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*MasterCard
International*



7 May, 2004

Dr John Veale
Acting Assistant Governor (Financial System)
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear Dr Veale

Re: Visa Debit Designation

Thank you for your letter of 23 February, 2004 advising of the designation of Visa Debit. Mrs Bullock advised Carl Munson that the Bank would still accept submissions made after the date specified in your letter of 23 February. As such, please find enclosed our submission outlining some of MasterCard International's thoughts on the proposed standards and access regime for the Visa Debit program.

We would be happy to discuss these thoughts with you in greater detail at a time convenient to you. Please contact me on (02) 9466 3722 or Albert Naffah, Director Regulatory, Government & Legal Affairs on (02) 9466 3713 with any questions you may have.

Comments made in this letter, and in any subsequent discussions are without admission while reserving MasterCard's legal rights.

Yours faithfully,

A handwritten signature in blue ink that reads "Leigh Clapham".

Leigh Clapham
Senior Vice President
& General Manager - Australasia

MasterCard International



**Submission to the
Reserve Bank of Australia**

on

Designation of Visa Debit

7 May, 2004

Executive Summary

MasterCard International urges the Bank to consider the impact of forcing reductions to the existing level of the Visa Debit interchange fee. Issuers have warned that further reductions in such interchange fees may result in the discontinuation of the Visa Debit card program in Australia. This would deprive many Australian consumers – who want the benefits of a global card but do not qualify for, or are averse to, a revolving line of credit – access to such a payment system.

An artificially low debit interchange fee would also act as an entry barrier to MasterCard which, as you know, hopes to be able to introduce a debit card in Australia to compete with Visa Debit. The massive costs associated with establishing a debit card program should be shared by all the beneficiaries of the program, including merchants. Setting the fee too low prevents such sharing and thus prevents new entry.

The “Honour All Cards” rule should also be retained in its existing form to guarantee access to the payments system for all debit card holders. Forcing issuers and acquirers to re-establish separate and distinct acceptance networks for debit cards is a hugely expensive exercise, which will only result in incomplete and insufficient acceptance for debit card users, creating an incentive for many debit card users to use credit instead, and denying others access to a global payment system.

Regarding surcharging, the credit card exercise has demonstrated that it is predominantly merchants with market power that benefit. MasterCard calls upon the Bank to modify the surcharging standard to enable scheme operators to ensure merchants do not profiteer or abuse their market power when applying a surcharge. This can be done by granting scheme operators the ability to limit surcharges to the cost of acceptance (as opposed to the current standard which limits this ability to individual acquirers who, for competitive reasons, are unable to impose limits).

Introduction

This submission is made by MasterCard International Incorporated in response to the designation by the Reserve Bank of Australia (the “Bank”) of the Visa Debit program in Australia. This submission should be considered in conjunction with MasterCard’s letter to Dr Veale of 13 February, 2004 regarding the proposed (at the time) designation of Visa Debit. This submission is made without admission and while reserving MasterCard's legal rights.

MasterCard understands that the Bank is considering regulating a number of aspects of the Visa Debit program in Australia including:

1. the interchange fee paid by Visa Debit acquirers to Visa Debit issuers;
2. the applicability of the Honour All Cards (HAC) rule to Visa Debit cards; and
3. the applicability of the 'no surcharge' rule to Visa Debit cards.

MasterCard shall not make specific comments in this submission on each of these matters, but rather will set out a number of factors which it is recommended the Bank take into account as it determines whether and if so how to regulate the Visa Debit program.

MasterCard fears that a significant reduction in the Visa Debit interchange fee may make the product unprofitable for issuers, and therefore lead to its eventual demise. Indeed MasterCard has been advised by some existing Visa Debit issuers that, below a certain interchange fee level, they will simply replace the Visa Debit card with a credit card where possible. Such a result seems to be contrary to the Bank's stated objectives in seeking to encourage the use of debit cards. MasterCard encourages the Bank to understand from existing issuers the commercial consequences for them of an unduly low debit interchange fees and what level of interchange fee is required to sustain the Visa Debit program.

