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31 March 2014

David Murray AO
Chair, Financial Systems Inquiry
GPO Box 89
Sydney NSW 2001
31 March 2014

Dear Mr Murray

MasterCard submits these comments in response to the Government's Financial System Inquiry.

MasterCard welcomes the open nature of the review and the consultative approach those involved have taken. We look forward to this continuing in the spirit of cooperation to drive the best policy outcomes for Australian consumers and industry. It is important to note that the scope of our comments is limited to issues pertaining to the payment system. We offer no comment on questions raised by other elements of the Inquiry's terms of reference.

MasterCard's view of systemic regulation is underpinned by our belief that a truly competitive Australian payment system will play a vital role in improving the productivity of the Australian economy. Recent research conducted by Melbourne University has shown that the increased use of electronic payments and the consequent reduction in the use of cash facilitates the growth of economic activity because electronic payments are less costly than non-electronic payments[1]. It is clear that by reducing cash use all participants in the payments value chain benefit – consumers, businesses, banks, government and the wider economy.

This Australian research is reinforced by similar studies conducted in Canada, Germany, South Africa and the US where each has underlined the costs of cash in both developed and emerging markets and highlighted the positive role electronic payments play in increasing the efficiency of financial systems – both in terms of greater economic stimulation and heightened levels of consumer empowerment and choice.

As a participant in the Australian payment system since 1984 and having adapted to both the intended and unintended consequences of regulatory intervention we are uniquely positioned to offer considered recommendations to this Inquiry. We believe the competitive environment can be improved in a way that facilitates economic growth and benefits all stakeholders. To that end, our submission will comment on the context of electronic payments in Australia, including some of the unintended consequences of the regulatory interventions. We will offer some thoughts on how distortions in the system can be realistically redressed so as to achieve an environment in which the payment system is 'fit for purpose', efficient, and promotes growth and improves productivity in the Australian economy.

[1] University of Melbourne, Melbourne Institute of Applied Economic and Social Research (2013), *'E-Payments and Economic Activity in Australia'*, Summary Report, p 5.

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We welcome any opportunity to contribute further. Please do not hesitate to contact me should you wish to discuss our submission.

Sincerely

Eddie Grobler
Division President, MasterCard Australasia

Executive Summary

The regulatory interventions in the Australian payment system over the past decade have caused negative and unintended consequences to both consumers and small to medium sized businesses. That is at least in part, because the regulations were not applied equally to all competing schemes. These inconsistencies allowed for 'gaming' of the system to the benefit of one scheme, at the cost of others.

The payments industry and the various sectors that make up the value chain surrounding it have changed enormously since the Reserve Bank of Australia (RBA) regulated MasterCard. Since 2003 we have seen sharp increases in cross border transactions, driven in part by more affordable and accessible travel for the majority of Australians, but also the remarkable growth of the internet and ecommerce. Competition within the payments sector is fierce, with new entrants in each part of the value chain, who directly and indirectly benefit from the long term investment and development that organisations like MasterCard have made in payments technology (and who ride our rails at low cost and with low barriers to entry). It is fair to say that absent MasterCard's sustained investment for over 50 years in this sector, few of these secondary providers in payments could exist today.

One fundamental change since the RBA's first series of regulatory interventions is in the ownership, governance and commercial structures of MasterCard. The former 'card association' model which existed in 2003 has been replaced by a publicly listed company with an independent board (NYSE:MA). Today, strategic and financial decisions are based on delivering shareholder value and growing the payment systems. MasterCard now has the same corporate reporting and performance disciplines and obligations as American Express. This is a very different situation from that which existed when the RBA 'designated' the MasterCard payment system in 2001. The RBA has made this very point itself in its review of the regulations governing the Access Regime:

> *"The environment has now changed significantly. Most importantly, MasterCard and Visa have both changed corporate structure to become publicly listed companies rather than member associations of banks. This suggests that the schemes are likely to be more open to new types of participation, while the emergence of new business models is creating stronger interest in direct membership."* [2]

This evolved payments landscape underlines that the time is right for Australian regulators to step away from the burdensome oversight of some participants in the value chain and allow a truly competitive marketplace. As demonstrated by the RBA's comment above, MasterCard would welcome more risk-appropriate participants to continue to build a robust competitive environment.

The regulation of the past decade has resulted in unintended consequences, to the point where independent analysis identifies that Australians are worse off as a result of the RBA's intervention. The most critical of these sees consumers now paying more for paying. The assumption that merchants would reduce prices as a result of a reduction in interchange fees (and therefore operating costs) was flawed. Today, even the RBA acknowledges that truth in its slow but consistent retreat from specifically linking the package of regulations with savings passed through to consumers in the general level of prices, demonstrated as follows:

- In 2002, the RBA said savings (as a result of regulation) would be passed "through to the community in the general level of prices"[3];
- In 2005, the RBA's Payment Systems Board (PSB) said it believed there had been "smaller price increases [for consumers] than otherwise would have occurred" in the absence of regulation[4];

[2] Reserve Bank of Australia (March 2014), *'Payment Card Access Regimes: Conclusions'*
[3] Reserve Bank of Australia (August 2002) *'Reform of Credit Card Schemes in Australia'*

- In 2006, the RBA stated that the flow in savings for merchants on to consumer prices was "difficult to measure"[5];
- In 2007, the PSB acknowledged that merchants saved a considerable sum "which in the normal course, would be passed through into lower prices for goods and services" but did not suggest there had been any savings for consumers[6];
- In 2010, the PSB said, since "the introduction of the reforms, decreases in merchant service fees across all four schemes are estimated to have produced cumulative savings to merchants of around $6 billion", but again, did not mention any pass through of these savings to consumers nor specifically mention any consumer benefits from surcharging[7]; and
- In 2011 in its consultation acknowledging problems created by surcharging regulations, the RBA stated "merchants have increasingly been adopting a number of surcharging practices that have the potential to distort price signals and thereby reduce the effectiveness of the surcharging reforms."[8]

The failure to capture all participants in the regulatory structure has also contributed enormously to the unbalanced way the industry has developed over the past decade. American Express has grown market share considerably. As we detail in subsequent chapters, this has been the consequence of issuers identifying a way to recover lost interchange revenue through the issuance of American Express Global Network Services (GNS) cards (known as companion cards). Consumers demanded a high reward product and issuers found a way to provide it through unregulated means.

The regulatory interventions that allowed uncapped surcharging provided an opportunity for unreasonably high surcharges to consumers, which bear no relationship to the actual costs of acceptance for merchants. Subsequent changes to the regulatory environment which sought to reduce both the occurrence and quantum of unreasonable surcharges have failed to take effect largely because there is no regulator responsible for their enforcement. MasterCard has estimated the cost of surcharging to Australian consumers to be in the vicinity of $800 million per annum.

Finally, a regulatory environment which applies differently (or not at all) to different participants within the payment system is inherently unfair and has led to adverse outcomes for end users – particularly consumers and small businesses. At its simplest, the regulatory environment should apply either to all participants equally, or not at all.

