For Public Release

MasterCard International Incorporated

Submission to

Reserve Bank of Australia

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Overview

This submission from MasterCard International Incorporated to the Reserve Bank of Australia (RBA) is structured in three parts.

Part A consists of a review of the dynamics of competition between all payments mechanisms and explains MasterCard's position that interchange fees, membership eligibility criteria and the "no surcharge" rule should be analysed within the context of such competition. From this perspective, an assessment of some of the potential ramifications of the Australian Competition & Consumer Commission's (ACCC) and RBA's Joint Study's suggestions and conclusions, from the point of view of Australia's macro economy, are presented.

Part B details MasterCard's position on, and the rationale in support of, its rules regarding membership eligibility and "no surcharge."

Part C contains the answers to the fifteen questions addressed to MasterCard by the RBA in a letter dated May 2, 2001.

Part A

MASTERCARD'S CONCERNS WITH THE POTENTIAL IMPACT OF AN ARBITRARY LOWERING OF INTERCHANGE FEES

The study prepared by the ACCC and the RBA, entitled "Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access" (Joint Study), concludes that:

> *"… interchange fees in all three card networks provide, or contribute to, revenues above the average costs of the relevant card services … [and] preliminary figuring by the study suggests that these margins are not needed by financial institutions to earn their required return on capital. … [Furthermore,] price signals and competitive responses that would be expected to put pressure on margins in card payment networks have not worked effectively. These difficulties are reinforced by restrictions on access to card networks, … and by the "no surcharge" rules in credit card schemes." (p. 74)*

The Joint Study then goes on to state that interchange fees for the so-called credit card associations (i.e., MasterCard, Visa and Bankcard) should be reduced.

MasterCard acknowledges that concerns with the efficiency of four-party systems being adversely affected by unjustifiably high interchange fees are legitimate. Indeed, in this submission, MasterCard will bring to bear international experience in Korea and Japan, where interchange fees are set so high that four-party payment systems have failed to develop properly. At the same time, MasterCard submits that setting interchange fees too low can also adversely affect four-party systems.

MasterCard believes that any improvement in the efficiency of open payment systems would benefit all the participants – issuers, acquirers, merchants and cardholders – and should be welcomed. An efficient four-party payment system, as will be submitted below, is indispensable to the dynamism of the Australian society and national economic interests, especially for its vibrant tourism industry, and in its drive to become a knowledge-based economy and an IT regional hub. It is precisely with such issues in mind that MasterCard has some concerns with the potential ramifications arising from the conclusions of the Joint Study.

The Joint Study focuses on the four-party payment systems (which are sometimes referred to as "open systems"), of which there are three in Australia – MasterCard, Visa,

and Bankcard. While the Joint Study acknowledges that its exclusive focus on open payment systems “may have implications for the competitive position of credit cards vis-à-vis store cards and charge cards” (p. 5), it nevertheless draws conclusions on precisely the basis of a partial analysis of a much bigger picture. These conclusions, if implemented, could impact the open systems selectively and exclusively. Policy induced biases would in turn be created to artificially tilt the competitive playing field to favour the closed payment systems over the open systems, **with far reaching consequences for Australia’s society and economy**.

1. The Competitive Dynamics of the Payments Market

MasterCard believes that payment systems compete with one another intensely and in a dynamic and complex fashion. They compete in four inter-locking dimensions:

- Competition between payment mechanisms – cash, cheque, credit cards, charge cards, store cards, debit cards, etc.
- Competition between card systems – open versus closed, and each open system against the other open systems
- Competition between members within each payment card association
- Competition between retail merchants in how they use different payment mechanisms to gain competitive advantages.

These four dimensions of competition are organically linked, and any changes in rules and regulations affecting one will have immediate impacts on and potentially far-reaching consequences for all others.

1.1 Competition between payment mechanisms

All payment mechanisms compete for consumer and merchant acceptance and preference. The rise of card payment systems in the past few decades has been due in large measure to their ability both to address the inconvenience and reduce the costs of using cash and cheques. In carrying cash, the consumer is paying an opportunity cost, as the cash is rendered "unproductive" as opposed to earning interest in a savings account. The consumer also faces risks of theft and accidental loss. The use of cheques is typically difficult when outside of one's local community and, even close to home, acceptance may be limited. Consumers also pay to use cheques such as in fees for dishonoured cheques, government debits tax and cheque account keeping fees. From the merchant's perspective, the opportunity cost of accepting cash is significant as it involves time consuming processes of making daily deposits, in addition to also facing risks of theft and accidental loss. The costs of accepting cheques can also be high. One of those costs is for returned cheques. In the U.S., for example, about 1% of all cheques transacted are returned[1]. While merchants can obtain payment guarantees, they come with a cost of between 1-2.2% of the face value of each cheque. In addition, merchants pay bank fees for the processing of cheques. These fees vary quite significantly in line with size of the merchant, and the financial institution/s involved. Thus, there are costs associated with all payment mechanisms, not just for payment cards. The dynamic interactions between user preference on the one hand, and the costs and benefits pertaining to each payment mechanisms on the other underpin this dimension of competition. The competitive characteristics of the different payment mechanisms are summarised as follows:

[1] David Evans and Richard Schmalensee, 2000. *Paying with Plastic*. Cambridge: MIT Press.

Characteristics	Cash	Cheque	Credit Card	Store Card	On Line Debit Card
Universality of acceptance	High domestically	Low domestically, & nil internationally	High: domestic & international	Limited	High: domestic & international
Payment Guarantee	None	Sometimes (1)	Yes	Yes	Yes
Level of security	Low	Medium	Medium to high	Medium	Medium to high
Accounting record	None	Yes	Yes	Yes	Yes
Payment Fulfilment	Immediate	Slow	Slightly Deferred	Deferred	Slightly deferred
Implicit/ explicit credit	Foregone interest	Implicit	Explicit	Explicit	None (2)
Typical size of payment	Small to medium	Medium	Medium	Small to medium	Small to medium

(1. If accompanied by a cheque guarantee card. 2. Some have access to an overdraft.)

In this complex and evolving arena of competition, the competitive advantages of the different payment mechanisms are intricately and organically linked – jointly influenced by shifting consumer demand and the evolving supply of payment choices. The fact that consumers have such choices indicates strong competition among payment forms and that neither the credit card schemes or their members can be viewed as holding market power. Rather, the availability of choice in payment methods is a feature of a dynamic modern economy with a high standard of living such as Australia. . Arbitrary changes that affect the competitive advantage of one particular payment mechanism could have far reaching and unintended consequences for both the payment systems as a whole and the economy at large.

1.2 Competition between card systems

There are two levels of competition within this dimension. First, the four-party systems such as MasterCard, Visa and Bankcard compete with the closed systems such as American Express, Diner's Club and various store cards. Secondly, the open systems compete among themselves.

1.2.1 *Open versus closed systems*

The competition between the open and closed systems is a potent source of competitive restraint on the fees and charges levied on both sides of a credit card transaction. Within this competitive context, the viability of a four-party system is critically dependent on its interchange fee being set efficiently, such that there is a balance in incentives between issuers and acquirers, and that the resultant costs to both cardholders and merchants in using the system are sufficiently competitive compared with the closed systems. Indeed, the viability of the four-party systems is critically dependent on its ability to generate high levels of efficiency benefiting all participants – issuers, acquirers, merchants, and the cardholders. The four-party systems can achieve high levels of efficiency precisely because of the interchange fee arrangement, which allows the four-party systems to allocate joint costs. This arrangement has been proven to be able to, in principle as well as in practice, generate high levels of system efficiency, and thus social welfare benefiting both system participants and the society at large. Removing or altering this arrangement could result in the efficiency of the four-party systems being eroded, crippling their ability to compete with the closed systems.

If the interchange fee is set inappropriately – either too high or too low in relation to what benefits the system can deliver to all its participants – then the participants will behave (according to incentives created by the inappropriate interchange fees) in such a way that the four-party systems are rendered not viable. The following two sub-sections examine what happens when the interchange fee is set either too high or too low.

(a) Open versus closed systems: interchange fee set too high

When interchange fees are set too high, the very efficiency of four-party systems are destroyed. As a result, four-party systems cease to be competitive, and the card payments industry will degenerate into a fragmented and inefficient situation dominated

by “on us” transactions[2] and closed system card companies. The situations in Korea and Japan today illustrate just such a situation, characterised by a proliferation of “on us” transactions, few interchanged transactions, high interchange and merchant fees, low card transaction volumes, and unattractive acquiring economics. An international comparison highlighting the inefficiencies of the Korean and Japanese payments markets is shown below.

Markets or System	**% of On-Us transactions[1]**	**Average interchange fee**	**Average merchant fee**	**Transactions per active account/ year[2]**
Korea[3]	99%+	2.9%	3.2%	8.8
Japan[4]	91%	Up to 5%	1.5% - 8%	5.6
Australia	24.6%[9]	0.95%	1.78%	
Europe[5]	Italy 16%, Germany 51%	Italy 1.1%, Germany 1.37%	Italy 2.5%, Germany 2.1%	45.1
Open Schemes (U.S.)[6]	5%	1.6%	2.03%	58.3
Amex (U.S.)[7]	100%	Not applicable	2.72%	47.8%
Diner’s (U.S.)[8]	100%	Not applicable	2.6%	19.5

(1. Excludes international transactions. 2. U.S. and European data from Nilson 1999 and 2000. Amex data include corporate card purchases. 3. Based on Edgar, Dunn & Co. Research. 4. Based on Edgar, Dunn & Co. Research. 5. EDC Research. 6. American Bankers, 2001. Data include MasterCard and Visa. 7. American Bankers, 2001. 8. Credit Card Management. 9. MasterCard total for Australia, 2000.)

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[2] “On us” transactions refer to those in which the cardholder and the merchant deal with the same card issuer/acquirer. All three-party payment system transactions are “on us” by definition and, even in a four-party payment system, many transactions are likely to be “on us.” Transactions that are not “on us” are referred to as “interchanged” transactions, since they involve the interchanging of transaction information and funds between separate issuers and acquirers. One measure of the efficiency of a four-party payment system is its ratio of interchanged to “on us” transactions. The higher the ratio, the more efficient the system, since a the facilities that make interchanging of transactions possible are being more widely used.

As shown above, both interchange and merchant fees in Korea and Japan are significantly higher than the open systems in Australia, Europe and the U.S., as well as the closed systems in the U.S.. High interchange fees also mean that card companies are not motivated to compete in acquiring. For card companies that are willing to acquire interchange transactions, they tend to set the merchant fees as high as possible to maintain their profitability. And it also leads card companies to focus on acquiring "on us" transactions.

Because "on us" transactions are the norm, merchants are required to negotiate and sign agreements with each card company whose cards the merchant wants to accept, which is very inefficient. Korean and Japanese card companies also cannot expand merchant acceptance as effectively, thus they are unable to capture the economies of scale of a much bigger network that would have resulted had they been able to operate effectively as a four-party system. Because of the use of an "on us" model, the setting of interchange fees by card companies in Korea and Japan is significantly less transparent, with minimum inter-company competition.

The consumers also suffer. Cardholders in Japan carry on average 15 different cards since card acceptance by merchants is highly segmented. This means the cardholder has to pay 15 annual fees, make 15 separate payments each month to settle the bills and so forth.

These are some of the major direct consequences of interchange fees being at such a high level that the open systems have failed to grow and compete in these payments markets.

