The Treasury

Review of the Australian Payments System

Mastercard response to Issues Paper

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Introduction

Thank you for the opportunity to make this submission to the Treasury Review of the Australian Payments System.

We make this response with the stated purpose of the review in mind - ensuring the payments system and the regulation surrounding it, remains fit for purpose and supports continued innovation for the benefit of end users.

Mastercard aims to facilitate:

- An efficient and effective payments system;
- Recognition of the value electronic payments deliver to businesses and the wider economy;
- Protection of consumer benefits and mitigation of unnecessary cost impacts; and
- Development of evidence-based policy which considers the impact of regulation on all system participants.

Technology, innovation and competition have fundamentally changed the payments landscape in Australia, and it is critical that the regulatory environment is rigorous enough to maintain the security and stability of the payments system while at the same time being flexible enough to respond to further changes.

Mastercard's position in relation to this review is summarised as follows:

- We support the Reserve Bank of Australia (RBA) through the Payments System Board (PSB) remaining the primary regulator for the Australian Payments System;
- However, the regulatory scope for the RBA and the PSB should change to account for the evolution and likely future direction of the payments sector;
- Mastercard believes the local payments market is competitive, as demonstrated by:
    - the emergence of new ways to pay, such as Buy Now Pay Later schemes;
    - the introduction of significant innovation by incumbent players, such as tokenisation, contactless and digital wallets;
    - the emergence of fintechs and neobanks to challenge incumbents with new offers to consumers and merchants;
    - the residual market for cash payments, and the smaller and declining market for cheques; and
    - the near universal acceptance of a range of different payment types across the country.

- However, the current regulatory regime and the regulatory approach is too narrowly focused on reducing merchant costs for the theoretical benefit of consumers who, it is argued, should enjoy lower prices as a result. In fact, there is no evidence the reduction in acceptance costs has led to lower consumer prices. As technology drives the evolution of the market, the risk is the current regime may be perversely stifling competition, a dynamic known for delivering lower costs, better prices and more choice.

As noted in Mastercard's submission to the RBA's Review of Retail Payments System:

> *"The Australian payments market will continue to evolve and innovate quickly. New entrants, technologies, payment options and the introduction of new products and innovations by schemes like Mastercard are proof of a competitive, dynamic sector that needs a regulatory framework to promote this evolution rather than inhibit it."*[1]

About Mastercard

Mastercard is a technology company in the global payments industry that connects consumers, financial institutions, merchants, governments, digital partners, businesses and other organisations worldwide, enabling them to use electronic forms of payment instead of cash and checks. We make payments easier and more efficient by providing a wide range of payment solutions and services using our family of well-known brands, including Mastercard®, Maestro® and Cirrus®. We are a multi-rail network that offers customers one partner to turn to for their domestic and cross-border payment needs.

Through our unique and proprietary global payments network, which we refer to as our core network, we switch (authorise, clear and settle) payment transactions and deliver related products and services. We have additional payment capabilities that include automated clearing house ("ACH") transactions (both batch and real-time account-based payments). We also provide integrated value-added offerings such as cyber and intelligence products, information and analytics services, consulting, loyalty and reward programs and processing. Our payment solutions offer customers choice and

[1] Payments System Board Review of Retail Payments Regulation - Mastercard Response to Issues Paper, January 2020, https://www.rba.gov.au/payments-and-infrastructure/submissions/review-of-retail-payments-regulation/mastercard.pdf

flexibility and are designed to ensure safety and security for the global payments system.

A typical transaction on our core network involves four participants in addition to us - account holder (a person or entity who holds a card or uses another device enabled for payment), issuer (the account holder's financial institution), merchant 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 account holders by issuers, or establish the rates charged by acquirers in connection with merchants' acceptance of our products. In most cases, account holder relationships belong to, and are managed by, our financial institution customers.

We generate revenues from assessing our customers based on the gross dollar volume ("GDV") of activity on the products that carry our brands, from the fees we charge to our customers for providing transaction switching and from other payment-related products and services.

It is of vital importance to note that Mastercard does not earn revenue from Interchange

Who should regulate the payments system?