Productivity and economic growth in Australia will both benefit from a truly competitive payment system, driving a continued increase in electronic payments. This Inquiry represents a unique opportunity to remove regulatory restraints that have driven adverse outcomes for users, or alternatively to at least ensure that any regulatory environment that exists is competitively neutral and addresses the needs of a competitive and rapidly evolving payment system.

We therefore make the following recommendations:

Recommendation One
That the Financial Systems Inquiry recommends the government actively supports cash displacement with more efficient electronic transactions that support economic growth, increase efficiencies and stimulate employment by reducing friction, waste and the shadow economy.

Recommendation Two
That the Financial Systems Inquiry recommends the RBA step back from payment system regulation and allow payment schemes to determine interchange fees and rules (e.g. surcharging)

[4] Reserve Bank of Australia (2005) *'Payment Systems Board Annual Report 2005'*
[5] Reserve Bank of Australia (2006) *'Payments System Board Annual Report 2006'*
[6] Reserve Bank of Australia (2007) *'Payments System Board Annual Report 2007'*
[7] "Annual Report 2010" Reserve Bank of Australia, Payment Systems Board
[8] "Review of Card Surcharging: A Consultation Document" Reserve Bank of Australia (June 2011)

independently to address consumer costs, promote efficiency and productivity growth through delivering an economy less reliant on cash.

Recommendation Three

a. *That the Financial Systems Inquiry recommends a Government regulator be charged with responsibility for enforcing or removing surcharging at unreasonably high levels to provide clearer pricing signals to consumers between payment schemes; or*

b. *The RBA remove surcharging regulations, to allow payment schemes to once again prohibit surcharging.*

Recommendation Four

That the Financial Systems Inquiry recommends a level playing field be introduced, so that any regulation affecting MasterCard and Visa also apply to other providers, including American Express.

Introduction

MasterCard is a technology company in the global payments industry that connects consumers, financial institutions, merchants, governments and businesses worldwide, enabling them to use electronic forms of payment instead of cash and checks. As the operator of the world's fastest payments network, we facilitate the processing of payment transactions, including authorisation, clearing and settlement, and deliver related products and services. We make payments easier and more efficient by creating a wide range of payment solutions and services using our family of well-known brands, including MasterCard®, Maestro® and Cirrus®. We also provide value-added offerings such as information services and consulting. Our network is designed to ensure safety and security for the global payment system.

A typical transaction on our network involves four participants in addition to us: cardholder, merchant, issuer (the cardholder's financial institution) and acquirer (the merchant's financial institution). We do not issue cards, extend credit, determine or receive revenue from interest rates or other fees charged to cardholders by issuers, or establish the "Merchant Service Fee" (MSF) charged in connection with the acceptance of cards and other payment devices that carry our brands. In most cases, cardholder relationships belong to, and are managed by, our financial institution customers.

Our ability to grow is influenced by personal consumption expenditure growth, driving paper-based forms of payment toward electronic forms and increasing our share in electronic payments and providing other value-added products and services.

We continue to drive growth by:

- Growing our core businesses globally, both through our products - credit, debit, prepaid and commercial – and increasing the number of payment transactions we process;
- Diversifying our business by seeking new areas of growth in markets around the world by focusing on:
  - Existing and new markets;
  - Encouraging consumers and businesses to use MasterCard products for new payment areas, such as transit, parking, person-to-person transfers and paying bills;
  - Small merchants and merchants who have not historically accepted MasterCard products; and
  - Financial inclusion for the unbanked and under-banked; and
- Building our business by:
  - taking advantage of the opportunities presented by the ongoing convergence of the physical and digital worlds; and

- using our data analytics, loyalty solutions and fraud protection and detection services to add value.

Our technology, expertise and data make payments safe, simple and fast. We work with merchants to help them enable new sales channels, create better purchase experiences, increase revenues and fight fraud. We help national, state and local governments drive increased financial inclusion and efficiency, reduce costs, increase transparency to reduce crime and corruption and advance social programs. For consumers, we provide better, safer and more convenient ways to pay. We provide financial institutions with solutions to help them increase preference for their MasterCard-branded products.

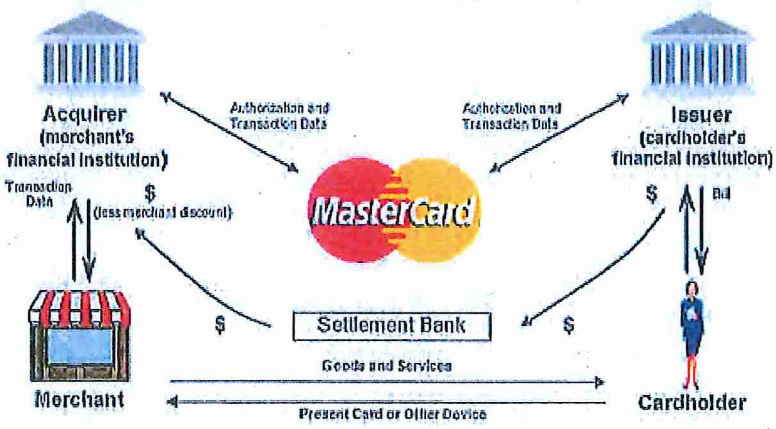
We generate revenue by charging fees to issuers and acquirers (our customers) for providing transaction processing and other payment-related products and services, as well as by assessing these customers based primarily on the dollar volume of activity, or gross dollar volume ("GDV"), on the cards and other devices that carry our brands.

Payment Services and Solutions
We provide transaction processing and a wide range of payment-related products and services to enable the design, packaging and implementation of our products and programs. Our payment solutions are built upon our expertise in payment programs, product development, payment processing technology, payment security, consulting and information services and marketing.

Our Operations and Transaction Processing Network
We operate the MasterCard Network, our unique and proprietary global payments network that links our customers (issuers and acquirers) around the globe to facilitate the processing of transactions, permitting MasterCard cardholders to use their cards and other payment devices at millions of merchants worldwide. Our network facilitates an efficient and secure means for merchants to receive payments, and a convenient, quick and secure payment method for consumers and businesses that is accepted worldwide.

We process transactions through our network for our issuer customers in more than 150 currencies in more than 210 countries and territories. With a typical transaction involving four participants in addition to us, our network supports what is often referred to as a "four-party" payments network. The following diagram depicts a typical point-of-interaction transaction:

Typical Point of Interaction Payment Transaction



In a typical transaction, a cardholder (or an account holder who may not be using a physical card) purchases goods or services from a merchant using a card or other payment device. After the transaction is authorised by the issuer, the issuer pays the acquirer an amount equal to the value of the transaction, minus the interchange fee (described below), and then posts the transaction to the cardholder's account. The acquirer pays the amount of the purchase, net of a "merchant service fee" (referred to in the chart above as the "merchant discount") to the merchant.