In comparison, the situation in Australia is clearly very different from that of Korea or Japan as shown in the table below. Thus, from the perspective of an international comparison, two observations can be made. The first, and the more obvious, is that the interchange fees in Australia are much lower in absolute terms. The second is that, given the healthy growth of the open systems, the absence of market fragmentation, and the proliferation of interchanged transactions in Australia, the interchange fees of the open systems in Australia would appear to be set at appropriate levels. This conclusion is supported by the comparison of Australian interchange fees, merchant fees and "on us" transaction levels with those of Europe and the U.S. in the table on page 7 above.

Country	Interchange fee	% of on us transaction	Average transaction/card[1]	Number of cards per capita[2]
Korea	2.5%	99%+	A$3,612	0.61
Japan	Up to 5%	91%	A$1,276	1.84
Australia[3]	0.95%[4]	24.6%[5]	A$7,539	0.55

(1. Asian Banker Journal. 2. Asian Banker Journal, Central Banks. 3. Merrill Lynch, 2000. Credit Cards: An Ace Up the Sleeves. 4. Joint Study, RBA and ACCC. 5. Based on MasterCard's total transaction in Australia in 2000.)

(b) Open versus closed system: interchange fee set too low

From an economics perspective, the interchange fee is not an ordinary, single, market price of credit card transactions. It is fundamentally a balancing device for increasing the value and safeguarding the efficiency of the open systems by shifting costs between issuers and acquirers, and thereby the charges between cardholders and merchants. It thus allows the open system to internalise the externalities between the two sides of a credit card transaction (transferring some of the positive externality enjoyed by the merchants to compensate for some of the negative externality borne by the issuers). The risk of setting the interchange fee too low is that there is insufficient incentive for issuers, who have to bear significant costs in marketing credit cards to potential cardholders, to cover losses due to fraud, and to compete against closed systems such as American Express and Diners, as well as store cards and to aggressively market the service and build the network of cardholders.

To compensate for an interchange fee that is set too low, issuers may then need to resort to raising annual fees and other charges to cardholders. This will deter the growth of the cardholder network as consumers, in deciding which payment system to join, tend to be very price sensitive in their decision making.[3] Thus, a relatively small increase in fees to

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[3] Technically, consumers are said to have a higher price elasticity of demand compared with merchants. For example, in the U.K., when annual fees on card accounts were introduced by most issuers in that country

the cardholders could cause a significant drop in cardholder membership. A smaller cardholder membership in turn would make acquiring merchants more difficult as the benefits that the system can deliver to the merchants in terms of potential shoppers holding cards have now diminished.

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

In this process, large issuers and acquirers would seek to maximise self-interest by focusing on "on us" transactions, and would effectively be motivated to evolve towards the more socially costly and less efficient three-party system. Smaller issuers and acquirers will not have such an option, and would thereby be squeezed out.

This "death spiral" process is unlikely to be a purely theoretical speculation when seen in the context of the competition between the open and closed systems. The closed systems such as American Express and Diner's, and potentially proprietary cards issued by large retailers, have been able to establish themselves in Australia, and are potent competitors, in spite of their typically higher cardholder fees, interest rates, and merchant charges. In contrast, the greatest competitive advantage of the open systems are their higher levels of efficiency based on their larger networks of both cardholders and merchants that are effectively maintained by the interchange fee arrangement. As a result, the open systems can deliver superior services (wider merchant acceptance) at lower costs (lower cardholder and merchant fees). Arbitrarily lowering the interchange fee will certainly erode the open systems' competitive advantage, tilting the competitive playing field in favour of the closed systems. From the point of view of social welfare, the Australian economy will clearly suffer should the open systems be arbitrarily constrained and the closed systems, which are more costly and less efficient, encouraged to grow by default.

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between 1989 and 1991, even though the annual fee imposed was small (on average only about £10) the number of card accounts declined significantly.

One of the net losers in this scenario is likely to be the average wage earner when the open credit card systems become more expensive. They will be deprived of the convenient and cheap source of personal credit which they previously enjoyed as cardholders in an open credit card system. For the average wage earner, there could very well be no practical alternative sources of easy credit as many of them would find it difficult and time-consuming to qualify for personal bank loans.

The Joint Study's view that the costs of offering loyalty programs are not part of the "resource costs" of credit card transactions, and therefore should not be included in the determination of interchange fee, if implemented, will clearly contribute to the probability of such a "death spiral." Loyalty programs are fast becoming the industry standard, and they form part of the benefit features of payment cards that consumers have come to expect. As pointed out by Gans and King, loyalty programs entail real costs to issuers and deliver real benefits to consumers, and should be taken into account regardless of what methodology is used for interchange fee determination.[4] If the costs of offering loyalty programs are arbitrarily excluded from the determination of the interchange fee for the open systems (which will likely result in such programs being dropped or significantly reduced), while the closed systems can continue to offer loyalty programs with their cost being fully factored into higher cardholders and merchant fees, then the open systems will be put in a position of **serious competitive disadvantage**.

There is as yet no empirical data to illustrate the "death spiral" in action, since in no market anywhere has any four-party open system been forced to arbitrarily lower its interchange fee by regulatory decree.[5] The conceptual principles, however, are not in doubt. As stated in a rigorous economic analysis recently by Schmalensee, Dean of the Sloan School of Management at MIT, that a profit maximising interchange fee in an open system also maximises the society's welfare, and there is no economic basis for eroding

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[4] Joshua S. Gans and Stephen P. King, November 2000. "The Role of Interchange Fees in Credit Card Associations: Competitive Analysis and Regulatory Issues." Melbourne Business School, University of Melbourne.

[5] In the electricity utilities industry in the US in early 1980s, in the aftermath of the second energy crisis, the death spiral risk was very real. Electric utilities saw their costs rise very fast, thus translating into very high cost to consumers (as utility rate making is largely cost-based), just as consumers were becoming enthusiastic about energy conservation technologies and devices. So electricity demand started to drop just as prices were rising rapidly – leading to a crisis in the industry.

the viability of the open systems in favour of the closed proprietary systems.[6]

1.2.2 *Competition among four-party systems*

Open systems, like MasterCard and Visa, compete vigorously for business through brand differentiation. It has been widely recognised that advertising campaigns launched by open systems typically aim at one another, sometimes with tangible results in terms of affecting their respective market shares.[7] Tens of millions of dollars are spent each year by MasterCard and Visa respectively on marketing activities to try to attract co-branding, and bidding for banks' businesses. Vigorous marketing can be rewarding. For example, both Sears and Wal-Mart[8] decided in 1996 to issue a co-branded card with MasterCard rather than Visa in the U.S. In Australia, the first co-branded card issued was a MasterCard issued by Westpac in partnership with General Motors, in 1995.

Since the early 1970s, competition between MasterCard and Visa has been intense in improving their systems, vying for technological superiority (MasterCard chose to implement a decentralised system while Visa opted for a centralised system, for example). Competition through system enhancing improvement has continued over time. In 1991, for example, Visa bought Interlink as a complement to its on-time debit program. And in 1996, MasterCard started to market against Visa by highlighting card features such as purchase protection plans which Visa had removed from its gold card features in 1996. More recently, MasterCard developed "Maestro", an online, PIN-based debit card; and Visa introduced the offline signature-based debit card "Visa Check". Maestro and Visa Check differ quite substantially from each other. Maestro requires the acquirer to obtain a positive electronic authorisation from the issuer, with the cardholder authenticated by a PIN, and currently it can only be used at certified electronic terminals. Visa Check however utilises the credit card infrastructure and, as it applies the same floor limits and processes as credit, cardholders can use Visa Check in card present and card not

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[6] Richard Schmalensee, 2001. "Payment Systems and Interchange Fees". National Bureau of Economic Research, working paper 8256.

[7] See David Evans and Richard Schmalensee, 2000. Paying with Plastic – the Digital Revolution in Buying and Borrowing. Cambridge, MA: MIT Press.

[8] They are the largest retailers in the US.

present situations. MasterCard ensures that when customers need to access their own deposit funds they are provided with a more secure method of transacting as compared to accessing a line of credit. It should be noted that Australian financial institutions have branded almost 10 million proprietary debit cards with Maestro.

MasterCard and Visa also compete intensively in undertaking sponsorships. While Visa has sponsored the Olympic Games, MasterCard has been successful in sponsoring the Jordan Formula One motor racing team and the World Cup Soccer.

MasterCard and Visa also compete very vigorously on price. Traditionally MasterCard has sought to win member business by offering pricing discounts, or financial incentives in return for such business. In recent times MasterCard has implemented a Member Business Agreement (MBA) strategy with key members around the world aimed at giving members favourable pricing in return for agreed business performance. These MBAs commit MasterCard to discounting fees, and providing financial support for the promotion of a member's MasterCard product/s as well as value added services such as consulting support in the form of expert advice as to world's best practice etc.

MasterCard continues to explore ways to reduce cost, and therefore its pricing for the delivery of technology solutions in its payment products, so as to enhance its ability to compete with Visa as well as the likes of American Express. This is in addition to MasterCard's initiatives to provide much more of its services online at a cheaper rate than its competitors.

The level of competition between the two major open systems appears to have increased in recent years as the two associations' membership profiles have diverged. MasterCard has become more identified with non-bank financial institutions. In summary, MasterCard believes that the competition between card systems is intense as well as dynamic. For four-party systems, their competitive advantage is critically dependent on the interchange arrangement being allowed to function efficiently. To the extent that the four-party systems' competitiveness is eroded because the interchange arrangement has been adversely affected, then the three-party closed systems could benefit from the competitive playing field being tilted in their favour. At the same time, care must be taken not to place any four-party system at a competitive disadvantage, eg: by adopting an interchange fee

setting methodology that favours one system's products over those of others. This means that, in addition to recognising the importance of interchange fees to four-party systems, the RBA should avoid imposing an inflexible interchange fee setting process.

1.3 Competition between members within each credit card association

Member issuers within both MasterCard and Visa compete against each other.[9] To begin with, the financial importance of the card business varies a great deal between the members. Some are more motivated to build a more commanding market position than others, and accordingly they invest more heavily in their card business. More importantly, the range of demand and supply conditions facing the card issuers are powerful influences shaping the card products which are offered by them. On the demand side, there is great diversity in consumer taste and preferences for various ways for making payments, and in their appetite for financing those payments with unsecured loans. On the supply side, competition between member issuers is driven by different levels of tolerance for credit risk and in the expected profits of providing services to cardholders of greatly varying usage patterns.

The intensity of competition in this dimension in Australia is reflected by the fact that there are some 200 different credit card products offered by the 60 credit card issuers, those credit card products having widely varying features. Interest rates on outstanding balances vary by as much as 10%, and the interest free periods offered range between 0 to 55 days. In addition, there are significant differences in loyalty programs which are offered on credit card products , as well as in annual fees, policies, services, and ways of paying.

With 60 card issuers and at least 7 acquirers of credit card transactions in Australia, the Australian market does exhibit healthy competition. It also needs to be recognised that Australia's is a relatively small economy and will never be able to support the larger numbers of issuers and acquirers which exist in some other countries, for example, the U.S. and the U.K. Compared to other sectors of the Australian economy, such as grocery

supermarket retailing, the current number of participants in credit card issuing and acquiring is quite large.

This intense competition among members within a four-party system, and all the accompanying social benefits that such competition creates, would be lost if the three-party systems were to become the dominating system by default. Likewise, such competition would be diminished to the extent that four-party system participants are encouraged to develop their "on us" business at the expense of interchanged transactions.

