

Paper for RBA Payment Systems Review Conference

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Introduction

Evidence demonstrates that five years after the Reserve Bank regulated the payments industry the RBA's objectives to improve efficiencies remain largely unachieved.

In fact, evidence submitted by MasterCard to the RBA's review of the payments systems regulations show that far from reducing costs to consumers the combination of increased annual fees, reduced benefits and the increased prevalence of surcharging at the point of sale actually means cardholders have been disadvantaged. The unintended impacts of the RBA's regulation simply underlines the fact that strong competition is superior to direct price regulation.

MasterCard believes that the RBA should focus on facilitating workable competition between payments systems instead of enforcing draconian and ad hoc price regulation.

In relation specifically to interchange - a complex balance with numerous issues impacting the way the market establishes the rate – it is clear that any artificial, academic manipulation of those market forces will always result in a skewed system. This is best evidenced by the fact the regulations have now placed American Express in a position of competitive advantage.

MasterCard believes strongly in vibrant and robust competition which operates on a level playing field. In our full submission MasterCard highlighted evidence that shows the existence of payment cards, and credit cards in particular, provides tangible benefits to an economy. Benefits the regulator has so far failed to consider. For example, the value to merchants of accepting credit cards is particularly important to them in terms of sales promotion and competitive success.

Two types of shopping behaviours are targeted by merchants in their marketing and sales efforts: (a) impulse spending which is defined as spending decisions made on the spot and not part of a planned purchase; and (b) optimistic spending defined as spending above planned purchases.

A 2007 survey by MasterCard of shoppers' impulse and optimistic spending behaviours across five cities (Sydney, Hong Kong, Singapore, Manila and Taipei) showed that both types of spending are positively correlated with credit card usage. In short, it demonstrated that credit card acceptance is critical to helping merchants increase sales and therefore adding value to merchants over and above simply being a convenient payment instrument.

Previous, independent research has also shown that the presence of payment tools such as cards build economies.

The RBA has described itself as a 'reluctant regulator' in this area. If that is truly the case, then now is the moment for the RBA to support the industry's calls to move toward a model of self-regulation which is in the broader interests of consumers and an effective, efficient market economy.

Cards – More than just a payment tool

It is fair to say that every industry and organisation involved in this process approaches the discussion of regulatory intervention with a fair amount of emotion. Regulation – by its very nature – provokes some sort of response from all parties.

From a business perspective, there's no question that the RBA's intervention in introducing a regulatory regime has damaged MasterCard's business,)as has been demonstrated by the declining growth rates in payment card usage and that of our issuing and acquiring customers.

To that end, MasterCard has invested considerable time and resource – both using our own internal, global experts and making use of outside, independent analysts – to investigate the specific impact of regulation.

Consumers have suffered

What we found reinforced our view that consumers have suffered. Five years after the regulatory intervention by the Reserve Bank – which had the specific goal of enhancing competition, improving efficiency, and benefiting consumers – available evidence suggests that the Bank's objectives have been largely unachieved. Overall, the payments market has not been made more competitive or efficient and Australian consumers are now saddled with higher costs as issuers increased annual fees and reduced benefits to compensate for the RBA-mandated reduction in interchange fees.

The detailed written submission MasterCard made to the RBA's Payment System review describes the impacts of the regulations as supported by evidence in the Australian marketplace. Some of the intended and unintended ramifications of the regulations have included:

- higher cardholder fees and interest rates, with reduced features and benefits;
- a reduction in average merchant fees of more than 0.60% since the introduction of the regulations equating to approximately A\$1 billion per annum;
- no evidence of reduced consumer prices to reflect the reduced merchant cost;
- a widening in the gap between the average merchant fees of the regulated and unregulated schemes;

- a competitive advantage derived by the unregulated three-party schemes, as evidenced by growth in the collective market shares of American Express and Diners Club;
- the interchange regulations have disadvantaged one regulated scheme against the other regulated scheme, simply due to the differential make-up of each scheme's portfolio;
- the surcharging of credit card transactions by merchants across all retail and non-retail segments (with some examples of price-gouging);
- there have been no significant new entrants into the Australian market since the introduction of the regulations in 2003; and
- reduced investment and innovation in payment products (e.g., significant delay in the introduction of chip/PIN cards).

Competition vs. Regulation

The experience of the past five years has merely served to reinforce the general presumption that competition is superior to direct regulation in achieving efficient outcomes. MasterCard considers that regulators should therefore focus on facilitating workable competition between payments systems rather than directly regulating interchange fees.

Such an approach by the Bank would be entirely consistent with the evidence from Australia and Europe that a merchant's ability to discourage card usage through such means as offering cash discounts, steering and surcharging means that the merchant community has the ability to effectively constrain interchange fees. Indeed, we see regular evidence of merchant behaviour discouraging card usage to the point where it is clear the balance of power lies increasingly with the merchant. Through the various tools at their disposal (including surcharging), they are well equipped to make a decision as to which payment mechanism they accept without actually blocking card acceptance.

While MasterCard believes surcharging is not consumer friendly, in the spirit of achieving a mutually acceptable outcome we believe that the merchant's ability to impose a surcharge, or just as importantly, the ability to threaten the imposition of a surcharge, is preferable (along with the various other tools available to merchants) to continuing on with what can only be described as a draconian measure of regulating price through interchange.