Interchange Fees. Interchange fees represent a sharing of a portion of payment system costs among the issuers and acquirers participating in our four-party payment system. They reflect the value merchants receive from accepting our products and play a key role in balancing the costs consumers and merchants pay. We do not earn revenues from interchange fees. Generally, interchange fees are collected from acquirers and paid to issuers to reimburse the issuers for a portion of the costs incurred by them in providing services that benefit all participants in the system, including acquirers and merchants. In some circumstances, such as cash withdrawal transactions, this situation is reversed and interchange fees are paid by issuers to acquirers. In Australia we establish "default interchange fees" that apply when there are no other established settlement terms in place between an issuer and an acquirer. We administer the collection and remittance of interchange fees through the settlement process. Interchange fees can be a significant component of the merchant service fee, and therefore of the costs that merchants pay to accept electronic payments. These fees are subject to regulation in Australia, the details of which will be outlined in the following chapters.

Merchant Service Fee. The merchant service fee (MSF) is established by the acquirer to cover its costs of both participating in the four-party system and providing services rendered to merchants. The fee includes, amongst other things, the interchange fee,

Additional Fees and Economic Considerations. Among the parties in a four-party system, various types of fees may be charged to different constituents for various services. Acquirers may charge merchants processing and related fees in addition to the merchant service fee. Issuers may also charge cardholders fees for the transaction, including, for example, fees for extending revolving credit. As described below, we charge issuers and acquirers fees for the transaction processing and related services we provide.

In a four-party payment system, the economics of a payment transaction relative to MasterCard vary widely depending on such factors as whether the transaction is domestic (and, if it is domestic, the country in which it takes place) or cross-border, whether it is a point-of-sale purchase transaction or cash withdrawal, and whether the transaction is processed over our network or a third-party network or is handled solely by a financial institution that is both the acquirer for the merchant and the issuer to the cardholder (called an "on-us" transaction).

MasterCard Network Architecture. The MasterCard Network features a globally integrated structure that provides scale and connectivity for our issuer customers, enabling them to expand into regional and global markets. It features an intelligent architecture that enables the network to adapt to the needs of each transaction by blending two distinct processing structures – distributed (peer-to-peer) and centralised (hub-and-spoke):

- Transactions that require fast, reliable processing, such as those submitted using a contactless card or device at a toll booth, can use the network's distributed processing structure, ensuring they are processed close to where the transaction occurred.

- Transactions that require value-added processing, such as real-time access to transaction data for fraud scoring, or customisation of transaction data for unique consumer-spending controls, use the network's centralised processing structure, ensuring advanced processing services are applied to the transaction.

Our network's architecture enables us to connect all parties regardless of whether the transaction is occurring at a traditional physical location, at an ATM, on the internet or through a connected device. It has 24-hour a day availability and world-class response time. The network incorporates multiple layers of protection, both for continuity purposes and to address cyber-security challenges. We engage in multiple efforts to mitigate against such challenges, including regularly testing our systems to address potential vulnerabilities.

Participation Standards. We establish, apply and enforce standards surrounding participation in the MasterCard payment system. We grant licenses that provide issuers and acquirers that meet specified criteria with certain rights, including access to the network and usage of cards and payment devices carrying our brands. As a condition of our licenses, issuers and acquirers agree to comply with our standards surrounding participation and brand usage and acceptance. We monitor areas of risk exposure and enforce our standards to combat fraudulent, illegal and brand-damaging activity. Issuers and acquirers are also required to report instances of fraud to us in a timely manner so that we can monitor trends and initiate action when appropriate.

Customer Risk Management. We guarantee the settlement of many of the transactions between our issuers and acquirers to ensure the integrity of our network. We do not, however, guarantee payments to merchants by their acquirer, or the availability of unspent prepaid cardholder account balances. As a guarantor of certain obligations of principal customers, we are exposed to customer credit risk arising from the potential financial failure of any principal customers of MasterCard, Maestro and Cirrus, and affiliate debit licensees. Principal customers participate directly in MasterCard programs and are responsible for the settlement and other activities of their sponsored affiliate customers. To minimise the contingent risk to MasterCard of a failure of a customer to meet its settlement obligations, we monitor the financial health of economic and political operating environments and compliance with our standards by our customers. We employ various strategies and processes to mitigate against these risks.

Processing Services

Transaction Switching – Authorisation, Clearing and Settlement. Through the MasterCard Network, we enable the routing of a transaction to the issuer for its approval, facilitate the exchange of financial transaction information between issuers and acquirers after a successfully-conducted transaction, and help to settle the transaction by facilitating the exchange of funds between parties via settlement banks chosen by us and the customer.

Cross-Border and Domestic Processing. The MasterCard Network processes transactions throughout the world where the merchant and issuer are located in different countries (cross-border transactions), providing cardholders with the ability to use, and merchants to accept, MasterCard cards and other payment devices across multiple country borders. We also provide domestic (or intra-country) transaction processing services to customers in every region of the world, which allow issuer customers to facilitate payment transactions between cardholders and merchants within a particular country. We process approximately half of all transactions using MasterCard-branded cards, including most cross-border transactions. We process the majority of MasterCard-branded domestic credit transactions in Australia, but the majority of domestic debit card transaction activity on our Debit MasterCard product is processed through the eftpos system (currently a network of bilateral links between Australian banks). One key point of difference between a transaction on a MasterCard card that is processed by MasterCard and one processed by eftpos is that we provide a settlement guarantee on the MasterCard processed transaction, not those processed by eftpos.

Context and the need for change

A brief history of regulatory intervention

The origin of the RBA's involvement in card payments regulation was the decision by the Commonwealth Government in 1997 to implement the recommendations of the Wallis Report, including empowering the RBA with regulatory oversight of the payment system. The subsequent *Payment Systems (Regulation) Act, 1998* established the Payment System Board (PSB) of the Reserve Bank, with responsibility for payment-system efficiency and stability. Among other things the Act gives the PSB wide ranging powers, including to designate a payment system, and where a system has been designated, to set regulatory standards with respect to such things as operating rules, standards for safety and efficiency and, should it be required, arbitrate on disputes particularly in relation to access, safety, competitiveness and systemic risk. The PSB also has powers to gather information from a designated scheme. Today, under Section 11(1) of the *Payment Systems (Regulation) Act 1998*, there are six designated Payment Systems:

- MasterCard (gazetted 12 April 2001);
- Visa (also 12 April 2001);
- Visa Debit (23 February 2004)[9];
- the EFTPOS System as described by the Consumer Electronic Clearing System (9 September 2004);
- the ATM System (10 December 2008); and
- the EFTPOS System as operated by Eftpos Payments Australia Limited (12 June 2012).