1.4 Competition between retail merchants in how they use different payment mechanisms to gain competitive advantages

Competition between the different payment mechanisms is embedded in competition in the retail sector. The more intensely retail merchants compete, the more the payment systems are integrated into their competitive strategies. As a result, competition at the level of retail merchants could have a material impact on competition between payment mechanisms in general and card payment systems in particular.

To begin with, the bargaining power of retail merchants is frequently under-estimated. This is certainly reflected in the views of the Joint Study, which suggests that merchants do not have the choice of opting out of credit card schemes. In this regard, the 1991 Boston area restaurants' "rebellion" against American Express is instructive. Hard pressed by the economic recession in 1991, many restaurants in the Boston area in the U.S. started to resent the 3.25% fee that they had to pay to American Express each time a patron paid with the Amex card. In contrast, MasterCard and Visa member acquirers were charging around 2%. A group of Boston area restaurants then asked American Express to reduce its merchant fee.

American Express refused – merchant fees accounted for 60% of its revenue from the card business at that time, and a half a percentage point reduction meant a loss to it of

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[9] This is a dimension of competition unique to the open systems as the closed systems do not have different issuing and acquiring members.

US$445 million annually. Thus, the famous “Boston Fee Party” got under way. By April 1991, over 250 restaurants in the Boston area threatened to drop American Express (to opt out of this particular card scheme), with vocal support from the media as well as restaurant associations from across the country. Faced with mounting pressure, American Express relented and announced that it would negotiate merchant discounts individually with merchants. It lowered its merchant discount dramatically over the next few years. In this case, retail merchants did use the threat of choosing to opt out of a card scheme to win concessions.

The fact that many merchants accept credit cards is a reflection of both the value of card acceptance and the fact that competition among merchants has resulted in them offering increased customer services to meet, if not exceed, those offered by competitors. Competition in such customer services, as a consequence, has led to merchants offering more choices to consumers in relation to the method of payment for goods and services. Further, those merchants which do accept credit cards do, in most cases, offer the consumer the additional choice of paying by debit card. The fact that this competition exists among merchants should not be interpreted as a sign that market power is held by the credit card schemes or that the schemes can somehow force merchants to accept payment by credit card for the goods and services they offer. An analogy may be found in new motor vehicles offered for sale in Australia. Air bags in motor vehicles are not mandatory at the present time in Australia and so vehicle manufacturers are not legally required to install them on new vehicles. However, a considerable number of motor vehicle manufacturers offer them as standard equipment on motor vehicles sold – even those vehicles in lower price brackets. This is no doubt in response to competitive pressures so that vehicle manufacturers meet the equipment levels in motor vehicles offered for sale by their competitors, rather than because air bag manufacturers have market power.

The perception, a mistaken one in MasterCard’s view, that retail merchants do not have any choice but to accept cards regardless of the merchant fees that they have to pay, is typically bundled with criticisms of the “no surcharge” rule. The “no surcharge” rule, which requires that merchants abstain from passing onto the customer their merchant fee, is seen by the Joint Study as restricting competition between merchants by limiting the

pricing strategies that they can use (p. 55).[10] In contrast, MasterCard believes that merchant competition in the retail sector is vigorous, and that the claim that the "no surcharge" rule restricts merchant competition is incorrect both in principle and in fact.

In principle, the "no surcharge" rule does not prevent the merchant from offering a discount for payment by cash or cheque in Australia. By offering such discounts, the merchant could achieve the same result as a surcharge. The difference between a cash discount and a surcharge hinges on how the merchant sets the original retail price. In the case in which a merchant is prevented from surcharging, the merchant can offer a discount for cash or cheque payment. If surcharging is allowed, then the merchant can set a lower retail price which does not include the merchant fee and add a surcharge to the prices of those goods or services purchased by customers who pay with credit cards. In other words, in spite of the "no surcharge" rule, merchants are free to vary prices according to the payment mechanism by offering a discount for cash or cheque payment. Thus, the reality is that merchants in Australia today do have a choice in passing the merchant fees onto the retail customers through a discount on payment by cash or cheque should they wish to. In effect surcharging can be viewed as a form of "bait" advertising, in the sense that a cardholder will be attracted to a merchant's shop to buy products for a specified price, only to be charged a higher price at the register. This is similar to merchants who advertise a specific product for a specified price, where in fact the only available product is a more expensive alternative.

In practice, retail merchants do integrate the differences in features and prices between payments mechanisms into their competition strategies. In Australia, for example, the large scale supermarket, Aldi, which was launched in 2000, in order to keep its prices low does not accept credit or debit cards . This is a powerful example of the degree of competition in the retail sector, demonstrating that merchants can, and do, utilise differences in payments mechanisms in their pricing and in designing their competitive differentiation.

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[10] In addition, the Joint Study sees that the restriction on merchant competition in turn suppresses "price signals" to the customers, and that the "no surcharge" rule is part of the arrangement that allows the acquirers to pass onto the merchants, and eventually to the customers unjustifiably high interchange fees.

Thus, **retail competition in Australia does not appear to have been restricted by the "no surcharge" rule**. On the contrary, competition at this level appears to be robust in Australia. This has important implications for thinking about how to appropriately determine interchange fees. Gans and King, in their recent analysis, suggest that even a moderate degree of competition at the retail level is sufficient in allowing market forces to be exerted on the credit card associations to establish a balanced and economically efficient interchange fee.[11]

2. Ramifications for International Transactions: Potential Impacts on Australia's Tourism Industry

One of the most significant contributions of the credit card, and **inexplicably very rarely mentioned, is in international travel**. Today, the ease with which a tourist can pay for his/her accommodation, meals, shopping, and transportation in a foreign country without having to deal with the cumbersome and time consuming business of conducting foreign currency exchange at home or abroad, is entirely due to services provided by credit cards. It also eases the planning of foreign visits, allowing the tourist to prolong the stay spontaneously without having to worry about the lack of foreign exchange. It is therefore not an exaggeration to suggest that the growth of international tourism in recent decades would not have been possible – at least not at the same rate – had credit card services not been available.

In Australia, tourism has become a major industry, accounting for a more and more significant share of national economic activity and employment. In the 1997/98 fiscal year, the tourism industry accounted for A$25.2 billion of economic activity, or 4.5% of Australia's GDP. Of this amount, about one-quarter of the economic values generated can be attributed directly to international tourists. Taking into account both direct and indirect effects, the 4.2 million international tourists to Australia accounted for A$12.8 billion of consumption in Australia in 1997/98. About 6% of the labour force is directly involved in the tourism industry (there were 513,000 employees involved in the industry in

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[11] Joshua S. Gans and Stephen P. King, ibid.

1997/98), with the largest portion of employment generated found in the retail sector (27%), followed by accommodation (18%), and cafes and restaurants (9%).[12]

The breakdown of home regions of visitors to Australia in 1997/98 is as follows:

Northeast Asia	Europe	Oceania
31% (19% from Japan)	22%	19%

(Australia Bureau of Statistics)

The contributions of tourism to the value-added process in several of the related industries are shown as follows:

	Manufacturing	Transport	Retail	Recreation activities	Hospitality
% of value-add from tourism	3.4%	23.0%	12.0%	12.5%	60.0%

(Australia Bureau of Statistics)

There will be a serious impact on international tourism as a result of any arbitrarily lowered interchange fee because of its consequences on international transactions. This can be illustrated by the following simple example.

Taking the current average merchant fee of 1.78% as a given, and the fact that the acquirer has to pay an international interchange fee of 1.48%, this then leaves the acquirer with 0.3% to cover the acquiring costs and other related expenses. If the interchange fee is to be lowered from its current average level in accordance with the Joint Study's suggestion, then presumably the merchant fee will be lowered accordingly. In this situation, if the cardholders are foreign visitors (and there were 4.2 million of them in 1997/98), then the acquirer would have to pay the 1.48% international interchange fee, which could leave the acquirer with a net loss of 0.2% for each transaction. This would simply make acquiring international transactions not viable.

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[12] Australian Bureau of Statistics.

As a consequence, acquirers may charge merchants who tend to have high levels of international transactions a higher merchant service fee. For acquirers seeking to expand their merchant acquisitions, they may intentionally seek to avoid known international tourist destinations and/or merchants catering more to international tourists. Among merchants who are charged a higher merchant service fee because of their high levels of international transactions, the bigger merchants may seek to expand their market shares by absorbing the high merchant service fee so as to under-price the smaller merchants who do not have the financial wherewithal to do so. Thus, a whole host of market distorting forces could be unleashed.

Such a situation will also hurt the open systems in their competition with the more expensive closed systems. The latter would not be at all affected as their "internal" interchange fees are not, and possibly cannot, be scrutinised on the same basis as the interchange fees in the open systems, and they would certainly take advantage of this new handicap imposed on the open systems to gain new market share and business at the open systems' expense.

3. Ramifications for Australia's Drive to Becoming a Knowledge-Based Economy

It is widely recognised today that the new foundation for growth and prosperity for the developed economies is to be found in building a knowledge-based economy. The revolutionary information economy is but one of the drivers in this development. Others include biotechnology, new material sciences, nano technology, new energy technologies, and new human resource infrastructure (continuing education etc.) It has been observed in the U.S. that the growth and development of a knowledge-based economy is highly correlated with rising self-employment and the proliferation of small businesses dominated by self-proprietorship. These are the knowledge workers who power the knowledge-based economy. **And the role of credit card services turns out to be of critical importance as a key pre-condition of the development of the knowledge-based economy.**

This is because both the self-employed professionals and small proprietorships have to cope with situations of "lumpy" incomes. Instead of regular monthly pay cheques, these knowledge workers may receive a lump sum payment at the end of a six month long

project. They may have to invest significant amount of funds to complete the work – in addition to having to finance their own and their families' daily living expenses – before they are paid. In such situations, credit cards turn out to be the most convenient as well as the cheapest source of business financing.

Data from the U.S. demonstrates this trend. A survey conducted by Arthur Andersen in the fourth quarter of 2000 of small and mid-size businesses shows that over 50% of them used credit cards for some form of business financing. Indeed, credit cards are the most popular source of business financing for small and mid-size businesses in the U.S. in 1999/2000. The specific details are summarised as follows:

Patterns of usage of credit cards by small & mid-size businesses	**% response**
To finance business operations	50%
To finance large capital outlays	46%
Credit card bills being paid off the end of each month	36%
Carrying a balance of less than $10,000	17%
Carrying a balance of more than $10,000	7%
Using personal credit cards for businesses	49%

(Arthur Andersen & National Small Business Association)

In Australia, over the past 15 years, small businesses with 1 - 4 employees have registered the strongest annual employment growth rates of 4.8%, among all businesses grouped by size. This compares with 3.2% for businesses employing 5 – 19 employees, 3.2% for businesses employing 20 – 99 employees, and 2.7% for those employing more than 200 employees.[13] In terms of self-employment, in mid-2000, there were 817,500

[13] Small Businesses in Australia, 1999. ABS.

workers in Australia reported as self-employed, accounting for about 13% of total employment.[14]

While it is difficult to precisely determine what proportions of the self-employed and small businesses can be classified as knowledge workers, it is reasonable to assume that, like most developed economies, the trends toward more knowledge intensive production have been set in motion over the past decade or so, and the data to a certain extent reflects these trends. But the more important issue is that, going forward, a more knowledge intensive economy means more knowledge workers, and rising numbers of knowledge workers will likely translate into more self-employment and small businesses, and that in turn means more demand for credit cards as a simple, convenient, and low cost means of "smoothing" the lumpiness of income typically faced by the average knowledge worker.