Mastercard supports the retention of the RBA and PSB as the primary regulator of the Australian payments system, with a change to the scope of their regulatory remit.

The Australian payments system is primarily governed by regulation designed by the RBA, with the coordination of system-wide standards and policy development by the Australian Payments Network (AusPayNet).

Other government entities are also involved in the regulation of the payments landscape (including fintechs). These include units of the RBA, the banking regulator (APRA), and the markets regulator (ASIC).

Any investigation into the regulatory architecture for payments should first establish which entity currently regulates identified activities and then consider the framework best placed in the future to achieve the desired objectives.

In other jurisdictions, formal powers to promote competition are embedded in sectoral regulators to ensure the trade-offs between objectives can be internalised effectively.

As new business models are developed and competition issues arise, coordination between the regulatory environment for payments and platforms is likely to be important. This is relevant given many digital platforms are entering into the payments market by leveraging their customer base from other markets.[2]

Refining the regulatory scope

When regulation began in 2002, the Australian payments market provided fewer options for users, with a small number of schemes operating primarily in a card present environment, alongside cheques and cash. Since then, the market has evolved rapidly. Today, users enjoy a diverse range of ways to pay and get paid.

The RBA's regulatory scope is governed by a broad public interest test as set out in the Payment Systems (Regulation) Act 1998:

> *In determining… if particular action is or would be in, or contrary to, the public interest, the Reserve Bank is to have regard to the desirability of payment systems:*
>
> *(a) being (in its opinion)*
>
> *(i) financially safe for use by participants, and*
>
> *(ii) efficient; and*
>
> *(iii) competitive; and*
>
> *(b) not (in its opinion) materially causing or contributing to increased risk to the financial system.*[3]

More specific objectives are related to system stability, service efficiency, the adoption of innovation, effective competition, and flexibility.

Once the objectives have been determined, the next question is: who is best placed to achieve these objectives, and what powers are needed to do so?

In considering these issues, Mastercard commissioned research from Oxera Economics[4], which concluded:

- Over the years, regulatory regimes have generally moved away from broad considerations of public interest to more specific objectives. A review of the regulatory architecture gives an opportunity to revisit the overarching objectives for payment regulation;
- The regulatory approach to payments has been considered in several other jurisdictions. There are many relevant objectives, including those

[2] Oxera (2020), The competitive landscape for payments: an Australian perspective p.2
[3] Section 8, *Payment Systems (Regulation) Act 1998* (Cth)
[4] Oxera (2020), Regulatory Architecture Design, p. 4

relating to whose interests are protected, the outcomes desired, and market characteristics Some examples are set out below:

    - to ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them;
    - to instil consumer and investor protection and market integrity;
    - to ensure financial stability;
    - to promote a safe and efficient infrastructure;
    - to promote effective competition in the markets for payment systems
      and services;
    - to promote the development of and innovation in payment systems—particularly the infrastructure used to operate those systems;
    - to support innovation (that is, to remove obstacles to the application of new technologies in the financial sector, to promote the uptake of technology and responsible innovation, and to ensure that wide-ranging changes to existing financial services legislation are evidence-based);
    - to empower consumers and ensure that they are well informed.

- Having established specific regulatory objectives, any proposed architecture should consider how trade-offs and conflicts are managed.
  - Objectives—for instance, of resilience and competition—can conflict. Encouraging competition may mean that new types of businesses are given access to infrastructure. This may raise concerns regarding stability, risk management, and resilience.
  - There is also a well-established tension between protecting national champions and promoting competition. For instance, some regions may wish to ensure that a domestic or regional scheme persists, perhaps to maintain security of supply. In preserving or supporting these local schemes, regulators may need to dampen competitive pressure from other providers.

Justifying a change in regulatory scope

In Mastercard's submission to the RBA Review of Retail Payments Regulation[5], our response was structured around three key themes, all of which remain relevant to the future scope of the regulatory arrangements for the Australian Payments System – Value, Transparency and Competition.