The PSB's first major study into the sector was conducted jointly with the Australian Competition and Consumer Commission (ACCC) and released in October 2000. The study indicated concerns about market practices in the industry, notably the setting of scheme interchange fees and a range of other matters related to competition and efficiency. When industry attempts to directly address the ACCC's concerns failed the PSB moved into a process of reform, starting with the credit card schemes. After a period of consultation, the first package of credit card reforms was announced in August 2002. That package had three main elements:

- A strict cost-based standard on interchange fees;
- Disallowance of no-surcharging rules; and
- Rules to expand access to the network.

Over the next few years, the reform process added a number of other elements, covering both credit and debit cards including:

- A bifurcation of the honour-all-cards rule to allow merchants to make separate decisions for credit and debit cards;
- A cap on debit interchange; and
- Changes to interchange fees in the eftpos system.

Since these first rounds of regulations, there has been only one notable change to the PSB's regulations affecting MasterCard. In 2013, the Standard allowing uncapped surcharges by merchants was amended to allow schemes to introduce a 'reasonableness' pricing cap on surcharges. However, while MasterCard welcomed this well-intentioned move, there has been no government regulator charged with oversight or responsibility to enforce excessive surcharging, meaning the changes have not driven meaningful change in merchant behaviours.

A second change is currently in the works but is reliant on other regulatory bodies to review and likely amend their existing structure. The suggested changes to Access Standards (at its simplest participation in the MasterCard scheme) highlights the changed environment that we now witness in Australia. This recent decision by the RBA (March 2014) to vary the Access Regimes underlines a point we shall return to throughout this paper – that the landscape today is very different that which existed when regulations were introduced. It underlines that the time is right for wholesale changes in the regulatory framework of the Australian payments industry.

The recent Melbourne Institute of Applied Economic and Social Research *"E-payments and Economic Activity in Australia"* report (Melbourne University 2013) examined the quantitative relationship between various types of e-payments and economic activity in Australia. It found that each payment type affects GDP differently with *"the use of electronic payments yielding larger changes in GDP than cash transactions"*.

[9] NB that MasterCard debit products are also regulated in effect through an Undertaking

Recommendation One
That the Financial Systems Inquiry recommends the government actively supports cash displacement with more efficient electronic transactions that support economic growth, increase efficiencies and stimulate employment by reducing friction, waste and the shadow economy.

Interchange

Arguably, the most controversial regulation from the RBA's Payments System Board was interchange regulation. But before we begin to analyse the regulatory impact, it is worthwhile providing some context.

The Value of Interchange
Electronic payments offer a wide range of benefits to all participants in the payments value chain – consumers and businesses who use our products to make payments; businesses that accept payments using our products; banks which issue and acquire MasterCard transactions; and governments. Like any valuable service with advanced technology behind it where innovation and development is vital, it comes at a cost. Businesses pay a Merchant Service Fee (MSF) to acquirers for acceptance and services.

What is Interchange?
As described earlier, interchange fees share a portion of payment system costs among the issuers and acquirers who participate in the four-party payment system. It is a small fee that reflects the value merchants receive from accepting our products. Under Australian regulation, it is capped on reset at an average of 0.50% for domestic credit card transactions and $0.12 for debit card transactions.

It is important to note that MasterCard derives no direct benefit from interchange fees and, accordingly, there is no incentive for MasterCard to set interchange at high rates which would negatively impact merchant acceptance or low rates – which would negatively impact card issuance.

In fact, the aim of setting the level of interchange fees at the optimal level is to ensure that issuers and acquirers are able to deliver services that optimise the output of our payment network and are in the best interest of the wider market.

The need for interchange exists because payment networks such as MasterCard provide a "joint service" simultaneously to two different types of users – cardholders who use the products and business who accept them for payments (referred to in payment systems as 'merchants'). Given the market for payment services has two distinct types of end users, it is sometimes referred to as a "two-sided market". It is important to bear both of these concepts in mind when analysing any aspect of a payment network's operation, as they affect both efficiency and profitability.

Setting interchange at the appropriate level for the two types of end users is a complex process. Theoretically, the entire cost of a payment network could be borne either by the cardholders or by the merchants. But experience shows that a payment network achieves its greatest efficiency and scale if the end-users share the cost. This sharing is often referred to as "balancing" the network. Ultimately, MasterCard's methodology equitably balances the cost of the payment network services between users. MasterCard believes that an interchange setting methodology must:

- ensure that interchange fees are set:
  - independently of those who pay or receive them;

    - transparently, so it is consistent with legitimate competitive concerns; and
    - objectively, in order that there is a legitimate basis for each interchange fee;
- take into account all relevant considerations, including:
    - the nature of the particular payment stream;
    - the interchange fees or corresponding fees or costs of competitive payment systems (to the extent known by the payment network operator);
    - the costs of the recipients of the interchange fees;
    - the levels of cardholder usage and merchant acceptance; and
    - the impact of interchange fees and other fees on particular categories of users (i.e. cardholders) and acceptors (i.e. merchants);
- require that interchange fees are published in a form available to all stakeholders;
- allow for the integrity of the process to be verified through an appropriate level of independent audit and regulatory oversight; and
- create a level playing field and not disadvantage four-party payment networks when competing with three-party payment networks.

Globally, MasterCard's interchange methodology incorporates these principles and is aimed at promoting the widespread issuance and acceptance of MasterCard products, taking into account costs, competition, issuer and merchant behaviour, possible fraud losses, the business environment, the regulatory environment, systems implications and other relevant factors, in order to maximise the value of the MasterCard brand and business for the benefit of its customer banks, merchants and consumers. Under the fee structure matrix usually adopted by MasterCard, transaction criteria, product criteria, category criteria, and volume are all taken into account in determining the level of interchange. While MasterCard retains the sole authority to set and change default interchange rates (in Australia within the confines of regulated caps), issuing and acquiring financial institutions are free to negotiate individual terms of dealing, including setting interchange fees bilaterally. Throughout the world, periodic adjustments are considered to interchange fee rates and these are generally based on a range of factors including changes in market conditions, competitive environment, and/or other factors as outlined above.

In Australia as a direct result of regulation much of what is described above is delivered in a way that cannot maximise the balancing effects of interchange. MasterCard's ability to set rates in a way that incentivises innovation, facilitates efficiency and delivers growth is reduced as a result of a regulatory framework that fails to acknowledge competitive forces. This regulatory framework was implemented at a time when MasterCard was owned and operated in a different way, in a different environment and with very different competitive landscape. In Australia, interchange regulation has had the effect of benefiting one distinct party in the value chain (large merchants) at the cost of others (consumers and smaller merchants).

Flexible interchange rates are essential

Flexible rates ensure merchants and consumers receive maximum value for electronic payments at the lowest cost. Experience shows that when governments attempt to address merchant cost concerns by reducing interchange, consumers and small businesses (including smaller merchants) suffer cost increases and reduced benefits.

That said, it is essential that merchant concerns about interchange costs are examined and appropriately addressed. To this end, MasterCard is committed to continuing this dialogue through direct engagement with Australian merchants who play a vital role in the system. We believe this has actively addressed business concerns while at the same time protected consumers and merchants from the consequences of arbitrary interchange restrictions.