In this context, the Joint Study's assumption that debit cards are a more cost-effective alternative for credit cards in Australia is a cause for concern. **To focus on credit and debit cards as alternatives is problematic for at least two reasons.** First, as pointed out in section 1.1 above, competition between all payments mechanisms is complex and inter-linked. Singling out two from the entire array of alternative payments mechanisms for a comparative analysis and then to derive highly generalised conclusions on that basis (credit cards are "over-used") cannot be justified. Secondly, from the point of view of the society's evolution toward a knowledge-based economy, credit cards have important functions that are different from debit cards. International credit cards are nothing less than the "fuel" that drives the growth of international online transactions and e-commerce activities. To see the two as mere alternatives, as implicitly assumed in the Joint Study, is to miss the emerging role of credit cards in Australia's dynamic evolution toward a knowledge-based economy.

4. Australian E-Commerce Development Would Be Disadvantaged

Payment cards are currently the most practical payment method for internet online transactions, as reflected by the fact that more than 95% of all purchases on the Internet

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[14] Australia Bureau of Statistics.

are made with payment cards. Still, many cardholders today are afraid to shop on the Internet because they fear that their card number may be stolen or misused. It is therefore of the utmost importance that card issuers be able to offer solutions enabling their cardholders to shop securely on the Internet.

In order for card issuers to meet this challenge and provide a secure e-commerce environment, two issues must be addressed:

- the provision of a better payment guarantee for Internet merchants and
- delivering the technical tools to authenticate cardholders transactions.

The provision of secure e-commerce transactions to cardholders and a better payment guarantee to Internet merchants will necessarily fall to payment card issuers, since they are the ones that manage the cardholder relationship and provide the payment guarantee. To encourage issuers to make the huge investment that is necessary to fulfill cardholders' and merchants' expectations, MasterCard is in the process of defining e-commerce rules and requirements, implementing system changes and establishing appropriate inter-regional interchange fees to help offset issuers' costs.

A substantial reduction in domestic interchange fees would effectively remove this strong incentive for issuers and undermine their ability to recover the costs related to e-commerce payment systems. The result would be that consumers would continue to perceive the Internet as an unsecure market and so would not shop there, and merchants would continue to suffer from high levels of fraud and cardholder repudiations.

Australian e-commerce service providers could in turn be affected if more secure online payment technologies are prevented from being developed because of an arbitrary reduction of the interchange fee. This could potentially put the Australian e-commerce industry at a competitive disadvantage vis-à-vis those of other countries. It would adversely affect Australia’s attractiveness for e-business, and thus jeopardizing the future of Australia as an e-commerce hub of the Asia Pacific.

In this connection, MasterCard believes that **government authorities should actively encourage further development of credit card products that could meet evolving needs of e-commerce development**. Online transactions are a fast developing market,

and experiments of alternative payments mechanisms are constantly being launched. The international four-party credit card systems, with their global reach and efficiency, are best positioned to evolve new product features to meet the needs of this fast moving and expanding market, and incentives must be provided for them to do so. **Australia is poised to be the e-commerce hub of the Asia Pacific, and a highly developed, efficient, and sophisticated credit card payment system for online transactions is a pre-requisite for success**.

Part B

MASTERCARD'S POSITION ON, AND THE RATIONALE IN SUPPORT OF, ITS RULES REGARDING MEMBERSHIP ELIGIBILITY AND "NO SURCHARGE."

1. Access to the MasterCard Credit Card System

1.1 Membership

The Bylaws of MasterCard currently restrict membership to those organisations in which there can be placed a high degree of confidence that they will be able to meet their obligations of participating in the MasterCard system. MasterCard regards the ability of participants in the system to have this degree of confidence in the financial standing of its members as essential to the operation of the MasterCard system. Participants need to have confidence in the ability of MasterCard members to meet their settlement obligations. MasterCard also, as guarantor of the obligations of its members in respect of transactions concerning the MasterCard card, has a direct financial interest in the financial standing of its members.

The Joint Study rightly recognises the legitimate concerns of the credit card associations in this regard. The Study in its review of participation in credit card schemes, expressed the view that:

> *"… some form of restrictions on issuing can be justified if their aim is to ensure that issuers are financially sound, able to meet their obligations and will not disrupt the credit card system. Since they are not taking deposits, such issuers need not be authorised deposit-takers, but the requirement of authorisation and on-going prudential supervision has been a long-established and effective screening device."* (p. 56)

The Joint Study comments that these restrictions are not the only way of establishing financial soundness of an organisation, and membership criteria based on institutional status may create higher barriers to entry than is justified to ensure security and integrity of the card schemes. It is suggested by the Joint Study that a broader set of criteria is needed so as to assess the qualification of such institutions which would enable "non-traditional firms" to participate in the established schemes and that this should not be difficult to devise.

MasterCard can report to the Reserve Bank that it has not had many, if at all, significant enquiries for membership of MasterCard by institutions that would not otherwise qualify for membership under MasterCard's existing rules. There may be a question as to whether the Joint Study in advocating an easing of the restriction on membership may be seeking a solution to a perceived rather than a real problem. As discussed in the answer to Question 1 in Part C below, if the interchange rate is significantly reduced, this could be expected to reduce the interest of organisations in becoming issuing members of MasterCard - including the interest of those that may not necessarily qualify for membership under MasterCard's current rules.

Further, the reduced profitability from issuing credit cards may result in some of MasterCard's smaller existing members relinquishing their membership. As this would lead to an inevitable increase in concentration of card issuance in MasterCard's larger members, MasterCard would have thought this likely result would be of concern to Australian regulatory authorities.

1.2 Scope for Membership of MasterCard

MasterCard believes that its current rules, as presently drafted, do provide considerable scope for various types of institutions, and not merely "authorised deposit-taking institutions", to qualify for membership of MasterCard.

The main rule concerning eligibility for membership of MasterCard provides that, in order for a corporation or organisation to be eligible to become a member of MasterCard, it must be "a financial institution that is authorised to engage in financial transactions under the laws and/or government regulations of the country, or any sub-division thereof, in which it is (i) organised or (ii) principally engaged in business".

What constitutes "financial transactions" for these purposes is widely defined and is not limited to activities of organisations which would be treated as authorised deposit-taking institutions for Australian purposes. The term is defined to mean "the making of commercial or consumer loans, the extension of credit, the effecting of transactions with payment services cards, the issuance of travelers cheques, or the taking of consumer or commercial deposits".

There is a requirement, with respect to any financial institution that does not take deposits, that "financial transactions" constitute substantially all of the business conducted by such institution. Accordingly, in various countries around the world, not only are organisations which would be regarded as "authorised deposit-taking institutions" eligible to become members but also other types of organisations. For example, there are card companies in Asia which are members who are organisations which *only* issue cards and acquire transactions but which do not accept deposits. In the Asia/Pacific region MasterCard has 54 members which are not banks.

It should be noted that GE Capital in Australia is a member of MasterCard even though it is not regulated and supervised by Australian regulatory authorities. This is because GE Capital is nevertheless subject to supervision and regulation in the United States – where its head office is located. On this basis it would be possible for an organisation to become a member of MasterCard and operate in Australia, even though it is not subject to regulation and supervision in Australia, as long as it is subject to the regulation and supervision of some country's regulatory authority – which would be generally expected to be where its head office is located.

1.3 Importance of Members being Regulated and Supervised

The Study is correct in observing that a financial institution, in order to be eligible for membership, must be "supervised". There is a requirement under MasterCard's rule that such a financial institution must be regulated and supervised by a governmental authority.

MasterCard agrees with the statement in the Joint Study that the requirements imposed for membership under its Bylaws may not necessarily be the only way of establishing the financial soundness of a firm. It would no doubt be possible to formulate other criteria to evaluate the financial soundness of an organisation. However, this suggestion does have significant practical implications which may not be fully appreciated by the Joint Study.

MasterCard at the present time has approximately 22,000 members who are located in 210 countries and territories. To devise eligibility criteria to evaluate the financial soundness of prospective members in all these different countries would be an enormous and costly task. It would also be costly if MasterCard itself were required to monitor, over time, the financial soundness of its various members. For this reason, the reliance by MasterCard on regulation and supervision of members by relevant governmental

agencies or authorities has a significant practical benefit as it relieves MasterCard, and in turn its members, and eventually cardholders and merchants, from bearing the cost if MasterCard were required to formulate and apply membership criteria and then monitor compliance with that criteria.

In addition, linking eligibility for membership to regulation and supervision in local jurisdictions also means that there is scope for new categories of organisations being eligible for membership. This would be the case if there are changes to the laws in that jurisdiction which provide for new types of organisations to be able to undertake "financial transactions" (as that term is widely defined in the Bylaws) and to be regulated and supervised by governmental agencies or authorities. In Australia, for example, amendments made to the *Banking Act* by the *Financial Sector Reform (Amendments and Transitional Provisions) Act,* 1998 expanded the range of institutions which may qualify for authorisation by the Australian Prudential Regulation Authority as a deposit taking institution so as to carry on banking business. The definition of "banking business" in the Banking Act was drafted in recognition that there was potential for any definition of financial system activity to become dated and, for this reason, the Governor General was given power to make regulations extending the definition.

It would be an onerous task for MasterCard, if it did formulate criteria for membership for a particular jurisdiction, to then periodically review that criteria in light of changes in the relevant jurisdiction.

MasterCard understands that reliance on governmental prudential supervision and regulation is no guarantee that members who are subject to such supervision and regulation will not run into financial difficulties. And yet if MasterCard were to admit members that are not under governmental prudential supervision of any kind, then the task and risks facing MasterCard in providing such supervision would be enormous, so would the costs involved. Were a member of MasterCard to collapse it could be expected that it would have similar adverse ramifications for the Australian payments system.[15] Given the fact that issuers and acquirers in the MasterCard system are, at any given time, linked by millions of dollars of payment obligations, the sudden collapse of one member

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[15] The recent collapse of HIH Insurance, with liabilities anticipated to be in the vicinity of A$4 billion, illustrates the risks involved.

could have serious "domino" effects in spreading a "liquidity crisis" across the entire system, affecting not just financial institutions, but the Australian economy generally as well.

If MasterCard were required to formulate criteria for application in particular jurisdictions but not others, there is an argument that the costs associated with evaluating potential members and monitoring existing members in that jurisdiction under those criteria should be borne by the members in that particular jurisdiction. This is on the basis that it would be inequitable for that cost to be shared among participants in the MasterCard system located in other jurisdictions.

There would also be an issue as to who should bear the additional cost of MasterCard's investigation and oversight of the members which are not regulated and supervised by a government agency or authority. While it would appear reasonable to expect this cost to be borne by the new members, this might result in undermining the economic benefits of membership for such entities. Conversely, socialising the cost would force regulated and supervised members (and ultimately their cardholders and merchants) to pay for benefits received solely by their competitors, thus weakening their desire to participate in the system.

As mentioned, MasterCard acts as the guarantor of its members' obligations in respect of MasterCard transactions and, in the U.S., has been required to set aside funds for this purpose. There is an issue whether, if liberalised membership criteria in respect of a particular jurisdiction resulted in MasterCard being exposed to a greater incidence of member failure in that jurisdiction, and for which it assumes liabilities as guarantor of members obligations, it is equitable that MasterCard members worldwide bear (through fees and assessments payable to MasterCard) part of the increased funding cost of enabling MasterCard to meet those obligations. On one view it may be more equitable that members in the particular jurisdiction concerned bear, through fees and assessments payable to MasterCard, that increased funding cost. This has obvious consequences for increasing the costs of running that credit card system in that jurisdiction.

