themselves in forcing consumers to pay more for their credit card programs, with no proven benefit to the community.

MasterCard applauds the measures implemented by the Reserve Bank which promote greater transparency and provide for greater access to the credit card industry. As such the use of cost-based formula in the setting of interchange fees (which MasterCard has employed for more than 30 years in those countries in which it determines interchange fees), together with the establishment of a new type of banking license in the form of Specialist Credit Card Institution (a type of institution have been permitted to participate in MasterCard for many years) are moves supported by MasterCard. Indeed MasterCard would even support the ongoing abolition of the "no surcharge rule" (something MasterCard has done of its own volition in Europe) if reasonable consumer protections were enshrined into the regulations. These protections should include, amongst other things, a requirement that any surcharge applied by a merchant should not exceed the actual merchant fee and associated costs incurred by that merchant for accepting a credit card for payment. In addition, a recognition of the costs of other payment instruments, including cash should also be considered.[5]

By establishing greater transparency leading to clearer price signals, together with an access regime that facilitates easier entry into the industry, the Reserve Bank should not need to regulate interchange fees. If the Reserve Bank rolled back the restriction on interchange fees, it would remove the competitive disadvantage it has imposed on the industry, while at the same time making credit cards more affordable for consumers. Given the freedom of a merchant to surcharge together with the added transparency, normal competitive forces can be relied upon to ensure that credit card interchange fees are set at appropriate levels.

6. Debit card regulations

[5] During the credit regulations consultation period, the Reserve Bank chose to prefer a cost of cash study undertaken by the Australian Retailers Association by way of a self-complete fax back questionnaire, over a 2002 intensive study undertaken by PricewaterhouseCoopers (PwC) using the strictest research methods available. The PwC study found that the average true cost of cash to cash efficient high volume retailers was 2.3% of the transaction value. This compares to the less than 1% payable by merchants today for a MasterCard/Visa credit card transaction.

The Reserve Bank had hoped that as a result of its regulation of the credit card industry, consumers would come to prefer debit cards as their payment instrument of choice. However as demonstrated above, affected credit card users took the predictable step of migrating to the unregulated three-party schemes which continued to offer attractive rewards programs and other benefits without increasing cardholder fees, nicely supported by merchant fees two and a half times higher than those applicable to MasterCard and Visa.

The Reserve Bank's immediate reaction was to expand the regulations by bringing debit cards into the regulatory net so as to "fix" the problem. The Bank has happily embarked on a regulatory journey with no end in sight, where the its solution to regulations that are clearly not working is to introduce further regulations.

There is good reason why governments often only resort to regulation as a last option. It is because the consequences of regulation are almost always difficult to predict, and just as difficult to repair. The payments industry and the millions of customers and thousands of businesses that it touches are in a state of immense uncertainty as the Reserve Bank's experiment continues to unfold chapter by chapter. Many participants in the debit card system have predicted dire consequences, particularly for the smaller issuers like credit unions and building societies, if the Reserve Bank's proposed regulations are implemented. Smaller issuers speculate that a scheme debit card program could become too expensive for cardholders and many would take up a credit card instead.

The Reserve Bank's approach to concerns of this nature has been to state that if smaller institutions cannot operate efficiently enough to survive in the new regulated system, well then so be it. An interesting approach considering that promoting competition is one of the obligations imposed on the Reserve Bank by the Payments System (Regulation) Act 1998.

Of specific concern is the failure by the Reserve Bank to recognise the full range of costs associated with establishing and maintaining a debit card system, and that it is appropriate that some of these costs are recovered through an interchange fee. Furthermore the proposal to separate the acceptance requirements as they relate to debit and credit cards through amendments to the "Honour All Cards" rule may result in significant non-acceptance of scheme debit cards.

It is clear that the anticipated outcomes of payments system regulations already implemented have not manifested themselves. The Reserve Bank should be looking to learn why its predictions have been so wrong rather than rush into more draconian regulations.

7. In conclusion

It is commonly accepted today that, because of the inherent uncertainty in the impact of regulation, governments should only resort to it in the case of a clear market failure, and then only to the extent necessary to correct the perceived failure. Neither guideline has been followed by the Reserve Bank. The payment card industry in Australia was not given a genuine opportunity to voluntarily address the concerns identified by the ACCC and

Reserve Bank. Moreover, the results of the Reserve Bank's haste to implement regulations has been a number of unintended consequences, dismissed by the Reserve Bank when introducing the regulations, such as the growth in the market shares of the more expensive three party schemes, and the enormous contribution towards the profits of Australia's merchant community without any evidence that any of the savings enjoyed by merchants have been passed back to consumers in the form of lower prices for goods and services.

Consumers who are cardholders (which, in Australia, are most consumers) are paying more for their cards and increasingly facing surcharging at the till, most of which not based on the actual cost faced by the merchant for accepting the credit card payment.

MasterCard calls upon this Committee to recommend a reasonable rollback in those aspects of the Reserve Bank's standards indicated above, namely

1. Removal of the price fixing regulations applying to credit cards;
2. Controls on surcharging so that consumers are protected; and
3. Halting of introduction of regulations relating to debit cards as the proposed regulations are clearly anti-consumer

By doing this, the Australian payments will be allowed to operate under the beneficial pressure of competition, rather than the dictates of misguided regulation.