The following points provide an overview of the role of interchange and the importance of avoiding arbitrary limits.

Merchants receive enormous benefits from accepting cards

These include reducing the significant costs associated with counting, safeguarding and transporting cash and limiting the losses that occur when cash received is lost or stolen. Merchants who accept cards also receive the most important commercial benefit: the ability to accept cards increases sales. Studies show that consumers spend more when they use cards and merchants make more money when they accept cards. This is not surprising since shoppers using cards are not limited to cash on hand but can access their funds on deposit or credit available from their banks when they make their purchasing decisions. These increases in spending (in a responsible way with appropriate consumer protections) are precisely the reason merchants began accepting cards and, with the increasing numbers of cards in Australia, these spending increases have become more valuable over time.

The benefits merchants receive are generated primarily by the card issuers
Card issuers incur all of the costs of attracting cardholders to the network, issuing the cards and servicing the accounts. Card issuers manage the accounts and extend all of the credit that enables consumers to purchase more from merchants than they could if purchases were limited to cash on hand. Card issuers also take most of the risk—the merchant gets paid by the card issuer even if the consumer never pays for the transaction.

While card issuers generate the bulk of the benefits merchants enjoy, they do not have a direct relationship with the merchant
In the MasterCard system, merchant relationships are handled by a second group of financial institutions (the acquirers). Acquirers connect merchants to our network but it is the issuers that create the benefits and take all the risk for the merchants. So the question is: How do issuers receive fair compensation for providing all of these benefits to merchants without having a direct relationship with those merchants? The answer is interchange. The acquirer then passes this interchange fee on to the merchant as part of the overall Merchant Service Fee (negotiated between a merchant and its acquirer).

When interchange is set based on market conditions, everyone benefits
That is because MasterCard sets the rates at levels that maximise the benefits issuers create for merchants, while keeping merchant costs low enough to maximise the value merchants receive from accepting our cards. By ensuring that merchants provide compensation for the value they receive, we are also able to ensure costs are kept down for consumers. The benefits of our approach can be seen when compared to other models. For example, when retailers extend credit themselves (such as store based credit), the interest rates charged to consumers are almost always higher than for a MasterCard credit card because in a retail credit program the consumer pays for all of the benefits the consumer receives as well as all of the benefits merchants receive. American Express operates a different model where the bulk of the costs are paid by merchants and, consequently merchants typically pay significantly more than they do for accepting MasterCard branded cards.

The market response to American Express is instructive — because it imposes higher costs on merchants, far fewer merchants accept Amex cards[10] and far fewer consumers have Amex cards in their wallets, making the overall utility of Amex to consumers and merchants lower than with MasterCard. By using interchange to balance the costs between consumers and merchants, we address both the store credit and the Amex problems. In our network, consumers and merchants receive the benefits of electronic payments at lower costs than they would incur if forced to absorb the costs on their own. This is a major reason why more consumers hold, and more merchants accept, our cards than store cards or American Express.

The impact of interchange caps on consumers is frequently discounted
Because interchange is paid by merchants, there is a tendency to view it simply from the merchant perspective. For example, the European Commission has based its view of interchange on its so-called "merchant indifference test" and the limits are designed to ensure merchants are indifferent as to whether a consumer pays in cash or by debit or credit card. This test begs the question why the

[10] HSN Consultants Inc., (March 2014), *'The Nilson Report'* Issue 1036, pg's 1, 9

merchants' indifference should trump the consumers' and ignores the very significant consequences for consumers when interchange levels are set solely to achieve merchant indifference.

When the RBA looked at interchange over a decade ago, they focused too heavily on costs to merchants. For example, in its "Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access" report in October 2000, the RBA made 249 references to merchants, but only 33 references to consumers. Similarly, in its "Reform of Credit Card Schemes in Australia" consultation document in December 2001, the RBA made 626 references to merchants, but only 123 references to consumers.

Artificial limitations on interchange harm consumers
When interchange fees are artificially reduced through government intervention (as they have been in Australia) merchants no longer pay compensation for the benefits they receive from issuers. As a result, consumers end up paying higher costs and receive fewer services and benefits. The experiences here in Australia, as well as those in Spain and the US bear this out.

- In Australia, after the RBA reduced interchange fees benefiting large merchants (through lower acceptance costs), consumers paid the price, paying up to 50% more for their cards.
- In Spain, government intervention resulted in a €3.329 billion reduction in interchange over the five year period between 2005-2010. Again, while merchants received a significant cost reduction of almost €2.75 billion during that period, consumers paid the price and had to bear more than a 50% increase in annual fees for standard four-party payment cards. The additional cost to consumers amounts to €2.350 billion over the five year period. Other fees have also been increased, such as those charged to consumers for overdrafts and debt claims. Consumers saw their card rewards and promotions reduced in addition to paying more for these reduced benefits.
- In the US, consumers suffered similar consequences when debit interchange was regulated there. Many no-cost or low-cost bank accounts were eliminated and consumers now pay increased fees for basic deposit account services.

Artificial limits on interchange harm Small and Medium Enterprises (SMEs)
SMEs feel the effects of interchange limits in three ways.

First, many SMEs are cardholders who rely on their credit cards as an important source of credit to keep the business running. These cards also simplify the process of purchasing inventory and supplies by replacing the cumbersome purchase order and cheque writing process traditionally used for these operations. While this may seem like a relatively modest benefit, it can be extremely important to small merchants because it allows them to focus on the business rather than administrative tasks. Artificial reductions in interchange have precisely the same impact on SMEs as they have on other cardholders – the costs of their cards go up when merchants who accept cards no longer pay for the benefits those merchants receive.

Second, many SMEs also accept cards. While they may view interchange reductions as potentially beneficial, experience shows otherwise. For example, the RBA's most recent PSB Annual Report (October 2013) showed that, as a result of interchange regulation Australian SMEs are more likely to pay much more (up to ten times more) to accept card payments than large merchants. Similar results were found in the US. This is because of the natural disparity in bargaining position between large and small merchants – larger merchants are able to negotiate to obtain the full cost reduction from interchange fee reductions while SMEs find that negotiation more difficult. This results in widening disparity in costs between large and small merchants, which causes SMEs to fall further behind in their efforts to compete with larger merchants.

Third, artificial interchange reductions can have an even more painful impact on SME's in the form of a reduction of credit availability. The flow of interchange enables issuers to take more credit risk and extend more credit than is possible when relying entirely on cardholders to compensate for that risk. When interchange is artificially reduced, issuers can be forced to considerably reduce risk to reduce costs in an effort to offset the reduction in interchange revenue. Reduced risk means reduced credit availability which harms SMEs as both cardholders and acceptors of cards. Reduced credit availability means less credit extended to SMEs to run their businesses. Given the relatively sluggish lending to SMEs from other sources, reductions in credit card lending is particularly painful. Reduced credit availability also means that the cardholders who purchase from SMEs will have less credit available to spend in their shops.