Alternatively, if the prospect of member failure becomes too great in a particular jurisdiction, there may be a question of whether it is remains appropriate for MasterCard to continue to act as a guarantor of its members obligations within that jurisdiction. It

would still be necessary for MasterCard to act as guarantors of the obligations of members within that jurisdiction to members outside that jurisdiction. Nevertheless, were MasterCard not to so act as guarantor in respect of members within that jurisdiction, it would obviously have severe repercussions for the continuing viability of that scheme in that jurisdiction.

In this connection, it should be pointed out that MasterCard has been proactive in bringing in new participants into the system, when it is prudent and appropriate to do so

1.4 Avenues for Membership of, or Participation in, the MasterCard system

Under MasterCard's Bylaws as they presently stand, there are a number of ways in which organisations can become members of, or otherwise effectively participate in, the MasterCard system. There are outlined below:

a. Institutions Engaging in Financial Transactions

As indicated previously, under MasterCard's current Bylaws, the definition of "financial transaction" is quite wide. It would be possible for an organisation which is not necessarily an authorised deposit-taking institution but which is engaged in "financial transactions", such as credit card transactions, to become a member provided such organisation is regulated and supervised by a governmental agency or authority and "financial transactions" constitute substantially all of the business of that organisation. On this basis, there would be nothing to prevent a merchant establishing a separate company to engage in credit card transactions if that company were subject to government regulation and supervision and such transactions constituted substantially all of its business. There is another issue concerning whether an organisation established by a merchant should be permitted to acquire transactions of that merchant. This issue is further addressed in the response to question 6 in Part C below.

b. Establishment or Acquisition of an Authorised Deposit-Taking Institution

There is nothing in MasterCard's Bylaws to prevent an organisation establishing or acquiring an authorised deposit-taking institution which may then be eligible to become a member of MasterCard. Such an institution would clearly be subject to government regulation and supervision for the purposes of the Bylaws.

It is noted in this regard that, in April 2000, the Australian Prudential Regulation Authority issued a policy paper relevant to authorised deposit-taking institutions which are members of a conglomerate group. In that policy paper it was stated that the authorised deposit-taking institution which is a member of a conglomerate group must function as a separate legal entity from the rest of the group so as to quarantine the assets and liabilities of the various entities in the group. This policy concern is not dissimilar to the reasons for the requirement in MasterCard's Bylaws concerning membership to the effect that, for financial institutions (other than those taking deposits) financial transactions constitute substantially all of the business conducted by such organisation.

Although an organisation could establish an authorised deposit-taking institution which may be eligible to become a member of MasterCard, there would nevertheless remain issues concerning MasterCard's policy against self-acquisition (dealt with in the response to Question 6 in Part C below).

If a merchant reaches such a size as to be interested in membership in MasterCard, then it would seem likely that the establishment or acquisition of an authorised deposit-taking institution which was eligible for membership of MasterCard could also be a viable proposition for that merchant.

c. Co-Branding

Under MasterCard's existing rules there are considerable opportunities for organisations to obtain benefits from participation in the MasterCard system without actually becoming a member. One way is by the organisation entering into a co-branding arrangement with an existing MasterCard member. Examples of co-branding arrangements to which MasterCard members are parties include the following:

Member	***Co-brand Partner***
Commonwealth Bank	Woolworths
Commonwealth Bank	Daimaru
St. George	Virtual Communities

GE Capital	Shell
Westpac	Energy Australia (with Franklins and Optus as secondary co-brand partners)
Westpac	General Motors Holden
Bank of Western Australia	Hospital Benefits Fund

Under a typical co-brand relationship, a member of MasterCard would enter into a contractual relationship with an organisation which may not necessarily qualify in its own right to be a member of MasterCard but which nevertheless, through the co-branding relationship, obtains benefits from participation in the MasterCard system.

Typically the co-brand partner's name and identifying logos and marks are displayed prominently on the credit card and the issuing members name may be displayed less prominently. Importantly, the co-brand partner will share with the issuing member the revenues and/or profits associated with the use of the card.

The method of sharing revenue and/or profits can vary depending on the arrangements agreed between the members and the co-brand partner. In general terms it involves the issuing member paying the co-brand partner in respect of loyalty points which have accrued from the use of the co-brand card by a cardholder when those points are redeemed by the cardholder with the co-brand partner. Effectively this means that the member subsidises sales by the co-brand partner to cardholders holding the co-brand card.

Where the card is used to acquire goods or services from the co-brand partner, and the issuer is also the acquirer of the transaction, the co-brand partner often obtains the benefit of a substantial reduction in the merchant service fee in respect of those transactions.

Importantly, the Bylaws and Rules of MasterCard do not provide any restrictions on the co-branding relationships which may be entered into by a member or on the terms of that relationship. There are some restrictions placed on the card design and other factors which could potentially affect the MasterCard brand.

Accordingly, through co-branding relationships many organisations – including merchants – can obtain many benefits of participation in the MasterCard system but without being subject to the obligations of and risks associated with membership. The benefit so far as MasterCard is concerned is that, notwithstanding the involvement of the merchant in the MasterCard system through the co-branding relationship, there is an issuer in that relationship which has satisfied MasterCard's eligibility criteria and so no additional risk is posed for the system. Indeed all participants in the MasterCard system benefit if the co-branding relationship increases card issuance and usage.

It should be noted that MasterCard was a pioneer in the development of co-branding programs. This started in the U.S. at a time when MasterCard was losing market share to Visa and co-branding was seen as important in redressing this issue.

d. Member Service Providers

Another way an entity not eligible for membership can participate in the scheme, is by becoming an authorised Member Service Provider ("MSP"). MSPs participate in the scheme by providing services to a MasterCard member or group of members. They can conduct the credit card issuing or acquiring business on behalf of a member without qualifying for, or otherwise being subject to the obligations of, membership of MasterCard although, as explained below, are generally required to be supervised by a member.

MSPs can be in the form of Independent Sales Organisations ("ISO") under MasterCard's Rules. ISO's conduct services such as merchant solicitation, cardholder solicitation, and customer service.

MSPs can also be in the form of Third Party Processors ("TPP") under MasterCard's Rules. TPPs conduct services including but not limited to, terminal operation, authorisation routing, voice authorisation, call referral processing, electronic data capture, clearing file preparation and submission, settlement processing, cardholder and merchant statementing, and chargeback processing.

Under MasterCard's Bylaws and Rules there is nothing to prevent an acquiring member from contracting out its acquiring business to a TTP. In such a situation the TTP would often be the interface between the merchants and the acquiring member - even though the acquiring member would have the direct contractual relationship with the merchant

and it would be the acquiring member which is responsible for complying with MasterCard's rules and has responsibilities for the actions of merchants in credit card transactions. Further the member is responsible for, and must control, all aspects of the issuing and/or acquiring business undertaken by the TTP.

First Data Resources Australia is an example, in Australia, of a TTP which processes acquiring and issuing business for a number of large Australian banks.

There is also nothing under MasterCard's Bylaws or Rules to prevent an organisation, or even a group of organisations (such as a group of merchants) from forming a TTP for the purpose of being the interface between those organisations and acquiring members or from acquiring a TTP for this purpose.

There is similarly nothing to prevent merchants requiring an acquiring bank to deal with a particular TTP in respect of transactions in which they are the merchant. Such a move would provide those merchants with many of the benefits of effective participation in the acquiring business but without being subject to the obligations of member acquirers.

In addition, under MasterCard's Bylaws, if a TTP were directly or indirectly controlled by one or more existing members of MasterCard, then it may be possible for that TTP to become a member of MasterCard.

It is expected that a TTP would be solely or principally engaged in operating programs utilising one or more of MasterCard's trademarks or services or related activities.

As indicated below, it is a requirement under MasterCard's Rules that each organisation granted membership must have issued a reasonable number of MasterCard cards. This rule is dealt with further in the response to Question 5. Accordingly, it would not be possible under MasterCard's existing rules for a TTP to be a member *only* for the purpose of acquiring MasterCard credit card transactions.

2. "No Surcharge" Rule

MasterCard notes that the Study was critical of the rule against surcharging. This issue has been partially addressed above in Section 1.4 of Part A in the context of competition in the retail sector. This section provides additional rationale for justifying such a rule.

MasterCard regards surcharging as objectionable because it allows the merchant to capture value in the transaction which the issuer has created. It results in over-compensation of the merchant in the transaction to the detriment of the other participants in that transaction – particularly the cardholder. The merchant service fee paid by the merchant to the acquiring bank represents the fee payable by the merchant for being able to participate in the MasterCard credit card system and make a sale because of that system. It represents compensation paid by the merchant to the acquirer and the issuer for the costs and risks to which they are subject in the transaction and the value they have created in the system. If the merchant is entitled to recoup this fee from a cardholder, then the merchant is not paying their fair share from participating in the system and, as a consequence, the cardholder pays too much.

Surcharging is thus equivalent to setting the interchange fee too low by making the cardholder bear a disproportionately heavy burden of the costs of running the system. The net result would be the same – fewer cardholders, leading to fewer merchants acquired, leading in turn to fewer cardholders – the setting in motion of the "death spiral."

Were surcharging allowed in respect of all transactions, MasterCard would be concerned that they unfairly discriminate against holders of its credit card as compared to the customers of a merchant who pay by some other means. In this regard MasterCard believes also that surcharging undermines the "Honor all Cards" and "Non-discrimination" rules of MasterCard.

To be scrupulously fair to all customers the merchant would, on the Joint Study's argument, need to price differently goods or services depending upon the particular payment method used. While the merchant is subject to a merchant service fee if they accept payment by credit card, all payment methods involve some cost to the merchant as pointed out in Section 1 in Part A. For a merchant who accepts cash in payment, there are costs associated with the handling and banking of the cash as well as the increased risk of loss associated with theft and mishandling of the cash paid. For a merchant who accepts cheques there are costs associated with handling and banking the cheques as well as the waiting time for being credited with value for the cheque by their bank and the risk of the cheque being returned. As shown in Section 1.1, Part A above, the costs of handling cash and cheques can be quite significant.

Accordingly, if there were a policy desire to allow merchants to surcharge, then MasterCard sees no justification in allowing the merchant to discriminate in any such surcharging against credit cards simply because the merchant service fee is a more explicit cost than the costs associated with other forms of payment. If a merchant is allowed to impose a surcharge for accepting payment by credit card then, theoretically at least, the price of the good or service should be similarly adjusted to take account of the implicit cost to the merchant of the payment method used. Clearly, to require a merchant to engage in such differential pricing would be impractical. However, while it may be more practical to allow the merchant to impose a surcharge only where a credit card is accepted in payment, the point still holds true that to allow the merchant to do so does not address the discriminatory treatment of payment by credit cards compared to the other methods of payment.

Allowing surcharging would, in MasterCard's view, be detrimental to its credit card business in Australia. It is expected that, if surcharging were to be allowed, a merchant would need to clearly indicate the cash price of a good or service as well as the surcharge price for that good or service. Many consumers who are used to paying for goods and services by credit card, and who do not carry around large amounts of cash (whether because of the inconvenience or security issues associated with doing so), may not wish to make the purchase at the higher price which incorporates a surcharge. In this respect not only is there discrimination against a credit card holder which MasterCard believes is contrary to its rules but also it is quite possible that the merchant will lose a sale. It is possible that, while some of these lost sales will be completed by the cardholder at other merchants who do not impose a surcharge, a number of impulse purchases of goods and services by cardholders will be lost completely with potentially adverse effects on the Australian economy.

