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The Rt Hon Mel Stride MP
Chair, Treasury Select Committee
House of Commons
London
SW1A 0AA

BY EMAIL ONLY

02 August 2022

Dear Mr Stride,

Thank you for your letter of the 13th of July 2022. We welcome the opportunity to respond to your question concerning how interchange rates are set.

As you will be aware, the Payment Systems Regulator (PSR) is also looking at this issue and has recently begun a market review of UK-EEA consumer cross border interchange fees. We look forward to working with them on this over the duration of the review and hearing their conclusions.

Before responding to the Committee's specific question, it might be helpful to first outline the nature of the cards market, of which interchange is one element. Therefore, in addition to our submission to the Committee's recent call for information on the work of the PSR, we also welcome the opportunity to further outline how the card payment system operates in the UK; the value and benefits consumers, businesses and the wider UK economy derive from it; and challenge some of the misconceptions about the scale of card acceptance costs.

As such, this letter will set out that:

- Card payments are fundamental to the functioning of the UK's economy and deliver significant value to consumers, businesses, government at all levels and the wider UK economy. They are a platform for further innovation as consumer needs and preferences evolve and for economic growth.
- All payments methods, from cards to cash to account to account, have a cost associated with them.
- 'Card fees' – i.e. interchange fees, acquiring fees and scheme/network fees – are very small compared to
    - a) other costs that merchants incur to take card payments and
    - b) the costs of accepting other forms of payment such as cash
- The level of card fees has been overstated in some quarters and of all the fees associated with accepting cards, fees received by Mastercard are by far the smallest.
- Interchange is a small fee typically paid by acquirers (the merchant/retailer's bank) to issuers (cardholder's bank), to recognise the value delivered to retailers, governments, and consumers by accepting digital card payments and the costs incurred by such payments. It is not levied on consumers or paid to the card schemes.
- Card issuer costs have changed in the 15 years since the interchange rates for cross border transactions were fixed; and the transaction mix has also changed significantly in this time with more Card Not Present (CNP) online transactions where fraud costs are higher than for domestic transactions.

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- Cross border interchange rates are higher than domestic interchange rates in part because of the value that merchants receive from being able to conduct secure cross border transactions, but also the increased functionality required and greater risks (e.g. fraud) to all parties (merchants, issuers and consumers) associated with conducting cross border CNP (i.e. online) transactions.

Context – Mastercard in the UK

The UK's digital payment systems are amongst the most advanced in the world due to the significant investment by the industry in both existing infrastructure and innovation over many years in areas such as contactless, fraud prevention and cyber security amongst a range of others. At Mastercard we provide the technology that keeps a significant proportion of the UK's payments moving safely and securely. Both the card and account-to-account payment systems that we run are integral to the functioning of the UK's economy day-to-day. They help individuals receive their salaries, pay for their utility bills, pay family or friends, whilst helping businesses make and receive payments from consumers and other businesses, and help both charities, and government collect and disperse funds.

We provide the means for consumers, businesses, charities, and governments to conduct card payments securely either in person or online, in over 200 countries across the world. We provide the ecosystem that facilitates the participation of card issuers and their customers (consumers) and acquirers, and their customers (retailers/merchants). It is this network that connects any consumer with a Mastercard issued debit or credit card, to millions of merchants anywhere in the world that accept Mastercard. As such it is an enabler of global e-commerce, allowing UK retailers such as Marks and Spencer[1], Asos and John Lewis amongst many others, to expand their reach to customers from across the world, from their base in the UK.

Our network, given its resilience, world leading capabilities, and global reach, is also the platform upon which significant innovation is developed. It has a central role in supporting UK and global fintech ecosystems, both as the platform upon which much innovation is built and scaled, and as a supporter, investor and champion of new entrants into the market. It is our card network that has played an important role in enabling challenger banks including Monzo, Starling and Metro Bank and card providers such as Curve to not only start up and successfully compete in the UK, but in doing so offer greater choice to UK consumers, and also expand internationally leveraging our global reach.

