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Dear Sir

MasterCard's Response to the Draft Revised Standard for the Setting of Interchange Fees

This letter provides the response of MasterCard International Incorporated to the Consultation Document released by the Reserve Bank of Australia ("Bank") on 20 July 2005 entitled "Proposed Changes to the Credit Card Interchange Standard" ("Consultation Document") and which contains two alternative draft revised standards for the setting of interchange fees in designated credit card schemes.

The comments in this letter are in addition to those contained in my letter to you of 12 April 2005 providing comments on the Media Release entitled "Payments Systems Reform" issued by the Bank on 24 February 2005 ("12 April Letter").

General Remarks

As noted in MasterCard's submission of March 2002, when the Bank proposed to standardise the interchange cost benchmark applicable to the four-party credit card schemes ("the credit card regulation"), MasterCard warned of the unintended consequences of regulatory intervention. Experience to date with the credit card regulation should serve as a salutary warning to the Bank in proposing yet further regulation of credit card interchange and, indeed, should act as a brake on proposals to regulate other parts of the Australian payments market.

One of the immediate objectives of the credit card regulation, driving down four-party credit card scheme merchant fees, has been achieved, but at what cost? Credit cardholders now pay substantially more to use their cards and receive fewer benefits.¹ Worse, despite what economic theory may dictate, there is no evidence that all or even most of the more than \$580 million in savings enjoyed by merchants through lower merchant fees has been passed on to consumers in the form of lower retail prices. Merchants have been silent on this issue, which one might expect would not be the case if benefits were being passed on by them through lower prices. Indeed the Governor, before the Standing Committee on Economics, Finance and Public Relations, admitted the difficulty in being

¹ As acknowledged in Reserve Bank of Australia, *Payments Systems Board Annual Report 2004*, at p. 11.

able to demonstrate a resulting reduction in price levels.² Instead, the Bank is left to urging that the realised reductions in merchant fees be, and expressing its belief that they probably are being, passed on to consumers. By doing this the Bank is applying a significantly lower standard to its own claims than the impossible standards it applied to the arguments made and evidence presented by the card schemes and other organisations the Bank's intervention in the credit card business. The truth is that consumers in Australia, faced with higher credit card annual fees, fewer credit card benefits, the surcharging of credit card transactions by some merchants with market power, and no measurable reduction in prices generally, are now demonstrably worse off as a result of the credit card regulation.

Another consequence of the credit card regulation is that banks have increasingly turned to issuing the cards of the unregulated three-party schemes, whose merchant fees have not shown any substantial downward movement.³ Undoubtedly and understandably, the banks resorted to offering these cards in order to retain customers that otherwise would have otherwise abandoned the four-party scheme cards issued by the banks to take up three-party scheme credit cards from someone else. This reaction by issuers, which was easily predictable, clearly undermines the purposes of the Bank's credit card regulation. Moreover, the shift in cardholder preferences towards three-party scheme cards is still at an early stage. MasterCard believes that the Bank's decision not to regulate three-party schemes⁴ will only serve to hasten the shift towards these more expensive and less efficient systems. This likely outcome not only threatens to thwart one of the chief intended outcomes of the Bank's credit card regulation, but indeed will lead to a result which is exactly the opposite of that sought to be achieved by the Bank. Although this outcome was predicted by MasterCard in its various submissions to the Bank at the time the Bank proposed the credit card regulation⁵, it can only be supposed that it is was largely unanticipated by the Bank as evidenced by the Bank's apparent lack of a plan for dealing with this unfair advantage handed by the Bank, through the credit card regulation, to the three-party systems.

Meanwhile the Bank has said that it is dissatisfied with another of the outcomes of the credit card regulation, namely, that the benchmarks of the designated schemes are not identical. It is interesting (to say the least) that the Bank has determined that a 0.025% difference in the cost benchmarks of the designated credit card schemes requires further regulation, but that it would not be in the public interest to address the enormous competitive advantage given to three-party schemes by the Bank's credit card regulation and the resulting increased difference between the merchant service fees of the four-party schemes and the three-party schemes.⁶ It is MasterCard's view that this further demonstrates that the Bank's original intervention in the payments market was badly conceived and the revised interchange standard will, for the reasons provided below, only serve to make the situation worse.

The lesson, of course, is that the consequences of regulation are often unpredictable, are not always the intended ones, and are difficult to remedy once they have materialised. Indeed, the Bank

² House of Representatives, Standing Committee on Economics, Finance and Public Administration, Reference: Reserve Bank Annual Report 2002-03, Friday, 4 June 2004 and House of Representatives, Standing Committee on Economics, Finance and Public Administration, Reference: Reserve Bank Annual Report 2004, Friday, 12 August 2005.