So, while we have seen evidence of merchant segments taking up their option to reduce card acceptance where they feel it benefits them for strategic, competitive reasons (for example acceptance of pre-paid) we also see some segments – including online retailers – rapidly growing card acceptance. Cards – and the ability to accept payments remotely – have spurred a whole new economy. Without the flexibility of card payments, there is every reason to believe that online retailers would not exist. And there remains many other retail segments where card penetration is growing rapidly – such as utilities and government payments.

It should be noted that the Australian payments landscape (and the Australian economy with it) has changed significantly over the last five years. As mentioned above, online payments have grown exponentially, as has the power of the retailer. Whether these changes can be directly attributed to the regulations is debatable, but what is clear is that this has been an historic period of substantial change. One could argue that the Australian payments system has matured and is now a lot more sophisticated than it was as recently as five years ago.

These changes are reflected in the manner in which the four-party card schemes now set interchange fees. Five years ago banks set the fees and there were only three interchange categories in operation for domestic transactions. Indeed as has been previously documented the schemes had the same interchange categories and the same level of fees. Today, the schemes (MasterCard and Visa) set the fees and have well over a dozen interchange categories each. The categories are not only split by transaction type, but also by product and merchant category. Some merchants have forced down their effective interchange fee to 0.30%. While other merchants are prepared to pay more than double that rate. This is a reflection that many merchants do heavily influence the level of interchange fees, while for some other merchants it is not an important consideration in the running of their business. Further evidence – if it was needed – that merchants are in as strong a position as they have ever been to make decisions as to what mechanism they choose to accept payment.

And the payments landscape in Australia still has a long way to go in its development. Many merchant segments continue to have no or very low levels of cards acceptance. Urban transit systems and taxation agencies are only two examples of merchants which do not accept card payments in Australia, but enthusiastically accept cards as a cost reduction tool in other markets. Australian merchants have proven that card acceptance is an option, and not an involuntary requirement of business. They have also proven that the cost of cards acceptance is not the main determinant of their decision to accept cards, but a whole range of factors inform their decisions in this regard. That example is underlined with numerous examples of countries with relatively high interchange in comparison to Australia that also have deep and strong card acceptance including, among others, Spain, Japan and Hong Kong.

MasterCard's approach

Considering the above, MasterCard has looked at this debate through the consumer's eyes – the well over 90 per cent of Australians above the age of 18 who carry and use some sort of payment card. We wanted to know how regulation has affected them. Has it changed costs? Do they think they are more or less convenient or efficient?. How has it changed how they use their cards?.

For the record, and in the interest of full and frank disclosure, MasterCard approaches today with the belief that – as indicated by independent research – regulatory intervention has demonstrably hurt consumers. But in the spirit of co-operation and in an attempt to reach an outcome that is acceptable to the majority of players, MasterCard has been prepared to agree to a middle ground solution.

As has been discussed above, MasterCard believes it is now clear that merchants do have and do exercise significant power when it comes to the determination of merchant fees. To this end, MasterCard has expressed to the Reserve Bank its willingness to agree to a model of co-regulation whereby the market re-assumes control for the setting of interchange fees, with the retention of regulations relating to surcharging and the “Honor All Cards Rule.” It should be noted however that MasterCard does believe that further protections need to be enshrined in Australian law or regulations which protect consumers from excessive surcharging.

MasterCard is open-minded to the call by other industry participants for the replacement of the interchange regulations with a set of agreed principals. Obviously MasterCard cannot commit to such an arrangement until it becomes privy to the details, and would want assurance that such an arrangement does not create the opportunity for prosecution under competition law, whether it be by the ACCC or a private litigant.

Finally, MasterCard would point out that if the Bank is genuinely serious about promoting competition in the payments market in Australia, then all payments vehicles should be put on the same footing for consideration; which would include not only four-party schemes, but three-party schemes; two-party payment cards, as well as cash and cheques. While MasterCard has some serious reservations about the cost research undertaken by the Bank and discussed in detail today, we do note that payment cards when compared to most other payment instruments deliver higher average transaction sizes, and are cheaper to merchants as a proportion of the transaction size than most other forms of payment. The research demonstrates that payment cards deliver significant advantages to merchants – even when understated in the manner done in this research.

From this perspective, the key consideration should not be the price at which each of these vehicles are available to the market, but the values delivered to the end users (the consumers), by these competing payment vehicles. Only consumers and merchants, moreover, are in a position to decide what value is being delivered to them. More often than not consumers' perceptions of such value is highly sensitive to where and when they need to make a payment, and for what purposes. No regulatory authority can hope to understand what the needs of millions of consumers may be at any given time and how their needs may change over any period. Only the consumers themselves know, and hence only they are in a position to decide what values are being delivered to them by which product or service.

This is no difference from the pricing of two similar personal fashion accessories, one with a designer brand and the other without. Their costs of production may be similar; and yet consumers perceive vastly different values between them; and consequently are willing to pay a much higher price for the former than for the latter.

Focusing exclusively on interchange is equivalent to a government regulatory authority aiming to regulate the pricing of personal fashion accessories and deciding that the branded goods should be priced the same as the unbranded if their production costs are



similar – an absurd conclusion. Such a stance is also against the broader interests of consumers and an effective market economy.