Conversely, our network also facilitates card acceptance innovation and with the support our network gives to new entrants to the acceptance market in the UK, such as Square, SumUp and Stripe, this has enabled many small businesses and micro-merchants to start accepting digital payments. This has been particularly important during the pandemic as the survival of thousands of micro and small merchants depended upon being able to transition to an online environment quickly. That the UK led the world for domestic e-commerce penetration in 2021, with nearly a third

[1] 'M&S Expands International Online Business to Over 100 markets', March 2021

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of all retail transactions being conducted online, is testament to the role that card payments have played in helping to support this transition[2].

Similarly, the experience in public transport is that being able to take card payments spurs further innovation that in turn delivers value for both customers and service providers. For instance, Transport for London's contactless ticketing system automatically calculates the best value fare based on the customer's specific journey history and then charges them at the end of the day - ensuring customers always pay the cheapest fare in the easiest and most convenient way[3].

Our network will also be the foundation upon which a growing number of social purpose fintechs from across the UK will innovate to address current and future challenges around inclusion, identity and sustainability.

Through Vocalink, we are also responsible for building and running the UK's Faster Payments and Bacs account to account payment systems, the UK's current account switching service and the cheque imaging service on behalf of Pay.UK. We also play a central role in facilitating access to cash in the UK. Whilst we do not make decisions on how many ATMs there are or where they are based, it is our infrastructure that underpins the LINK network of over 52,000 ATMs; and that also enables bank account access at Post Office branches.

The investment that Mastercard has made - and continues to make - in developing innovative new services and in the resilience of our systems, has allowed us to continue to support the UK economy and meet the numerous urgent challenges posed most recently by the COVID-19 pandemic head on. This includes helping to disperse critical financial support and economic stimuli to individuals, businesses, and charities through prepaid cards and the Bacs and Faster Payments systems; through to helping SMEs adapt to the changing commercial environment and providing our data insights to help inform the Government's response. We are also committed to supporting the digital and financial inclusion of individuals and businesses most impacted by the pandemic.

Finding balance – the four-party model and interchange

Like any business Mastercard charges its customers (card issuing banks and card acquirers) for the services and value it provides. However the nature of our core network – the four party payments system – means that we do not have a direct relationship with, nor levy any charges upon, UK consumers or retailers, but they are the ultimate customers of our services and so are very important to us.

In a typical transaction, an account holder purchases goods or services from a merchant using one of our payment products. 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 and then posts the transaction to the account holder's account. The acquirer pays the amount of the purchase, net of a discount to the merchant.

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[2] Mastercard Economics Institute; 'Economy 2022 In focus'
[3] UK Finance, 'TfL Success Story Shows how Contactless Ticketing can Benefit Consumers'

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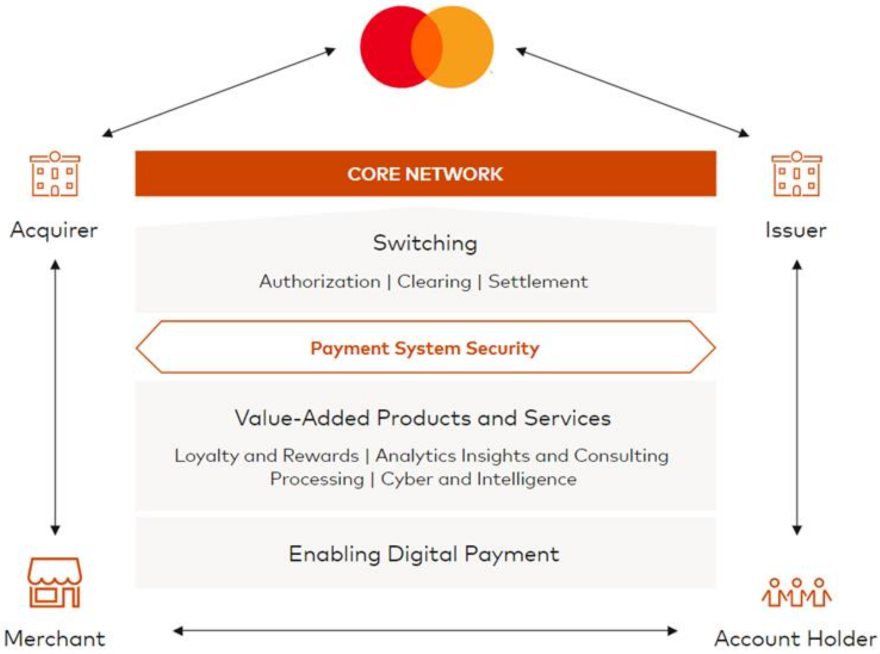

