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MasterCard International

12 April, 2005

Dr John Veale
Head of Payments Policy
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Dear Dr Veale,

Re: Credit Card Interchange Fees

We refer to the Media Release entitled "Payments Systems Reform" issued by the Bank on the 24 February, 2005, and in particular to the discussion under the heading "Credit card interchange fees" relating to consideration by the Bank of amending the credit card interchange standard "so that the same benchmark interchange fee applies in all schemes" (*i.e.*, MasterCard, Visa and Bankcard).

When it announced the standard, the Bank stated that its objective was "to promote efficiency in the Australian payments system and enhance community welfare by increasing competition and giving greater rein to the workings of the price mechanism" (emphasis added).[1] Further, in justifying its decision to impose the standard, the Bank claimed that "[i]n Australia, credit card interchange fees are not determined by a competitive market."[2] This theme – that regulating the setting of interchange fees would somehow promote competition – is repeated by the Bank throughout the announcement of the standard.[3]

There are many reasons for differences in the level of the cost benchmark from one designated scheme to another. This may be due in part to differences in scheme fees (since these are included in the cost benchmark). The differences may also be due to variances in the characteristics of the credit card products offered by each scheme and/or the relative mix of different products in individual member portfolios. These variances may relate to such factors as:

[1] *Reform of Credit Card Schemes in Australia IV – Final Reforms and Regulation Impact Statement ("Reform")*, August 2002, p. 9. See also *Reform*, Standard No. 1, "The Setting of Wholesale (Interchange) Fees", Objective (ii).
[2] *Reform*, p. 8.
[3] See *Reform* at pp. 22, 23, 24, 27, 33 and 34

- Revolve rates (*i.e.*, utilization of interest-free funds),
- Introduction of new technology (*e.g.*, chip cards and terminals),
- Fraud rates, and
- Economies of scale.

MasterCard notes that, with this latest proposal, the Bank proposes to eliminate to a great extent the remaining degree of competition between the credit card schemes in the setting of interchange fees. Moreover, the Bank surely understands that other likely consequences of imposing a single cost benchmark is diminution of competition between the four-party schemes with respect to both their product offerings (since different payment products clearly result in different costs to issuers) and the fees they charge their members. The Bank's proposal, therefore, is likely to lead to increased homogeneity in credit card offerings by the schemes and their members – in other words, less competition.

As justification for its proposal, the Bank observes that "One consequence of these [*i.e.*, the current] arrangements is that the scheme with the highest interchange fee may be at a competitive advantage in encouraging institutions to issue its cards, particularly if the higher fee is not offset by the issuer facing higher costs when issuing cards belonging to that scheme." While MasterCard generally agrees with this observation, it feels compelled to point out that this result is merely and unavoidably the consequence of the Bank's decision to regulate credit card interchange fees in the first place. The Bank proposes to "fix" the problem by imposing even stricter regulation. MasterCard believes that the better solution would be for the Bank to allow each scheme to set its interchange fees according to its own methodology, as is the case virtually everywhere else in the world.

The Bank's proposal will also create other problems. Averaging of costs across different schemes will almost certainly lead to mismatches between costs incurred and revenue received and to "free riding". If an issuer chooses to issue the cards of a scheme that imposes higher costing standards (*e.g.*, with respect to fraud mitigation or customer benefits), that issuer can only expect to recover a portion of the incremental cost while, due to averaging, the issuers of the other schemes' cards would effectively receive "bonus" interchange revenue with no offsetting costs. Standardising the cost benchmark – at either the weighted average of the costs of all schemes, or at the level of the cost of the cheapest scheme – will under-compensate the issuers in the more expensive scheme(s), and over-compensate the issuers in the lower-costing scheme(s).

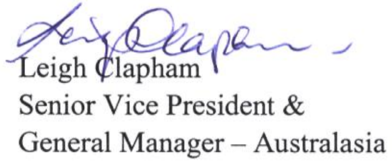
Moreover, this proposal is likely to make the three-party schemes – which the Bank has determined should not be regulated – even more attractive to issuers. This outcome is contrary to the Bank's stated objective of encouraging forms of "cheaper" payment.[4]

MasterCard also observes that, since promulgating the credit card interchange fee standard, the Bank has determined that it must regulate both on-line and off-line debit card, and has considered regulating ATM interchange fees and fees paid by three-party scheme operators to their issuers (though the Bank has decided not to regulate ATM interchange fees or, as noted above, three-party schemes for the time being). In the end, it is likely that the Bank will conclude that it must regulate all of these and other aspects of the payment system as well, in order to "fix" other "imbalances" in the market – which

[4] *Reform,* p. 9

themselves are the result of market intervention by the Bank. Again, MasterCard believes that the solution to bad regulation is not more regulation but rather reliance on competition and the market.

Sincerely



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