³ As indicated in the article "*Merchant Service Fees for Credit Cards*", Reserve Bank of Australia Bulletin, July 2004, p. 10 at 13 and in "*Merchant Service Fees and Market Shares for Credit and Charge Cards*", Reserve Bank of Australia Bulletin, August 2005 p. 67 at 68.

⁴ Reserve Bank of Australia, *Media Release*, 24 February 2005.

⁵ For example, in MasterCard's earliest submission to the Bank of June 8, 2001, at Section 1.2.1, p.7.

⁶ Three-party schemes' merchant fees are approximately 2.36% and 2.31% respectively for American Express and Diners Club, while those of four-party schemes are only 0.92% ("*Merchant Service Fees and Market Shares for Credit and Charge Cards*", Reserve Bank of Australia Bulletin, August 2005.) The result is that three-party schemes and banks that choose to issue their cards are able to offer cardholders payment products at lower prices than issuers of the cards of the designated credit card schemes.

admitted as much in its statement of 23 February 2005 when announcing its decision not to regulate the three-party systems:

“The Bank considered, in particular, whether there was a case to regulate the payments between American Express and Diners Club and their bank partners. It concluded that, at this stage, such regulation would not improve the overall efficiency of the payments system. In its view, regulation of these payments would have relatively little effect on merchant charges. Further, the existing incentives facing issuers of these cards could only be addressed through considerably more extensive regulation than that currently existing in the credit card schemes.”

Unfortunately, rather than admitting that it made a mistake, retracting its earlier regulations, and allowing the market to correct the problem, the Bank instead proposes to do nothing to correct the unfair advantage the credit card regulation conferred on the three-party schemes but rather intends to introduce further regulation of four-party schemes.

Comments on Consultation Document

Upon review of the arguments set out by the Bank in the Consultation Document, as well as those in the various submissions made to the Bank in connection with this matter, MasterCard International is of the view that there are pros and cons for both the current system of allowing different benchmarks within a highly regulated environment and the proposed system of applying a weighted average of costs across all of the regulated schemes.

MasterCard can understand why an issuer seeking to maximise its revenues may be attracted to a higher interchange fee scheme, particularly in an environment where interchange fees are set artificially low. It could be argued therefore that the regulations create a competitive imbalance in favour of the scheme with the higher level of eligible costs. The Bank is aware that MasterCard has argued strongly against regulations which are not competitively neutral.

Notwithstanding this, MasterCard stands by previous arguments it has made that a single cost benchmark will result in even greater under-compensation of issuers with higher cost portfolios (for example, those with a lower than average revolve rate), and greater over-compensation of issuers with relatively lower cost portfolios (for example, those with lower than average fraud costs). Such an outcome will reduce competition amongst credit card issuers, as they look to reduce costs, and lead to increased homogeneity of credit card products.

In the Consultation Document the Bank indicates that it does not accept the argument that a common cost benchmark may reduce competition, and states that there is strong competition amongst issuers of credit cards in terms of both price and product characteristics and that this situation would not be adversely affected by a common benchmark interchange fee.⁷

MasterCard does not disagree that there is, *at present*, strong competition amongst issuers of credit cards. Such competition has been enhanced by the fact that, at present, issuers have been able to recover eligible costs as they may apply to the relevant scheme. One distinct characteristic of the product offerings in recent times, however, has been the increase in number of “low cost” credit card offerings. While MasterCard believes that it is beneficial for there to be “low cost” credit card products being offered, it also believes that, with the common benchmark interchange fee, in the future there will be fewer “fully featured” credit card offerings and the competition between issuers will be based on increasingly homogeneous “low cost” credit card offerings. The issuers of more “fully featured” credit card offerings will, in the face of decreased revenue under the common benchmark interchange fee, reduce those offerings or switch their cardholders to offerings by the unregulated three-party schemes.

⁷ *Ibid.*

Handicapping one scheme by limiting its issuers' cost recovery abilities as compared with its competitors' issuers is a sure-fire way of reducing competition amongst four-party schemes, for the same reasons as regulating only four-party schemes reduces competition between them and three-party schemes. Since the introduction of the interchange standard, the move by issuers to issue the cards of the three-party schemes has been evident. [The Bank's own data shows that the unregulated three-party schemes now account for 17% of credit card spend, increasing from 13.7% in September 2003⁸] But the Bank's assertion that "a common benchmark fee, at around the current level of interchange fees, is unlikely to increase the attractiveness of the three-party schemes, since it would not change the average interchange revenue of issuers in the four-party schemes"⁹, does not make sense. In the Consultation Document, the Bank suggests that one reason for the differences in the interchange fees between the schemes is due to the mix of transactors and revolvers of certain issuers in the different schemes. Issuers with a higher mix of transactors, and which are currently in a scheme with a higher interchange fee will undoubtedly be worse off under the common-benchmark. Such issuers are likely to be encouraged by the common benchmark to seek to convert their transactor customers to three-party scheme offerings.