Artificial reductions in interchange impede innovation

When interchange regulation began, the reduction in revenue significantly changed the business case for issuing payment cards of all types. Just to get back to pre-regulation levels of profitability, card issuers needed to impose higher fees on cardholders and/or reduce credit availability and other services to reduce costs. This has an adverse impact on investment in innovation at precisely the same time as innovation is increasingly demanded by consumers and merchants alike. For example, as issuers seek to offset interchange reductions, they likely will be in a weaker position to invest in costly but vital security innovations like the move to EMV cards which was delayed as a result of interchange regulation. In a 2008 CRA International report on the effects of regulation in Australia, they made this precise point:

> *"The RBA intended that its interventions would reduce the profitability of issuing four-party cards, and this reduction in profitability naturally reduces issuers' incentives to invest in new types of four-party cards. Our interviews with the major Australian banks confirmed these views. Each of the banks in Australia we interviewed told us that the interventions have made it more difficult to develop a "business case" for investments related to four-party cards. Banks cited the introduction of EMV/Chip and PIN and the provision of prepaid cards to commercial clients as examples of projects that have been adversely affected by the RBA's interventions."*[11]

While interchange regulation is not the answer, merchant concerns about the costs of accepting electronic payments must be addressed

As electronic payments increasingly replace cash and cheques, merchants understandably are focused on the costs of those payments. MasterCard is committed to engaging with merchants to address their concerns and to ensure that interchange rates in our system are set at levels that maximise the value they receive while controlling their costs. Through commercial negotiations, we believe these issues can be resolved in a way that protects the interests of consumers and merchants alike without the need for regulation.

Looking at regulation through the eyes of participants

For Australian consumers there have been more negatives than positives as a result of regulation, as the effective price to cardholders for using their credit cards has increased.

Annual fees have grown; the value of reward programs has been diluted, surcharges on payment card transactions have been introduced by some merchants (often at rates that are substantially higher than the MSF's that they are paying) and the use of 'blended' surcharge rates further compounds this gouging of consumers. And, as described above, there is no evidence that prices paid by Australians at the point of sale have fallen as a result of the reduction in interchange fees. *"The Personal Credit Card Market in Australia: Pricing over the Past Decade"* report, written by Chan et al (2012) found that *"over the past decade it has become increasingly expensive for cardholders to earn reward points and other benefits by using their cards, while merchant service fees have fallen"*[12].

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[11] CRA International (April 2008) *'Regulatory Intervention in the payment card industry by the Reserve Bank of Australia'*

[12] Chan, Chong and Mitchell, Reserve Bank of Australia (March 2012), *'The Personal Credit Card Market in Australia: Pricing over the Past Decade'* http://www.rba.gov.au/publications/bulletin/2012/mar/pdf/bu-0312-7.pdf

However, for large merchants there have been more positives than negatives. With the reduction in interchange fees, the MSF's that they pay have fallen and indeed have continued to fall; there is no evidence that these lower costs have been passed onto the consumer through lower prices and the removal of the restrictions on surcharging has given some merchants a 'double whammy' of benefits. They are now allowed to directly charge consumers for using payment cards rather than building those card acceptance costs into the prices of their goods and services as they had been prior to the removal of the 'no-surcharge' rules. But at the same time, the use of 'blended' surcharges, which sees an average surcharge applied to all types of payment cards, no matter what their specific cost, has allowed merchants to gain extra income for every payment card transaction.

As we have indicated above, the shift away from costly and inefficient cash payments across to electronic payments has slowed in Australia. The continued use of cash does not add to the potential efficiency of the financial system, nor does it benefit any legal participants of the payments value chain. Speaking at the Institute of International Finance's conference in Sydney, ahead of the G20 meeting in February 2014, Daniel Mminele, deputy governor of the South African Reserve Bank claimed that every 1 per cent increase in payment card usage would increase consumption by 0.06 per cent and GDP by 0.03 per cent, as this would mobilise household savings and hence enhance productive opportunities.

Recommendation Two
That the Financial Systems Inquiry recommends the RBA step back from payment system regulation and allow payment schemes to determine interchange fees and rules (e.g. surcharging) independently to address consumer costs, promote efficiency and productivity growth through delivering an economy less reliant on cash.

Surcharging

Surcharging occurs when the merchant who accepts a payment by card, adds a charge to a purchase, partially dependent on the type of card presented by the cardholder. Surcharging theoretically allows merchants to signal to consumers that some payment methods are more expensive for merchants to accept than others, so that consumers can consider whether to pay by using a less costly method. For example, according to the RBA's statistics, by the end of 2013, the average MSF charge to merchants to accept MasterCard or Visa was 0.83%; to accept American Express 1.73% and to accept Diners Club 2.02%.

Australian consumers have been increasingly concerned with the growing trend by merchants to levy excessive and/or blended surcharges. This trend is not consistent with the original intent of the Reserve Bank of Australia (RBA) in allowing surcharging and is clearly detrimental to consumers.

As the RBA has stated, surcharge regulation was intended to 'improve price signals' to consumers about the relative cost of different payment options. We are in strong agreement with the RBA's observation in 2011[13] that there has been increasing evidence to suggest that it is now becoming more common for merchants to set surcharges at levels higher than the average merchant fees and that the increasingly widespread nature of this practice has the potential to distort price signals to consumers and thereby undermine the RBA's stated purpose for permitting surcharging. There is limited data on the proportion of transactions that are surcharged, with the RBA reporting a range of 5 per cent overall to up to 44 per cent in the holiday travel industry. Recent MasterCard data estimates that the cost of surcharges to Australian consumers is $800 million annually.

[13] Reserve Bank of Australia (December 2011) *'A Variation to the Surcharging Standards: A Consultation Document'*

The ability for merchants to give so-called 'price signals' by surcharging for some payment methods but not for others (such as cash and cheques) is a failure of common sense. This arrangement is based on the assumption that cash transactions are cheaper than card transactions, and this is clearly not always the case. A number of independent studies from around the globe put both the cost to merchants and the social costs of a cash transaction at around 1.3%[14] of the value of a purchase (and, in some cases higher). The cost of cash to society is even higher, since cash usage results in additional costs to governments (e.g. for printing and distributing money and from lost tax revenue) and to consumers (from loss and theft and the opportunity cost of a loss of interest income).

This is why MasterCard, with an average cost of acceptance significantly lower than many alternatives, has a 'no surcharge' rule in most jurisdictions outside Australia (where our ability to enforce this rule is removed by regulation). We understand the value our products create for all end users, including merchants.