As pointed out in Section 1.4 of Part A above, MasterCard's rules do not prohibit a merchant offering a discount from the price of a good or service if cash is paid rather than payment by credit card.

Merchants who do not wish to be subject to the merchant service fee have the choice of not accepting MasterCard credit cards. Despite the far reaching penetration of acceptance of credit cards among merchants, there are a number who do not accept them. For example, there are discount stores, cafes and a number of supermarkets do

not accept credit cards. Consumers have the choice of shopping with those merchants. However, if a merchant indicates (usually by signage at their entrance) that they accept MasterCard, then MasterCard regards it as unfair if a MasterCard cardholder is effectively enticed into that merchant's premises on this basis only to be confronted by a differential pricing regime – which may be the case if surcharging were to be permitted.

Even if surcharging is voluntary in terms of a merchant having the choice of whether or not to impose a surcharge, this would create confusion for a cardholder who may not be able to tell whether a merchant displaying a MasterCard sign on their door is a merchant which applies a surcharge or is one which does not. The present simplicity and certainty enjoyed by cardholders when they shop using their MasterCard card will be seriously undermined if merchants are allowed to impose a surcharge.

Part C

SPECIFIC QUESTIONS FROM THE RBA OF MAY 2, 2001

Interchange Fees

1. Is an interchange fee necessary to the functioning of an open credit card scheme? If so, why? If not, what are the alternatives?

An interchange fee is certainly most necessary for the functioning of a four party open credit card scheme. It is widely acknowledged that the interchange fee is, as discussed in Section 1.2 of Part A above, an efficient arrangement to balance the costs and benefits of credit card transactions in the open system between issuers and acquirers, and thereby the cardholders and merchants.

In an open credit card scheme it is important to understand that issuing and acquiring services are quite different both in terms of their nature and cost. Issuing services include:

- issuing cards,
- determining cardholder credit worthiness,
- managing credit and deposit accounts,
- processing card transactions,

- billing cardholders,
- underwriting credit and fraud losses,
- providing cardholder service (e.g., for lost and stolen cards),
- educating cardholders,
- marketing and promoting card usage,
- developing new payment products and services, etc.

Acquiring services are more limited primarily to:

- evaluating and signing merchants,
- maintaining telecommunications links to merchants,
- processing merchants' transactions,
- settling with merchants and handling charge-backs,
- monitoring merchant behavior and fraud monitoring.

These differing functions result in an imbalance between the issuers' and acquirer's costs, which must be corrected through an allocation of revenues between them. This is typically achieved through interchange fees.

The interchange fee arrangement allocates the costs of running the system through charges to cardholders and merchants. This is necessary and convenient because cardholders have a high price elasticity of demand and merchants are willing to pay for the numerous benefits of being able to accept payments cards. This is consistent with the economic principle of maximising efficiency, and in practice has proven to be effective in attracting both cardholders and merchants to grow the size of the network.

Interchange fees can be thought of as a reimbursement by the acquirer to the issuer for part of the issuers' costs so as to optimise the services they carry out for the benefit of both cardholders and merchants. Since it is not practical in a system involving many issuing and acquiring banks for them to negotiate bilateral interchange fees, the participating banks need to agree collectively on interchange fees. These are known as multilateral interchange fees. The many undesirable consequences of the interchange fee being set inappropriately – too high or too low in relation to its levels of efficiency

delivered to its participants as well as the society at large – are examined in Section 1.2 of Part A above.

MasterCard is not aware of any alternative to the interchange fee arrangement that is tested and proven to be feasible in practice.

2. In the open credit card systems operating in Australia, are there competitive forces that generate an equilibrium interchange fee? If so, what are they?

As discussed in Section 1 of Part A, the level of interchange fee is closely influenced by four dimensions of competition in the payments market. MasterCard believes that competition in the retail sector is particularly important in Australia in affecting the equilibrium level of interchange fee, and this belief is also supported by rigorous economic analyses as cited in Section 1, Part A.

3. How do you think interchange fees for the card schemes operating in Australia should be determined in practice? Please spell out the advantages and disadvantages of your proposal.

MasterCard believes that the level of the interchange fee should be determined by taking into account specific costs. This might be described as a "fee-for service" approach, which MasterCard uses in setting the global interchange fee and interchange fees in certain countries such as the U.S., and where the imbalance between an issuer's cost and revenues is redressed by acquirers compensating issuers in connection with the costs that issuers incur in providing the following services to the merchant:

- payment guarantee;
- funding for delayed payment (i.e. the interest-free period); and
- processing of the incoming transactions.

The interchange fee is then established by taking these costs as a starting point and taking into consideration other factors, including the need to provide incentives for widespread issuance and for merchants to accept cards or deploy technology and the level of competitors' fees.

The following are taken into account in determining the interchange fee level:

- Issuer's costs
- Incentives for adoption of new technology or transmission of additional data by merchants and acquirers (e.g. electronic terminals, airline itinerary data)
- Incentives for issuing new card types (e.g. corporate cards)
- Competitors' interchange rates
- Business/Economic environment
- And any other relevant factors.

There is significant flexibility in accounting for these factors, especially during an economic slowdown, in which certain costs could be deferred.

Generally, with respect to domestic interchange fees, MasterCard believes that its members are usually in the best position to make these determinations. Thus, MasterCard's interchange rules and policies call for member-established interchange fees wherever possible.

4. How frequently should interchange fees be revised? Please detail the arguments for and against your proposal.

MasterCard believes that annual revision of interchange fees would be appropriate. In jurisdictions where MasterCard sets the interchange fees, such as the U.S., the fees are reviewed and revised annually.

Annual revision provides an acknowledgment that the credit card payment system is in constant flux. This flux consists of the development of new products and technologies, shifts in cardholder and merchant behaviour, changes in costs associated with processing credit card transactions, economic fluctuations, and competitive developments. A review of interchange fees on an annual basis would enable a speedy response to these changes.

MasterCard believes that a review more frequently than annually would be difficult due to the need for changes to be implemented in each of the member's system. An important factor which also must be kept in mind is the need to ensure stability for all parties concerned, that is, merchants, merchant acquirers, issuers and cardholders. Merchants have a desire to lock away merchant agreements with an acquirer for a substantially long period of time so as to reduce the costs associated with negotiating such contracts, as well as securing a better deal. Issuers and acquirers also need to be able to forecast their expenses and revenues over the medium to long term. A constantly changing interchange fee will almost certainly lead to instability in the industry resulting in diminished issuance and acceptance.

Access

5. What specific risks do acquirers bring to a scheme, independent of their status as issuers?

The risks which acquirers bring to a credit card scheme are as follows:

(a) They may be unable to promptly meet their charge-back obligations. This is a risk for issuers in the event that an acquirer is unable to meet these obligations. Ultimately this risk would be borne by MasterCard under its guarantee obligations to its members. Such charge-back obligations could relate, for example, to the financial failure of a merchant after it has sold, by credit card, goods or services which have not been delivered to a cardholder. MasterCard at the present time, and as further described below, is dealing with a situation involving the failure of a bank in the U.S., which was a net acquirer, to meet substantial charge-back liabilities. The bank concerned is the National State Bank of Metropolis, Illinois and its inability to meet its charge-back obligations was the cause of its failure.

(b) They may be unable to pay merchants promptly. Obviously this is a risk for the merchants in the event that an acquirer is unable to meet these obligations. The inability of an acquirer to pay merchants may be due to the general financial position of the acquirer. It could also arise due to an acquirer's failure, for example, to meet charge-back obligations to issuers. Obviously, this risk of non-payment of merchants involves adverse implications for merchants, and indeed the association's brand.

(c) The terminals and other equipment installed by the acquirer at merchants for whom they acquire transactions are defective or that the procedures of the acquirer may not enable the proper and efficient processing of the merchant's credit card transactions. MasterCard also does from time to time make changes to its system which may require acquirers to upgrade their equipment at considerable expense. Acquirers would need to have the financial ability to make these upgrades.

(d) The acquirers do not comply with MasterCard's rules and do not ensure that merchants for whom they will acquire MasterCard credit card transactions, comply with those rules. As further described in the response to Question 6 below, this is a particular

issue in relation to self-acquiring. MasterCard rules of relevance may relate, for example, to background and credit checks that should be undertaken by acquirers in respect of merchants for whom they wish to acquire. If these checks are not undertaken properly then there may be a high incidence of charge-backs in respect of transactions undertaken by particular merchants. The merchant may also run into financial difficulty and fail prior to delivery of goods or services which it has sold by credit card. Credit checks may have alerted the acquirer to the financial position of the merchant. Similarly, if the merchant operates in an industry where there is a high incidence of fraudulent activity involving credit cards, then charge-back liabilities in respect of such fraud may have been able to be avoided by appropriate background checks. These problems have become more acute in the growing e-commerce environment in Australia. A recent example was the e-commerce pyramid selling scheme operated by World Netsafe which was successfully prosecuted by the ACCC in 2000.

Merchants also have various responsibilities under MasterCard's rules such as to follow correct authorisation procedures and monetary limits relating to transactions. Failure to adhere to these policies, and failure by the acquirer to enforce these policies, may result in increased charge-backs and damage to the MasterCard brand.

(e) The acquirer may acquire transactions for high-risk or fraudulent merchants. Notwithstanding the obligation on the acquirer under MasterCard's rules to undertake background checks and credit checks, the desire of an acquirer to grow their acquiring business may lead to the acquirer signing up merchants which are high-risk (such as in certain Internet businesses) or in areas of business which have a high incidence of fraud. This risk taking by acquirers (which may be more if self-acquiring is involved or if merchants are related to the acquirer) may result in increased charge-back liabilities.

MasterCard has rules which seek to address fraudulent transactions processed by merchants. For example, under one rule (the "8% rule") should the volume of counterfeit and fraudulent transactions from a merchant exceed 8% of that merchant's MasterCard transactions for two successive months then, if that merchant is not terminated by the merchant's acquirer, the acquirer is subject to charge-back liability for fraudulent transactions for one year, commencing after that two month period

MasterCard notes the following comment in the Joint Study:

> *"More objectionable, from the study's point of view, is the requirement in both the MasterCard and Visa rules that acquirers must also be issuers. Combined with the restrictions on issuing, this limits acquiring to authorised deposit-taking institutions. The study sees no justification for such a restriction."* (p. 57)

As explained in Section 1 of Part B above, the class of organisation which may qualify for membership of MasterCard is wider than authorised deposit-taking institutions. Further, it is quite possible for an organisation, although it may not itself qualify for membership, to nevertheless participate in the economic benefits of membership through co-branding opportunities.

MasterCard's rules requiring members of MasterCard to issue a reasonable number of MasterCard cards seeks to achieve a number of objectives so far as MasterCard is concerned. Foremost is MasterCard's desire to promote the growth of the MasterCard scheme and the development of the MasterCard brand. In MasterCard's experience this is best achieved by encouraging card issuance by members as such encouragement of card issuance benefits *all* participants in the MasterCard system. An increase in the number of MasterCard cardholders will encourage an increase in the number of merchants who are willing to accept MasterCard cards in transactions and, as a consequence, this will also benefit merchants and thereby encourage growth in the acquiring side of the members' business.