Given the higher cost of the product offerings of the three-party schemes, MasterCard fails to see how this outcome is consistent with the Bank's objective of encouraging less expensive payment vehicles.¹⁰

The fact is, that using either a single benchmark for all the schemes, or individual benchmarks per scheme, will result in a number of non-ideal outcomes as described above. The only solution that will preserve competition amongst and within the credit card schemes is allowing such schemes to operate according to the proper constraints of the market, as opposed to flawed regulation, the impacts of which are often difficult to predict and impossible to control. For this reason, MasterCard respectfully declines to "choose its poison" by electing between options that are both flawed.

Draft Revised Standard

Were the Bank to decide to introduce a revised interchange standard which, as indicated above MasterCard does not urge, MasterCard offers the following comments on the draft revised standard. Of the two approaches to calculating the weighted-average benchmark, MasterCard believes Version A is preferable to Version B. With Version A, by requiring the appointment of an independent expert for each of the Schemes, the confidentiality of the cost data of each of the issuers is more assured than if there were to be only one independent expert appointed - as proposed in Version B. In addition, it should be noted that particular experts have over the years developed a thorough understanding of the mechanics and processes used by a one credit card scheme, but have not attained a similar expertise for the other schemes. To ensure the most efficient and indisputable results, it would make more sense for each scheme to be able to appoint an expert that is familiar with its processes. Further the appointment of an independent expert for each of the Schemes is more in keeping with the approach of the present interchange standard and, on this basis, has the advantage of providing an approach which is familiar to nominated participants.

There are a number of questions which go unanswered with Version B. For example, under that version, it is unclear whether all credit card issuers will participate in nominating the independent expert, or whether this exercise will be restricted to the nominated scheme participants. If the latter, it may be the case that particular nominated participants may have their own preference as to who should be the independent expert. However, there is no provision in this version dealing with how to resolve possible disagreements among nominated participants as to who should be the independent expert. Should there be unanimous agreement among the nominated participants as to who should be

⁸ Reserve Bank Bulletin [insert details]

⁹ Consultation Document at p.6.

¹⁰ Reserve Bank of Australia, Reform of Credit Card Schemes in Australia IV – Final Reforms and Regulation Impact Statement August 2002, p.9.

the independent expert or is it sufficient that a majority of nominated participants agree? What is the position if there is a deadlock among the nominated participants as to who should be appointed as the independent expert?

MasterCard is also concerned that the timetable set out in the Standard may cause some issues to the scheme and its participants. The current draft of the Standard envisages the Bank advising the schemes of the common benchmark by the 30 September, and implementation of new interchange fees by 1 November 2006. This timetable does not provide sufficient time for determining what the actual fees should be, updating of computer systems, and effective communication of revised merchant fees by acquirers to their merchants. MasterCard suggests an amendment to the Standard whereby the schemes provide to the Bank the cost-based benchmark and relevant data no later than 15 August of the relevant year, and the Bank publishes the common benchmark by 31 August of the relevant year.

Concluding Comments

In conclusion, MasterCard reiterates that, since promulgating its credit card regulations, the Bank has been forced to regulate other aspects of the Australian payments market in order to re-balance the competitive landscape and achieve the objective of the so-called credit card "reforms". At the same time, the Bank has had to admit that it cannot fix a major problem created by its "reforms", the increased issuance and use of more expensive three-party scheme cards. This unnecessary and haphazard intervention into the workings of the four-party systems, which have brought extraordinary benefits to a vast cross section of Australian society, has already hurt consumers in an unprecedented manner through higher credit card fees, the erosion of credit card benefits, the introduction of surcharging by some merchants, and without it being able to be established that there has been any general reduction in retail prices. In the long run, unless the Bank admits its mistake and returns the payments industry to a state of unregulated competition, it will also hurt the merchants. To date, even the strongest supporter of the Bank's intervention would have to agree that the only winners from the Bank's actions have been the major retailers and the three-party schemes. Eventually, it will be only the three-party schemes.

MasterCard hopes that the Bank will consider the comments made in this Response and is happy to discuss further with the Bank any of the points made in this Response.

This Response is provided on the basis that MasterCard reserves its legal rights.

Sincerely



Leigh Clapham
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