The RBA allowed surcharging from 1st January 2003 and this reform was considered to be important as it impacted on one of the key responsibilities of the PSB, that of "promoting the efficiency of the payment system". Since then the prevalence of surcharging in Australia has become widespread and research published by East and Partners in October 2013[15] suggested that over one-third of Australia's merchants imposed a surcharge on at least one type of payment cards they accept. This increasing use of surcharging caused the RBA to become concerned that some of the surcharging practices have developed in a way that distorts the very pricing signals to the consumer that surcharging was meant to convey. Some merchants have seized the opportunity to gouge consumers by applying surcharges at excessive rates, whilst merchants can also apply a surcharge at a 'blended' rate, which averages out all of the different MSF's for all of the card acceptance marques (see below the current MSF averages). These practices both distort the market and can cause consumers to under or over-utilise particular payment cards, which results in a less efficient payment system.

The regulatory journey in relation to surcharging represents a serious example of unintended consequences to end users – in this case consumers. Consumer detriment as a result of unreasonably high merchant surcharges was so significant that it led to the RBA reopening its consideration of the surcharging standard that originally imposed. Following a period of consultation with the payment card industry and other stakeholders, a draft revision of the surcharging standard was released in December 2011 and the new standards took effect on 18 March 2013. These allow the card scheme rules to limit a merchant surcharge to 'the reasonable cost of acceptance', which includes, but is not limited to, the MSF that the merchant pays to their financial institution. These new standards are designed to improve price signals consumers face when choosing how to pay. The changes theoretically enable all the card schemes (MasterCard, American Express, Diners Club and Visa) to limit surcharges and to address cases where merchants are surcharging at a higher level than is justified. However, precisely how such cases of excessive surcharging can be 'addressed' and enforced is unclear.

MasterCard is particularly keen to see the practise of 'blended' surcharging end, as it has significantly lower MSF's than those of American Express and Diners Club. The increase in blended surcharging is another unintended consequence of regulation, as when the merchant applies the same surcharge to all card schemes, the ability to 'price signal' to consumers is eliminated and there is no incentive to consumers to use a lower-cost payment card brand, instead of a more expensive one, or indeed to use another form of payment altogether. With blended surcharges, the merchant is simply recovering its costs of the higher cost scheme (or in many cases much more than this cost recovery pricing), while deriving additional revenue from users of lower-cost payment cards. If the practice of blended surcharging is allowed to continue and merchants are not limited in the amount

[14] Eg. McKinsey on Payments (November 2008) *'ATMs: Complex weapons in the war on cash'* and Schmiedel, Kostova and Ruttenberg (September 2012), European Central Bank, *'The Social and Private Costs of Retail Payment Instruments: A European Perspective'*
[15] East and Partners (2013), *'Annual Merchants Payments Report'*

that they can surcharge, then more damage is done to Australian consumers, who end up paying increased surcharges which result from these distorted price signals.

A review of the implementation of the RBA's revised surcharging standards has recently been carried out by the Commonwealth Consumer Affairs Advisory Council. The submissions to that review reveal some of the challenges in determining which entity should be responsible for enforcing the standards. MasterCard (and Visa) are not the appropriate entities to enforce inappropriate pricing behaviours of merchants, because as a four party scheme, we have limited or no direct relationships with merchants. Consequently, these card schemes need to work through acquiring banks, which have direct relationships with merchants.

However the submission from one of these acquiring banks, the Commonwealth Bank of Australia (CBA) is telling. The CBA submission[16] argued that acquiring banks should not have any enforcement role, because they have an interest in maintaining their business relationship with their customers. Any enforcement carried out by any acquiring bank, may result in merchants leaving that bank and then seeking a relationship with another acquirer, who may be less 'active' in enforcement. The CBA argues that the Australian Securities and Investment Commission (ASIC) is the 'best candidate for monitoring merchant compliance with the surcharging rules, given its role in ensuring that financial markets are fair and transparent and supported by informed investors and consumers'.

Consumer group Choice has also called for the government to step in, and pointed out that *"serial [surcharging] offenders won't stop slapping on extra charges until effective monitoring and enforcement is in place"*.[17].

Whichever entity takes up the responsibility for enforcing 'reasonable' surcharges must be empowered with and have the enforcement capacity to ensure merchants reduce surcharges and 'unblend' their surcharge rate. MasterCard therefore recommends that there should be a government regulator with specific powers to enforce the 'reasonableness test' for surcharging of card payments.

In the absence of an obvious and willing enforcer, the issue of the misuse of surcharging by some merchants could be most elegantly solved by the return to the previous pre-2003 situation, where surcharging was prohibited by most card schemes, and consumers could have confidence that advertised prices were also actual prices.

In February 2014, the Chairman of the ACCC raised the issue of online sellers of concert, theatre, sport and airline tickets who surprise buyers with surcharges at the end of a transaction. The Chairman indicated that 'drip pricing' will be a priority for the ACCC in 2014 and it expects "to take court action very soon". This issue is being driven as the ACCC observes that consumers may see a 'headline' price advertised at the beginning of the booking process, but when they progress to the payment phase, they find that additional fees and charges have been added. The ACCC considers this as potential a breach of laws requiring merchants to show the full price and of laws preventing 'misleading' behaviour. The ACCC has let it be known that it is "putting such merchants on notice that we will be taking a dim view of this sort of thing".

A return to the situation where surcharging was prohibited by all schemes is both an effective way of stopping this abuse of merchant power and of displaying 'competitive neutrality' in the way that the regulators deal with the various payment schemes.

Recommendation Three

a. That the Financial Systems Inquiry recommends a Government regulator be charged

[16] Commonwealth Bank of Australia (February 2012), Submission in response to the RBA's *'Consultation on a Variation to the Standards Relating to Surcharging'*

[17] Kollmorgen, January 2014, *'Excessive Surcharges Continue"* http://www.choice.com.au/media-and-news/consumer-news/news/credit-card-surcharging-update.aspx

with responsibility for enforcing or removing surcharging at unreasonably high levels to provide clearer pricing signals to consumers between payment schemes; or

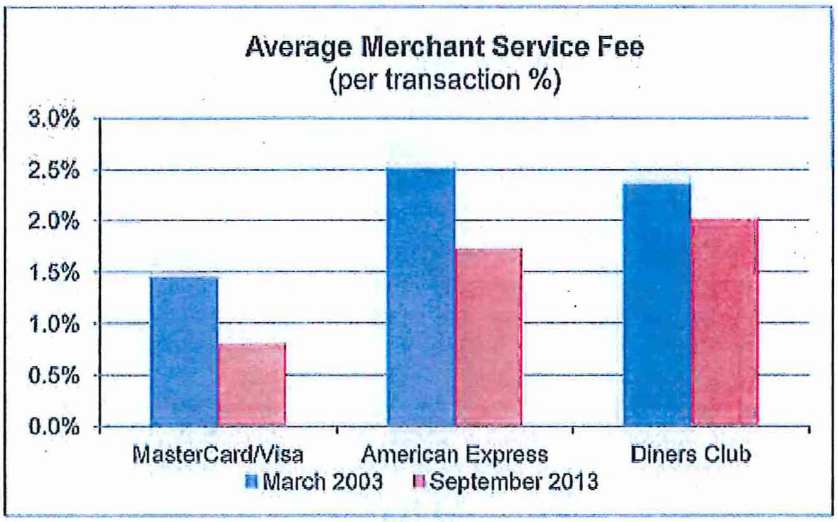
c. *The RBA remove surcharging regulations, to allow payment schemes to once again prohibit surcharging.*

The need for competitive neutrality

Pursuant to the *Reserve Bank Act* 1959, the RBA's Payment System Board (PSB) has a duty to ensure, within the limits of its power that, amongst other things, "the powers...are exercised in a way that, in the Board's opinion, will best contribute to controlling risk in the financial system, promoting competition in the market for payment services, consistent with the overall stability of the financial system".