MasterCard is of the view that the absence of rules encouraging issuance of cards potentially gives rise to a number of problems for the continued growth of the MasterCard scheme. This is because card issuance by members involves them incurring various costs, such as in advertising and promotional activities, to attract cardholders and promote the MasterCard brand. If a member were allowed only to acquire MasterCard transactions, or predominantly acquire those transactions, MasterCard believes that those members are not adequately contributing to the MasterCard brand.

There is also a "free-rider" benefit which members who are solely or predominantly acquirers obtain. This arises from the development and promotion of the brand associated with card issuance and from which acquirers benefit but for which net acquiring members do not, or do not adequately, contribute.

Accordingly, acquiring members which benefit from lower costs by free-riding off the promotional and development expenditure of issuing members could potentially "cherry

pick" the acquiring business of merchants and strike more favourable deals with them as to the level of merchant service fee than may be able to be offered by members who are both issuers and acquirers. This prejudices those members who are promoting the issuance of MasterCard cards and may cause them to reduce promotional and development expenditure. It is thereby inimical to the development and success of the MasterCard brand.

In MasterCard's view the costs associated with card issuance are not "one-off" costs nor costs which are only related to the establishment of a credit card system. Faced with competition from competing card brands and competing payment methods, card issuers in need to continually incur costs to develop and promote the MasterCard brand. Accordingly, it is an ongoing effort, involving considerable expenditure, to promote the MasterCard brand and to win new cardholders. This is not dissimilar to the position in most competitive markets.

There may be some countries where, for various reasons, issuance, or significant issuance, of MasterCard cards is not achievable. These are typically small tourism destination markets such as Fiji, where apart from foreign tourists, the potential of the local market for card issuing is very low. In those countries MasterCard's members may only, or predominantly, acquire credit card transactions.

As MasterCard is a global payments brand it is necessary that its Rules cater for members in these countries to ensure that the MasterCard card is accepted globally in as many places as possible. Australia would not be regarded as a destination market for these purposes and, accordingly, the reasons for catering for sole or predominant acquirers in those markets would not apply.

In criticising the rule that acquirers are required to issue a reasonable number of cards the Joint Study states:

> *"Acquirers pay their merchants and receive funds from issuers; as net receivers of funds, the do not introduce settlement risk for other financial institutions in the system. They need to be able to process transactions for their merchants in an efficient, reliable manner. They also have to bear the risk of merchant fraud and may face substantial costs if a merchant collapsed with goods paid for by cardholders but not delivered. Acquirers need sufficient skills and substance to be able to assess and cover such risks when signing up merchants. None of these functions,*

> *however, requires the acquirer to be an authorised deposit-taking institution. Merchants would have to hold their deposits with an authorised deposit-taker, but this need not be the acquirer." (p. 57)*

MasterCard believes that the Joint Study's comment understates the potential risks which may be borne by acquirers and which may give rise to settlement risk for issuers. As indicated above, the potential risks could, for example, relate to the a failure of a merchant who has sold, by credit card, goods or services in advance of their financial collapse. If the goods or services have not been delivered to the cardholder, then the acquirer may be subject to substantial charge-back claims. An example may be in the case of an air carrier which fails and has pre-sold tickets by credit card. This was the result when Compass Airways failed which left ANZ Bank, as acquirer, with significant charge-back liabilities. Had ANZ Bank had less financial resources at its disposal at the time, it could have run into difficulties in meeting these charge-back liabilities.

Another source of risk for acquirers is where they are not conducting their business prudently and may sign up too many merchants who are in businesses which typically give rise to a higher incidence of charge-backs. These businesses typically include Internet gambling and Internet sites offering "adult" products and/or services. As indicated above, there are also merchants who may be the subject of fraudulent activity or the merchant itself engages in fraudulent activity. An example is the collapse of Bank of Credit and Commerce International (BCCI) in the early 1990's. Although BCCI's problem were not due solely to its conduct of a risky acquiring business, its charge-back liabilities due to the high risk merchants it signed up added to its financial difficulties.

MasterCard's concern about acquirers having the financial wherewithal to meet charge-back claims is not mere speculation nor should be regarded as undue conservatism. While MasterCard is keen to grow its business, and expanding its membership is one way of achieving this, it needs to be done in a way which will not expose MasterCard to more significant risks of member failure nor which involves MasterCard in incurring significant additional cost in formulating criteria for membership and monitoring membership compliance with such criteria.

On December 14, 2000, the Federal Deposit Insurance Corporation ("FDIC") declared National State Bank of Metropolis, Illinois ("NSBM") insolvent and put it into receivership. NSBM was a one hundred year old financial institution with assets exceeding US$90

million. FDIC records indicate that, as of the end of September 2000, the bank was well-capitalised. When it closed, it owed MasterCard a considerable amount for chargebacks, Visa approximately twice that amount, and several processors with whom it did business further substantial amounts. From what MasterCard can determine, NSBM's acquiring business was sound as of the third and early forth quarters of the year, when it began to experience increasing chargebacks in connection with transactions acquired from internet and telemarketing merchants. Within the span of three or four months, it had run through its reserves and owed MasterCard and other creditors considerable amounts. It appears that a significant portion of NSBM's losses were caused by a relatively small number of merchants. This, despite the fact that NSBM was a regulated and supervised U.S. national bank. At a minimum, this example demonstrates that acquiring can be a risky business that requires a high level of sophistication by the acquirer and close supervision by banking regulators.

6. What specific risks do self-acquirers bring to a scheme? Please note where those risks are different from the risks for third party acquirers.

MasterCard believes that the risks which self-acquirers bring to a scheme, while not as great as issuers, are nevertheless significant. In summary these risks are:

- it may compromise an acquirer's ability to ensure compliance with MasterCard's rules in respect of the transactions acquired.
- it may compromise an acquirer's use of independent judgement and in respect of transactions proposed to be acquired.
- where a self acquiring merchant also undertakes acquiring other merchants' transactions, there may be impartial treatment of transactions acquired, which may adversely affect confidence in the system.
- failure of the merchant will result in losses by the participants in the scheme, as there will not be an independent acquirer acting as a buffer to absorb the direct impact of such a failure.

The policy of MasterCard against self-acquiring is quite flexible in its application. If there were to be some minor amount of self-acquisition by an acquirer, this would not of itself cause MasterCard undue concern. For example, if some incidental goods or services offered by a member were paid for by credit card. There is more concern if an acquirer were proposing to self-acquire a substantial volume of transactions. This may arise, for example, if under the April 2000 policy paper issued by the Australian Prudential Regulation Authority a conglomerate group established an authorised deposit-taking institution which became a MasterCard member and it was proposed that a significant volume of transactions of merchant organisations in that conglomerate group be acquired by the member.

The policy has not been the subject of application in Australia to date as there has not been any occasion when a member has sought to acquire a significant volume of its own transactions. The policy has been applied in the U.S. where there are instances of merchants owning financial institutions which are members of MasterCard. For example, MasterCard applied the policy to a large U.S. department store chain which bought a small bank and was proposing to use that bank to acquire MasterCard credit card transactions from its department stores.

If a member could acquire a significant volume of its own transactions (or a significant volume of transactions of an affiliate) then MasterCard believes that the reliance which MasterCard currently places on acquirers to act in their self interest to avoid charge-back liabilities could become significantly compromised. Acquiring members may be less assiduous in ensuring they, in the transactions they self-acquire, or that the merchants who are affiliates are complying with MasterCard rules.

An example of the motivations of some merchants in this regard is illustrated by a proposal which was put to MasterCard an air carrier in the U.S. which had proposed to MasterCard that it acquire a bank which would become a member of MasterCard and which would then acquire credit card purchases of air tickets by customers using MasterCard. The background to this proposal was the requirement of the air carrier to lodge a security deposit with the acquirer of that company's transactions so as to reduce the risk for that acquirer should the company not be able to provide services to holders of tickets which had been sold in advance using MasterCard. This would cause the relevant issuing banks to make refunds to their cardholders and, as a result, subject the air

carrier's acquiring bank to large charge-back liabilities to the issuing banks. Needless to say, this proposal was rejected by MasterCard. If MasterCard could not rely on acquirers to act in their self-interest to monitor merchant compliance with MasterCard's rules then it may need to undertake that monitoring function itself. This is not something which MasterCard currently does to any significant extent. If it were required to take on additional responsibilities in this regard then that would entail additional costs. There is then an issue of whether it would be equitable for *all* members to be required to fund this additional cost or whether it is more appropriate that this be funded by *only* those acquiring members undertaking significant volumes of self-acquisition.

Member acquirers that self-acquire, or have affiliates from whom they acquire transactions, may also not be impartial in their treatment of all the merchants with whom they deal. They may be more prone to arrange prompt payment of their own or their affiliates transactions rather than those of other non-affiliated merchants. The situation could also arise where the acquiring member is in financial difficulty and gives preference to paying affiliated merchants in priority to other merchants. This could undermine the confidence placed by merchants and other participants in the MasterCard system.

7. In the presence of an interchange fee and membership fees, what is the justification for net issuer penalties? How large are such penalties?

In the Asia Pacific region (including Australia), MasterCard charges an Acceptance Development Fee (ADF) to members recognising the importance of fair contribution by both issuing and acquiring members to the continued development of the brand. The ADF is calculated on the basis of each member's ratio of merchant volume to the total volume. The ADF will no longer apply when a member has successfully grown its card base so as to reduce the disparity between its acquiring and issuing volume.

Question 7 refers to the ADF as being in the nature of a "penalty". MasterCard would like to state categorically that this is an incorrect description. As explained in the response to Question 5 above, credit card issuance involves substantial costs in terms of promoting the brand and attracting new cardholders. As also previously explained, were acquirers not to contribute to these costs there would potentially be "free rider" and "cherry picking"

concerns which MasterCard regards as unfair to MasterCard issuers and potentially to the detriment of the MasterCard brand.

The ADF represents what MasterCard believes to be the acquiring members' fair contribution to the development and promotion of the MasterCard brand in the market place so as to generate greater uptake and acceptance of MasterCard cards.

Acquiring members wishing to reduce the amount of its ADF can do so by expanding their issuing base and bearing the costs associated with that.

It should also be understood that an appropriately set interchange fee does not, of itself, resolve this issue. While the interchange fee paid to the issuer may provide some means of compensating the issuer for costs incurred in respect of promoting and developing the MasterCard brand, it does not fill the "gap" in the costs incurred in promotion and development which is left by the net acquirers' failure to do this. The ADF is used by MasterCard to fill such a gap incurred in promotion and development of the MasterCard brand.

No surcharge rule

8. Do you agree that the no surcharge rule is integral to the success of the open credit card systems? If so, why and if not, why not?

MasterCard has a rule which does not allow a merchant to impose a surcharge on a MasterCard credit card transaction. MasterCard believes that its rule against surcharging is critical to the success of its system. Closed systems such as American Express and Diner's Club, also have rules which require merchants in those closed systems not to impose surcharges. Accordingly, MasterCard does not believe that the rule against surcharging has been critical to the success of open systems vis-à-vis closed systems. It is more a case of being of the rule being important to the success of all credit card systems relative to other forms of payment such as cash and cheques. There are other reasons why open credit card systems have been successful relative to closed credit card systems and these are explained in the response to Question 11.

MasterCard's views on surcharging are also set forth in Section 1.4 of Part A and Section 2 of Part B above.

9. If the no surcharge rule were removed from the scheme regulations, do you think it would be removed from merchant agreements?