Interchange is an important facet of this model, and as such the Committee should be aware of a number of factors:

- Interchange is a small fee typically paid by card acquirers (the merchant/retailer's bank) to card issuers (cardholder's bank), to recognise the value delivered to merchants/retailers, governments and consumers by accepting electronic payments, the infrastructure required to make this possible and do so securely and the costs incurred in these respects. It is not a consumer facing cost. Mastercard does not receive any revenue from it.

- It is critical to providing, for example, the payment guarantee that ensures merchants/retailers are paid for purchases regardless of whether the issuing bank is ever repaid for the credit it extends to a consumer or small business. This requires maintaining the mechanism that underpins guaranteed payments – critical for ensuring liquidity, particularly in times of economic stress. It also affords such payment guarantee at scale — for credit card transactions, merchants/retailers will be paid for every transaction undertaken on our network, whether consumers ultimately repay their credit card issuer for the unsecured consumer credit that was extended to them.

- Setting interchange rates at the right level is important. Too high and merchants/retailers may choose to not accept cards or to discourage card use in favour of other payment options. Too low and issuing banks have no incentive to cover the risks of issuing payment cards. The optimum level also helps ensure issuers and acquirers deliver effective services, and spur innovations in payment solutions. In the case of fintechs, without appropriately set interchange fee levels it is arguably less likely that some of the UK-based innovators would have been able to enter and scale up in the retail banking market, without this revenue stream.

- For domestic transactions, interchange rates are capped by law at 0.2% of the transaction value for debit cards, and 0.3% for credit cards. As outlined below, Card Not Present (CNP)

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cross border transactions across two different regions are significantly more complex than domestic transactions; carry more risk, require increased functionality, and as such carry a higher cost for the card issuer. However, they also deliver significant value to merchants/ retailers, opening up global markets by facilitating secure and convenient payments for consumers in 200 countries around the world. Cross border interchange rates are therefore higher than domestic interchange rates, which in part reflect the greater risk (e.g. of fraud) compared to domestic transactions. In the UK in 2019, while cross border transactions only accounted for 11.8% of the value of all transactions, it accounted for 53.5% of the value of all fraud, demonstrating how heavily fraud is driven by cross border transactions compared to domestic transactions[4].

- As set out below, interchange equates to a very small fee for merchants compared to a) the value that merchants receive from both domestic and overseas card transactions b) the wider indirect and back-office costs that merchants incur to accept card payments and c) the cost of acceptance of other forms of payment such as cash and Buy Now Pay Later.

Alongside the interchange fee, the other constituent elements of 'card fees' or known collectively as the 'Merchant Service Charge' (MSC) are:

- The acquiring fee which is levied by the card acquirers directly on merchants and varies according to merchant size, with larger merchants usually paying less. As the Committee will be aware, this has been the subject of a market review by the PSR, that has recently concluded that the card acquiring market was working well for large merchants but not so for smaller merchants. Mastercard does not derive any revenue from this fee nor set its rates.

- Scheme or network fee - Acquirers and issuers pay scheme or network fees to Mastercard to participate in our card payment scheme. The amount of fees paid depends on the number and value of transactions conducted, and on the characteristics of the transactions, as well as the usage of optional services. This is the smallest constituent element of what are regarded as 'card fees' (as set out below – 'Cost of Payments').

The benchmark Interchange Fee levels applied

As you have acknowledged, the reason Mastercard had to consider changes to EEA cross border interchange fees in 2020 was the forthcoming end of the Brexit transition period after which the EU Interchange Fee Regulation would no longer apply to cross-border interchange fees between the EU and the UK.

Mastercard operates in a dynamic competitive environment which requires us to continually monitor our scheme rules and policies (including in respect of interchange fees) to take account of the market environment, the needs of our customers and the value our products generate for all users of the Mastercard system.