Finally, although debit and credit programs strongly compete with each other in the same market, the costs faced by the operators of such programs, and the differing consumer demand dynamics dictate that the Bank should not use the credit card interchange standards as a starting point, or even as a rough guide for establishing debit card interchange fees. MasterCard strongly believes that simply removing some of the costs from the credit card interchange cost formula will result in catastrophic results for the millions of Australians that rely on Visa Debit to make their day to day purchases.

Visa Debit Users

Existing issuers in Australia and overseas advise that the biggest users and the greatest beneficiaries of Visa Debit cards are people who seek the convenience of a global payment card (i.e., those that enable them to make purchases over the counter, remotely via the internet or telephone, and locally or overseas), but who do not want, or who do not qualify for, a credit card.

Although not exclusively the case, these consumers tend to be young adults, the elderly and those of lesser means. These consumers may have shunned the major banks and joined a regional bank, credit union or building society. They use their Visa Debit card as a means to access their funds in a convenient and cheap manner while still enjoying many of the benefits that a credit card can offer.

As such, the Visa Debit card is an essential means of access not only to their own funds, but to everything the Australian and global payments systems have to offer. Conversely, the same product allows many merchants to capture

additional customers, that they would otherwise not have access to, or to capture payment from these customers in a more cost effective manner. This is particularly the case for internet and telephone merchants, and therefore any interchange fee methodology should give due consideration to these factors.

The greatest impact of any adverse changes to the Visa Debit program will be on “middle” Australian consumers and families, a very important sector of the Australian community and furthermore of vital importance to the health of the economy.

Competition Effects

The importance of setting an interchange fee at the right level cannot be understated at any stage in the lifecycle of a payment card program, however the detrimental impact of setting it too low is most acute at start up. Not only are entry costs typically high due to such factors as lack of scale, but early participants also bear the cost of convincing potential customers of the benefits of using/accepting the card and shoulder the risk of the possible failure of the program. Setting up the acceptance and authorisation networks, implementing the necessary security processes, establishing customer education, service and support facilities, and issuing the card, statements and other communications are only some of the extensive list of entry costs that face issuers of a new debit program.

The interchange fee provides a mechanism for sharing these substantial costs among all the beneficiaries of the payment system. Establishing an interchange fee that is too low will not only have a detrimental impact on Visa Debit issuers, but will almost certainly prevent MasterCard from getting members to issue its debit cards and thus reduce competition. Indeed MasterCard believes there is strong merit in the argument that a higher interchange can be substantiated for a start-up operator who needs to amortise the significant capital investment over the early years of the operation. We therefore ask the Bank to consider the implications of any actions it may take with respect to the Visa Debit program on a new entrant in the “scheme debit” space.

Honour All Cards Rule - The Value of a Debit Program with Universal Acceptance

MasterCard understands that the Bank is considering introducing a Standard and/or Access Regime with respect to Visa Debit that would prohibit Visa from enforcing its “honour all cards” rule with respect to Visa Debit cards. This rule, which has analogies in many other card schemes, requires that merchants accepting Visa cards must also accept all Visa cards, be they credit or debit. The rule thereby facilitates universal acceptance by merchants of all cards of the scheme brand that the merchant typically displays at the entrance to the merchant's premises and/or at the point of payment.

MasterCard succinctly outlined its arguments with respect to the retention of the 'honour all cards' rule in its current form, in the 13 February letter referenced above. The key points made in that letter were:

- Over a period of more than thirty years MasterCard and its members have invested heavily in developing the MasterCard acceptance brand into one of the world's best known and most widely accepted brand, to the benefit of both cardholders and merchants;
- An essential feature of a four-party scheme is the fact that a card issued by any issuer can be used at a merchant whose transactions are acquired by any acquirer. This universal acceptance is ensured because of the existence of the "honour all cards" rule. The "honour all cards" rule is a critical feature of most card payment systems as the cardholder's trust in the scheme's payment services would be seriously undermined if they could not count on being able to use their cards where the scheme's acceptance marks are displayed. Thus, the "honour all cards" rule is critical in protecting the value of the MasterCard brand in Australia, ensuring that its cardholders can readily use their MasterCard cards. To have differential acceptance of a scheme's debit and credit cards will only give rise to cardholder confusion; and
- MasterCard strongly believes that an "uncoupling" of credit and debit acceptance will likely prevent MasterCard from introducing in Australia its own debit program, to the great detriment of competition and choice in Australia. This is because MasterCard could not justify the cost and risk attendant to trying to build a separate acceptance brand at the same time that it launched its new debit card program;