As it is the banks which have agreements with the merchants, this is a question which is, perhaps, best directed to the banks.

MasterCard expects that there may be some banks which, in the interests of attracting more acquiring business, would be willing to remove the prohibition against surcharging from their merchant agreement. In this regard, the interests of MasterCard and the acquirer may not necessarily coincide. While an acquirer may obtain a benefit from removing this restriction from the merchant agreement MasterCard expects that this benefit may only be short lived. For the reasons referred to in the response to Question 8 above, widespread surcharging is ultimately to the detriment of the scheme and, MasterCard believes would ultimately be to the detriment of acquirers and issuers due to decreased usage and, as a result, decreased issuance.

MasterCard is concerned that surcharging, if permitted, would benefit only those merchants that face reduced competition, since experience has shown that, in highly competitive retail sectors, surcharging is rare if not non-existent. Thus, merchants that can impose surcharges are the same ones that can impose excess levels of surcharges (i.e., levels that greatly exceed what is necessary to recoup the cost of acceptance). Not only would such "price gouging" tarnish the MasterCard brand, but cardholders might be discouraged from using cards even at merchants that choose not to surcharge, thus further damaging the MasterCard brand.

Competition

10. Which payments instruments do open card schemes compete with? How do they compete in each case?

MasterCard maintains that all forms of payment mechanisms, including cash and cheque, are in competition with the payment solutions offered by financial institutions participating in open card schemes as discussed in Section 1 of Part A above.

Payment mechanisms in Australia with which MasterCard credit cards compete include:

- Cash;
- Cheques;
- debit cards;
- stored value / prepaid cards;
- store cards;
- charge cards;
- closed system credit cards;
- direct debit/credit; and
- BPAY[16] .

11. Open credit card schemes appear to have much larger bases and wider acceptance than three party schemes. Why is this so?

The four-party open credit card schemes allow the participating banks to offer the same joint product that three-party schemes offer - i.e. a product jointly offered by acquiring and issuing banks to merchants and cardholders - while maintaining competition between the participating banks at both the acquiring and issuing levels.

By involving more issuers and acquirers, four-party open credit card schemes are far more effective in allowing cardholders to access credit in many more locations, and merchants to broaden significantly their customer base. This way the open schemes can take advantage of the "*network externalities*" to a much greater extent than the 3-party closed schemes.

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[16] Which is a facility enabling payment of bills from a customer's bank account via payment instructions given over the telephone or the Internet.

Four-party payment card schemes can offer substantially more benefits in comparison to the original three-party schemes. These benefits can be summarised as follows :

- *Both merchants and cardholders are free to choose their own bank.* They do not need to be tied to the same provider of services. This is because, as a result of the network of banks created by the payment card scheme, cardholders and merchants will be able to benefit from the scheme through the intermediation of their own banks which in turn will interface for the clearing and settling of the transaction pursuant to multilateral rules agreed at the level of the scheme. In such a system, the banks function as intermediary points of contacts to the scheme without requiring the cardholders and merchants to have a direct link between themselves through the same bank.

- *Universal acceptance through a common brand*. In such four-party transactions, the brand makes the link between the respective customers (the merchant and the cardholder) involved in the transaction. When the cardholder sees that a merchant displays the scheme's acceptance brand-logo at its point-of-sale ("POS"), it knows that its card will be accepted as a valid means of payment irrespective of the identity of its bank (honour-all-cards rule). As to the merchant, it knows, when it sees a card bearing the brand, that it will be paid (guarantee function).

- *Extension of geographic coverage.* Because merchants and cardholders can use different banks, a four-party system allows a wider geographic, and even global, reach, as long as there is a clearing arrangement agreed multilaterally between those banks at the level of the scheme. In particular, it allows banks which have not entered into any bilateral arrangements, notably foreign banks, to interface for the clearing and the settling of a transaction as a result of the meeting of their respective customers anywhere in the world.

- *Increase of intra-brand competition*. Four-party schemes allow the participating banks to offer the same joint product that three-party schemes offer - i.e. a product jointly offered by acquiring and issuing banks to merchants and cardholders - while however still maintaining competition between the

participating banks both at the acquiring and issuing level. This is a tremendous benefit to both cardholders and merchants, as it allows them to shop around numerous issuers and acquirers to get the best deal, while also assuring them that they will benefit from the efficiencies generated by a large payment network.

- *Lower fees*. Such intra-brand competition between the banks participating in the same scheme (in addition to inter-brand competition) has led four-party scheme to be less expensive than three party schemes. This has allowed such schemes to serve many people who would otherwise have been excluded from the benefits of payment cards.

- *Increase of card circulation.* By involving more banks, four-party payment card schemes have also allowed cardholders to access payment service facilities in many more locations, and merchants to broaden their customer base. This has contributed to an increase in the number of cards in circulation, thereby enhancing the efficiency of the whole system. Obviously, the more cardholders use the scheme, the more merchants will accept the cards and thus the more economies of scale will be possible for the system to operate.

- *Greater brand and product development.* Four-party systems allow the various members of the system to share in each others efforts, whether they be by promotion of the brand or the development of products offered. Every time a member markets a MasterCard product they increase awareness of the brand – to the benefit of the scheme and all other members. Scheme members are also constantly developing the functionality of their scheme branded products. This improved functionality is quite often taken up by other participants in the scheme, thereby improving the standard of product offerings generally made by open system participants. Members also derive great benefit from innovations developed by the scheme itself. Recent examples include MasterCard’s development of the corporate card and virtual card programs, which have been successfully leveraged by thousands of MasterCard members globally. This sharing of innovation and the mutual benefit of brand promotion and development is exclusive to the open four-party systems.

12. How are schemes promoted:

(a) At the schemes level?

MasterCard promotes the brand in many ways. “Above the line” promotion is executed through television, print media (magazines and newspapers), and outdoor advertising. “Under the line” efforts involve working with members to promote the brand, by direct mail, to the individual banks’ customer bases.

MasterCard’s advertising campaigns have varying themes, ranging from enforcing the greater acceptability message, or advising the market place of the various card programs offered by our members.

MasterCard also works with merchants and issuers to provide cardholders with special offers for using their MasterCard when making a purchase. These offers can take the form of merchants offering incentives for customers using their MasterCard at their individual stores, or prizes being offered to cardholders for use of their cards at any location. Communication of such offers is effected through a combination of over the line and below the line methods.

The objectives of the advertising are twofold, firstly MasterCard aims to achieve greater brand awareness so as to be “top of mind” when a customer is in the market for a new card product, and secondly MasterCard aims to promote greater use of the card as opposed to other cards, or payment instruments.

MasterCard also uses sponsorship opportunities to promote the brand, details of which are described in Section 1.2.2 of Part A above.

(b) At the individual bank level?

Banks generally promote their individual products, and the features specific to those products rather than the schemes behind those products. However, on occasions the promotion undertaken by the banks does have a flow through effect to the brand. Banks utilise various methods of “above the line” advertising, and “under the line” communications to promote their products and subsequently our brand. These include,

special promotions and cardholder competitions which encourage product take up and or usage, new product offerings, enhanced service levels, and loyalty programs.

13. Why are credit card interest rates around 3 percentage point higher than rates on other unsecured personal lending?

As the charging of interest is a matter solely for the issuing MasterCard member, MasterCard believes that this question is best answered by them. MasterCard's own view is that revolving credit is even less secure than unsecured personal lending, and it is also more costly to operate, and these are clearly some of the key factors accounting for credit card interest rates being higher.

14. Which of your cards offers loyalty points? What is the role of loyalty points? What evidence is there that they achieve the issuers' objectives?

The primary reason issuers offer loyalty points is to generate cardholder loyalty to the product. Card issuers structure loyalty programs in a manner which encourages cardholders to consolidate their spending on the one card product. Card issuers fund the cost of loyalty points calculated on the total spend undertaken on the card, this rewards cardholders equally for all spend, regardless of where the spend is undertaken.

As indicated in the response to Question 1, experience has shown that cardholders are very price-sensitive. While any increase in fees will result in a reduction in card holding and card usage the corollary is that any benefits offered to card holders in the form of loyalty points can have a significant positive impact on card holding and card usage.

Some card based loyalty programs also offer bonus points for spend at nominated merchants. This creates opportunities for merchants to participate in loyalty programs without the need to build their own costly programs. The costs of establishing and administering merchant based loyalty programs, like Coles Myer's Fly Buys are quite high, and prohibitive for smaller merchants. Card based programs with bonus merchant

functionality allow merchants to fund the cost of the bonus points in return for the loyalty of a specific card base.

Programs like OneLink MasterCard which are issued by regionally based credit unions, mortgage originators or community banks, allow local merchants to participate in a credit card loyalty program that they normally could not afford to do so.

RBA figures suggest that offering loyalty points with credit card products do assist card issuers in the achievement of their objective. Available data has also demonstrated that merchants do experience substantial growth in sales by participating in card based loyalty programs as bonus points providers.

15. Does the ability of issuing banks to offer a number of different brands of cards result in more competition between schemes than would be the case if they could only issue one brand? Please detail your analysis.

MasterCard submits that the ability of issuing banks to offer a number of different brands of cards generally results in greater competition between the schemes, which ultimately benefits consumers.[18] Likewise, many of the benefits of this inter-brand competition would be lost by restricting banks to the issuance of a single brand.

Multi-brand issuance by banks creates pro-competitive incentives for each scheme to try to outdo the other in providing its members with unique product offerings, innovations and financial and technical support in order to gain a greater share of an issuing banks' business. Furthermore, by taking competitively different approaches to certain problems or issues facing the industry, the competing schemes provide their issuing banks with options regarding the best possible solutions for their cardholders. Financial institutions are able to exploit the competition between the schemes by playing one scheme off of the other in order to obtain the best package of marketing support, product choices or product innovations. This competition ultimately benefits consumers as issuers are able to provide their cardholders with a preferred mix of card brands and features as well as lower fees and interest rates.

Many of the benefits that result from competition between or among schemes would either be diminished or be lost entirely if card issuers were permitted to offer only one brand of card. The intense competition between and among schemes is fostered under multi-brand issuance because issuers of multiple brands have the flexibility to take advantage of initiatives developed by any scheme. Issuers are able to maximise this opportunity by changing the focus of their future card solicitations or converting programs from one scheme to another. They can also respond quickly to consumer demand by offering their cardholders access to a preferred brand with unique features. Without multi-brand issuance, a bank issuer would lose substantial flexibility to change emphasis from

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[18] However, in certain geographic regions (not Australia) the breadth of this proposition depends upon the organizational structure of the payment network. In certain regions, broadly expanding issuance to permit MasterCard member banks to also issue on the networks of closed, proprietary schemes such as American

one brand to another because the transaction costs of switching away from the only brand it issues might prove prohibitive. Furthermore, at the system level, the intense continual competition between schemes for banks' issuing decisions could dissipate as banks moved exclusively to one brand.

In addition, multi-brand issuance has preserved the vitality of the smaller and more vulnerable systems such as MasterCard and indeed Bankcard. Because of the strong network externalities that are present in this industry, issuers would tend to favor the larger system over the smaller if forced to choose one brand. Ultimately, the smaller systems' existence could be threatened if enough volume were to move to Visa, the largest system. Thus, multi-brand issuance enables smaller systems to compete effectively in the industry by offering unique and differentiated innovations to attract issuers and consumers away from competing systems.

Express raises different, countervailing anti-competitive considerations that may blunt the pro-competitive benefits of multi-brand issuance.