[4] European Central Bank's Seventh Report on Card Fraud, February 2022

In determining the level of interchange rates there are multiple factors that Mastercard takes into account. As Mastercard does not receive interchange fee revenue, Mastercard's approach to setting these rates is based upon balancing the interests of all participants in the payments scheme. In particular, given the multi-faceted nature of Mastercard's four party payment system, Mastercard simultaneously looks to promote the issuing of Mastercard products by issuers, their take-up by cardholders, and the acceptance of Mastercard products by acquirers and merchants.

Competition from rival payment providers (be these other four party payment providers such as Visa, increasingly China Union Pay or alternative providers such as three-party cards) can also create a commercial imperative to change rates. To remain competitive and continue to offer benefits of electronic payments to consumers, Mastercard must be able to attract issuing and acquiring banks to the scheme. Interchange fees at the right level allow this by ensuring the costs of issuing and acceptance are properly and fairly balanced in the system. The rates Mastercard offers must be comparable with its competitors, otherwise its cards will simply not be issued.

We note that the PSR have informed you that it has not seen evidence of significant changes in issuer costs for the transactions affected by these rate changes. While issuer costs are not the only factor taken into account in setting interchange rates at Mastercard, it is, however, the case that issuer costs have changed over the years since the rates for these cross border transactions were fixed – going back to 2007 (15 years ago). Cross border transactions have developed significantly over the years and the transaction mix has fundamentally changed with the growth in CNP sales. Different types of transaction have different costs – particularly as regards fraud (which is higher for CNP transactions).

That change in transaction mix and the differences in costs was recognized in the rates agreed with the European Commission in 2019 further to its Mastercard II investigation. Specifically, these rates were set with reference to the so called 'Merchant Indifference Test', a regulatory benchmark that had previously been devised and applied by the European Commission in determining regulatory caps on interchange rates. This approach was intended to take into account the costs to merchants of alternative payment methods and to set the interchange fee at such a level that the average merchant would be indifferent between accepting a card and accepting other means of payment.

As explained below, in the absence of any other regulatory guidance, Mastercard used this benchmark (as well as other factors) to help inform the interchange rates that currently apply between the UK and EU/EEA.

UK issued cards at EEA merchants

For UK-issued cards used at EEA merchants, Mastercard decided to apply the interchange fee rates contained in the commitments given by Mastercard to the European Commission (EC) in 2019 in relation to inter-regional transactions, i.e. transactions on non-EEA issued consumer cards being used at EEA merchants.

The EC commitments contain different interchange rates for card present (CP) and card-not-present (CNP) transactions.

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- The rates for CP transactions are the same as those that applied previously and were informed by the Merchant Indifference Test that considered cash as the alternative payment method for cards.

- In the case of CNP transactions, cash is not an alternative for debit and credit cards and instead, the Merchant Indifference Test considered other alternatives such as bank credit transfer and e-money transfers.

As these rates had been previously accepted by the Commission and the UK was now outside of the EEA, there was no objectively justifiable reason for Mastercard to apply different rates to UK-issued cards compared with any other non-EEA issued cards (for transactions at EEA merchants).

EEA-issued cards at UK merchants

In the absence of any alternative regulatory benchmark which applied specifically to the UK, Mastercard decided also to apply the same rates as those contained in the EC commitments (applying the same Merchant Indifference Test), in relation to transactions made by EEA-issued cards at UK merchants. Again, this reflected the insight that a benchmark based on cash would not be suitable for the growing proportion of these transactions which were card not present, with an awareness of the competitive considerations related to rival payment services for cross border transactions.

Cost of Payments Acceptance

The scale of card fees generally has been overstated in some quarters, and as such we feel it important to put this in context for the Committee.

All payments methods, whether cash, instant account to account payments, Buy Now Pay Later (BNPL), or cards have a cost attached to them – through direct (e.g. network, interchange and other fees), indirect (e.g. mis keying on payment terminals and fraud costs), and back-office costs (e.g. staff costs). These costs reflect the functionality and value that each different payment method provides.