Additionally, if consumers are faced with a situation where credit cards are accepted at many more locations than debit cards, many may abandon debit cards in favour of credit cards or transfer their spending from a debit card to a credit card. Furthermore, MasterCard believes that there is no basis in Australian competition law for challenging the existing 'honour all cards' arrangements, nor would it be in the interest of competition to do so.

Surcharging

The Bank has previously claimed that the MasterCard, Visa and Bankcard schemes' "no surcharge" rules suppress market signals, and hide the "true" costs of the four-party schemes from their customers.

MasterCard would like to direct the Bank to the various submissions it made concerning surcharging in relation to the designation of the MasterCard credit card network. In those submissions MasterCard argued that the Bank's claims as to why merchants should be allowed to impose surcharges in respect of card

transactions are incorrect from both a conceptual as well as an empirical perspective.

We have previously pointed out that, from a conceptual point of view, the economic equivalent of surcharging in Australia today is actually possible through cash discounts. Under MasterCard's rules, merchants are free to offer cash discounts, which are in most respects the equivalent of surcharges. Thus, from a conceptual as well as practical perspective, merchants can pass onto the customers exactly the cost of accepting credit cards should they wish to, and there will be no "suppression" of price signals. Indeed the provision of cash discounts is a much more consumer friendly alternative to surcharging which, as MasterCard has pointed out in its previous submissions, is inimical to the development of the MasterCard brand.

From an empirical perspective, evidence points overwhelmingly to the conclusion that very few merchants impose surcharges, and even when they are free to do so, because they do not perceive it to be in their best interest. This has been repeatedly demonstrated since the Bank's abolishment of the "no surcharge rule" in Australia in respect of credit cards, as well as in those markets where surcharging has been allowed for one reason or another.

The empirical evidence in Australia is quite clear. Only large merchants that operate in industries with restricted competition avail themselves of the opportunity to surcharge. For some merchants we now have the ludicrous situation where a surcharge is imposed on a price which can only be paid by a credit card, is applied together with other unspecified fees charges and is extremely poorly disclosed. However, in the more competitive retail sectors, surcharging by merchants has been virtually non-existent in the 15 months since the prohibition of the "no-surcharge" rule.

The evidence is clear – merchants' decisions on whether they choose to offer a cash discount (when they are prevented from surcharging) or to surcharge (when they have such an option) is based on their business judgement on whether there is net benefit in doing so. If a merchant decides that the benefit of accepting credit cards does not outweigh the cost, then he/she could, and would, offer a cash discount to encourage customers to pay with cash, even if the option of surcharging is not there.

From the point of view of retail prices, given that there is a cost to the merchant associated with every payment method, then retail prices should have always reflected this cost. Long before the introduction of payment cards (debit or credit), merchants had to factor in the cost of handling cash, which was just part of the operating costs. With the range of payments options available today, the only change is that the merchant has to factor in an average cost of the various payments methods, however estimated, into the final retail prices.

Notwithstanding the above, if the Bank still believes it is in the public interest to allow surcharging, despite the overwhelming evidence to the contrary, MasterCard calls on the Bank to ensure that merchants do not seek to profiteer from any proposed surcharging standard for debit cards (and the existing credit card standard), nor abuse any market power they may have when applying a surcharge for a card based payment. The Bank can achieve this by granting MasterCard and the other scheme operators the ability to limit surcharges to the cost of acceptance (as opposed to the current standard which limits this ability to individual acquirers who, for competitive reasons, are unable to impose limits). Such a change to the 'no surcharge' standard would also allow three- and four-party systems to compete on an equal basis as regards surcharging whereas, today, only three-party systems have the practical ability to prevent surcharging abuse by merchants.