Competitive neutrality has been compromised
The RBA's decision to regulate only MasterCard and Visa (and not American Express or Diners Club in relation to interchange and pricing) has demonstrably changed the competitive landscape in Australia. American Express in particular has benefited from a substantial increase in share of spend over the past decade.

This is despite the vast differential in the cost to merchants of accepting American Express and Diners Club cards. Indeed, as Graph 1[18] shows, the average MSFs attached to both of these schemes remains well above those for Visa and MasterCard products prior to regulation.



Graph 1

The Funding Australia's Future Project delivered in July 2013 by the Australian Centre for Financial Studies[19] (ACFS) considered the appropriate balance between stability and efficiency within the Australian financial sector, and how this trade-off has long been a major issue on the regulatory agenda. The ACFS report concluded that "regulation should not impede competition and the

[18] RBA *'Average Merchant Fees for Debit, Credit and Charge Cards'* Payments Data 2013 (http://www.rba.gov.au/payments-system/resources/statistics/index.html)
[19] Australian Centre for Financial Studies (2013), *'Funding Australia's Future'*

efficiency of markets", that "the regulatory system should also have a brief for neutrality" and that "one sector is not favoured over another at the expense of competition forces".

This submission argues that there is not competitive neutrality in the current regulation of the Australian payment system and that the creation of a level playing field, where all payment system providers are treated equally by Australia's regulatory system, will promote efficiency and competition in the market for payment services.

Under the *Payment Systems (Regulation) Act* 1998, the RBA "has the power to designate payment systems and set standards and access regimes for designated systems". The first intervention by the RBA in the payment system market in Australia in 2001 was to designate the four party schemes but leave the rival (and at that time exclusively three party schemes) American Express and Diners Club outside regulatory structures.

The PSB's Annual Report for 2013, points out "the shares of the four party schemes (MasterCard and Visa) and the [former] three party schemes (American Express and Diners Club) were largely unchanged in 2012/2013. The combined market share of the three party schemes remained around 20 per cent of the value of credit and charge card spending in 2012/2013". There has been considerable growth in the market share of American Express over the past 10 years (to preserve commercial confidentiality the market share of the former three party schemes is presented together, however because of the increased activity of American Express in the issuance of credit cards and the relative lack of activity and new products from Diners Club, it can be reasonably assumed that the vast majority of that 20 per cent market share is held by American Express).

As previously discussed in this submission, following the regulatory interventions which began taking effect in 2003, there emerged a commercial incentive for American Express to enter into arrangements with the major Australian banks to issue what are known as 'companion' cards. These American Express companion cards are provided to bank customers and issued alongside existing MasterCard credit card products. The higher MSFs which American Express charges merchants relative to MasterCard (see graphic above) incentivises bank issuers to offer these companion cards with a greater reward points for spending when compared to MasterCard product sitting alongside the Amex product in a wallet.

This fundamental change in American Express's business model in Australia now sees their business operate as a four party scheme in much the same way as MasterCard.

Through American Express's Global Network Services (GNS) division, banks and other institutions are incentivised to issue cards under the American Express acceptance marque, and, sometimes, to act as merchant acquirers on the American Express network. The GNS division has grown to represent more than 35 per cent of American Express's cards globally[20]. GNS cards are particularly strong in the Australian market, and yet thus far they have escaped any regulatory scrutiny. The paradox here is that American Express is offered preferential treatment by regulators, despite charging the existence of a higher MSF than for MasterCard payments. These American Express cards are then regularly accepted by merchants in combination with 'blended' surcharge rates (which include the MSF of American Express), driving up costs for consumers, whether they are American Express or the substantially more cost effective MasterCard cards. Perversely, this means MasterCard cardholders effectively cross-subsidise the benefits received by American Express (and Diners') cardholders.

This has led to a distortion of the market, and it highlights the absence of competitive neutrality in the payments marketplace. This has also been highlighted by the Customer Owned Banking Association (COBA) paper published in February 2014[21], which calls for the Financial System

[20] American Express Company, (2011), *2011 Annual Report*, p46
[21] Customer Owned Banking Association (COBA), (2014), *Competitive Neutrality in the Retail Banking Market*

Inquiry to take action to achieve a 'level playing field' for all participants in the financial services system.

An additional example of the current absence of competitive neutrality within the payment system is the lack of any meaningful regulation by the RBA of new and developing entrants within the market. Technological developments associated with the 'internet age' have encouraged new entrants into the payments market, which charge a fee for every transaction they handle.

For example, PayPal, which has over 5.5 million active accounts, and over 90,000 merchant partners in Australia[22], now competes directly against card schemes, in both the online space and also increasingly at the point of sale. However, unlike MasterCard, it is not restricting from having a 'no surcharge' rule. This means that when MasterCard introduces an innovative new way to pay online, as it did in 2013 through its MasterPass product, MasterCard's product is both price and surcharge regulated, whereas PayPal is regulated on neither of these.

In order to achieve a 'level playing field' in the payment system marketplace and absent a complete removal of all regulations, participants in the payment system must be treated equally. Regulation applying to MasterCard must apply to American Express and Diners Club, as well as newer entrants into the payment market.

Recommendation Four

That the Financial Systems Inquiry recommends a level playing field be introduced, so that any regulation affecting MasterCard and Visa also apply to other providers, including American Express.

Conclusions

Regulatory intervention in the Australian payments sector may have begun with good intentions. But, put simply, the circumstances surrounding the original interventions no longer exist. In particular, MasterCard and Visa are now independent public companies, and a substantial part of American Express now functions as a four party scheme model.

There have been unintended, negative consequences for end users of the system. Most notably, consumers are not getting accurate price signals about the costs of their choice of payment due to a distorted surcharging model, and small to medium sized businesses are paying more to accept MasterCard and Visa payments through the regulated interchange model.

Finally, there is an unequal playing field, meaning some market participants (including MasterCard) are subject to a substantial RBA regulatory burden and intervention, whilst others (notably American Express) are subject to only a partial RBA regulatory burden and intervention.

The FSI represents a unique opportunity to remove these unintended consequences of regulatory interventions, and to either remove the burdens for all participants, or alternatively to ensure that they apply equally to all participants.

[22] PayPal Inc., (2014) *'PayPal Australia Fast Facts'* https://www.paypal-media.com/au/about

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