The general consensus is (and this is shared by the RBA[6]) that Australia is a mature, low cost payments market with a high degree of competition. Technological trends are reshaping the payments landscape and facilitating new entrants. The already high level of competition in the Australian payments market suggests regulatory intervention should only occur in those sections of the system not exposed to competitive market forces.

However, regulatory and policy interventions appear to have the unintended consequence of reducing competition and potentially increasing risk. This is largely because the RBA's approach to the payments market is very narrow and focusses almost exclusively on reducing acceptance costs for merchants. As shown below, this leads to perverse outcomes that reduce competition, innovation and eco-system security.

A prime example is the impact of the RBA promoting dual network debit cards (DNDCs), which increases costs and creates competitive barriers for smaller banks. The participation of smaller banks and new entrants (like neobanks and fintechs) in the issuing market is desirable given the increased competition it delivers (obviating the need for RBA regulation) both in what is provided to consumers and merchants and how it is provided. The passenger scheme on a DNDC

Given the ownership structure of eftpos includes the major banks, its inclusion on all debit cards provides no great advantage to end users while ensuring small and new entrants are effectively having decisions about their business operations directly influenced by their larger competitors. Additionally, specific arrangements around the governance of eftpos tend to compound this: large banks are well placed to understand operational and business impacts at their smaller competitors as a result of their role.

[5] Mastercard's submission can be read at https://rba.gov.au/payments-and-infrastructure/submissions/review-of-retail-payments-regulation/mastercard.pdf

[6] See, for example, Tony Richards quoted in Hansard (2019), Hearings of the Senate Economic Legislation Committee into the Currency (Restrictions on the Use of Cash) Bill 2019 at https://parlinfo.aph.gov.au/parlInfo/download/committees/commsen/1f63821a-8028-453f-abd5-a3c30cd67115/toc_pdf/Economics%20Legislation%20Committee_2019_12_12_7452.pdf;fileType=application%2Fpdf#search=%22committees/commsen/1f63821a-8028-453f-abd5-a3c30cd67115/0000%22 and Phillip Lowe, Address to the Australian Payments Network, 7 December 2020, transcript at https://www.rba.gov.au/speeches/2020/sp-gov-2020-12-07.html

That matter is further compounded by eftpos' significantly lower functionality and security features when compared against its competitors.

From the market's perspective, DNDCs duplicate functionality for consumers across two payments networks, creating cost and complexity for issuers and acquirers. Furthermore, we note investments to support DNDC routing have been prioritised ahead of important investments to protect the payments system for the future - for example, upgrading acquirer processing capabilities, implementing tokenisation or enabling biometric transaction authentication.

We also note this anti-competitive impact is inconsistent with Australian Government policy on increasing competition and innovation in the financial services sector through open banking. As a general principle, Mastercard argues that policy and regulatory regimes in the financial services sector should work in concert to achieve desired outcomes, rather than at cross-purposes.

The RBA's focus on interchange fees is another example of the failure of the current regulatory approach to effectively promote competition and efficiency in the payments market.

Regulating interchange, ostensibly to reduce merchant costs (savings which should theoretically be passed on to consumers in the form of lower prices, does not account for the value of interchange in promoting security, resilience and innovation in the system. Economic arguments favouring lower interchange – or in their most drastic form removing it altogether – tend to underplay how it supports the efficient functioning of the payments system. When it comes to interchange, the RBA has long held the view that low cost is a proxy for efficiency and optimal market functioning. It very demonstrably is not.

Generally, interchange is collected from payment acquirers and paid to card issuers to reimburse them for a portion of the costs incurred for providing issuing services to the benefit of all participants in the system, including acquirers and merchants. While Mastercard sets interchange rates, it does not earn revenue from interchange.

Interchange facilitates security and efficiency by ensuring merchants and consumers receive maximum value for making and accepting electronic payments at the lowest possible cost and incentivises the development of new products and technologies. It functions as an incentive encouraging issuing banks to invest in innovation that generates economic value and opens new markets for local businesses.

Importantly, interchange fees provide an incentive and source of revenue for smaller issuers to provide customers with cards utilising the latest technologies.[7] Unlike larger banks, smaller financial institutions – including disruptive new entrants to the financial services marketplace like neobanks – have less scope to offset the costs of operating a debit payments business from their other business activities.[8] For these institutions, interchange revenues enable them to issue the range of card products to effectively compete with incumbent banks.

With significant reductions in interchange fees, through direct regulation and as a result of merchant routing for debit transactions, smaller financial institutions will not be able to offer services customers demand and they lack scale to invest in new product or security technologies. Given this, lowering interchange has had the unintended – and undesirable – consequence of discouraging new entrants and entrenching the market dominance of the existing players. Reductions in interchange hurt these businesses disproportionately and are harmful to competition in financial and payments services.9

The issues outlined above highlight the real potential that the current regulatory framework, focusing almost exclusively on the cost of acceptance for merchants, will simply lead to a 'race to the bottom', inhibiting competition, innovation, security and resilience. Again, this is inconsistent with the Australian Government's commitment to increase competition in financial services and foster the growth of a vibrant local fintech sector.

It is our view the misplaced regulatory focus and sometimes perverse outcomes that occur are partly the result of a lag between the RBA's approach and the current vibrant and technology-enabled market.

Underlying this is the RBA's long held view of the market power of the incumbent payment networks, based on the assumption of significant network effects generated by our infrastructure.

The emergence and growing market share of new payment options like BNPL directly challenge this theoretical understanding of the operation of the payments market in the 21st century.

In a paper commissioned by Mastercard, former Federal Minister and economist Dr Craig Emerson notes:

[7] ACIL Allen Consulting (2020), Payments systems and interchange fees, pp. 9-11
[8] Oxera (2020), The competitive landscape for payments: an Australian perspective, p. 71
[9] ACIL Allen Consulting (2020), Payments systems and interchange fees, p. 13

"… recent and ongoing technological innovations are ensuring any historical network effects in the retail payments market are less influential and will be even less so in the future. Indeed, driven by competitive pressure, international payments schemes such as Mastercard and Visa have been developing innovative payments methods such as mobile point of sale, PIN on glass and tap on phone. These are evidence of a competitive market."[10]

Conclusion

In providing this response and in the further discussions we hope to have with you, Mastercard has considered the interests and perspectives of consumers, businesses, industry participants and other stakeholders.

Mastercard agrees in principle that the current regulatory framework for payments may be approaching the end of its useful life. This framework was developed at a very different time, when there was less choice in the market and technological constraints limited the possibilities of innovation and new entrants into the financial system more generally. Now, the challenge for market participants is ensuring regulation developed some years ago and theoretical approaches to market dynamics do not unduly effect competition, security and efficiency in the payments system today.

Given, the structural issues outlined earlier have endured for a long time, we believe the RBA's almost exclusive focus on costs of acceptance for merchants suggests the RBA has lost sight of those matters.

We believe the Review should focus on the public interest element of what is expected of RBA and whether it is meeting these expectations.

Additionally, we believe the RBA's intervention on the grounds of market inefficiency should be tailored to focus on consumer harm and lack of competition among providers of payment services to business.

If there is an appetite to impose a new regulatory architecture, it is essential to bear in mind the principles of proportionality and certainty.

Regulation should always ensure that it does not damage commercial incentives that are clearly working well in the market. According to Oxera:

"All regulation leads to unintended consequences. Regulatory architecture should avoid boundary problems, especially in dynamic market environments where new players will design their business model around regulatory opportunities. It should also ensure that the regulatory system effectively internalises important trade-offs. For

[10] Emerson Consulting (2020), Submission to the Treasury and RBA Reviews of the Retail Payments System, p. 4

instance, price regulation can have the unintended consequence of dampening entry and innovation.

The risk of future regulatory change can disrupt entry and investment today. Accordingly, any new regulatory arrangements need to be seen to be reasonably long-lived, such that the commercial basis for innovation and investment today cannot be easily undermined in the future at the whim of the regulator."[11]

If you would like to discuss any aspect of this submission further, please contact Chris Siorokos, Director Public Policy on 02 9466 3720 or by email to chris.siorokos@mastercard.com

Yours Sincerely,

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[11] Oxera (2020), Regulatory Architecture Design, p. 9