The BCG's recent whitepaper[5] sets out**, that for an average domestic card transaction of £50, the total cost to the merchant of accepting a card payment is just £1.20. By way of contrast, for the same average transaction value of £50[6], it costs merchants significantly more to accept a payment by cash (£1.75p) or by Buy Now Payment Later (£2.05p).**

Of this £1.20 cost of acceptance for an average value domestic £50 card transaction the combined interchange and acquiring fee is 24p[7] (not received by Mastercard) and the scheme fees (received by Mastercard) is just 6p.

[5] 'The hidden cost of cash and the true cost of electronic payment in Europe'; Boston Consulting Group; March 2022

[6] Please note, the BCG whitepaper's findings are in Euros, and converted to £s for the purpose of this letter. There may be small fluctuations in the calculations, based upon changes to exchange rate.

[7] BCG calculates the proportion of interchange and acquiring fees to be approximately equal when measured across a number of European markets – so 12p each for an average domestic card transaction value of £50

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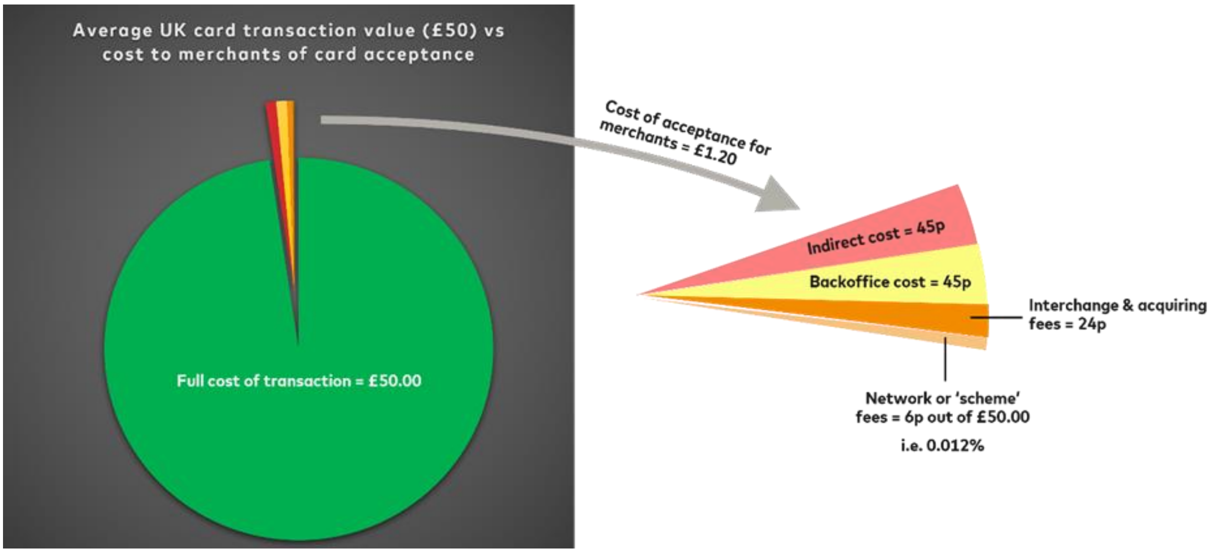
Indirect costs, such as the purchasing and maintaining of payment terminals and the cost of fraud, account for 45p of this £1.20 cost of acceptance for merchants. Back-office costs such as invoice reconciliation, chasing payments and running point of sale terminals also accounts for an additional 45p of this £1.20 cost of acceptance. Mastercard is not responsible for these costs.



Source: 'The Hidden cost of cash and the true cost of electronic payment in Europe'; Boston Consulting Group; March 2022

We believe it is important that the Committee understands this context – that card fees combined are still only a quarter of the broader costs of acceptance for merchants for domestic transactions and the smallest part of the cost of acceptance. For cross border transactions this proportion will increase as cross border interchange rates increase to reflect increased risk but will still be significantly less than the other costs that merchants incur to process card payments.

Value of card payments

Card payments provide a range of important features to issuers and acquirers that, in turn, benefit consumers and merchants - and that are not all available with other forms of payment. These benefits include:

For consumers

- Providing a secure, quick, and easy way to pay for goods and services; and in a range of circumstances, redress from the card issuer should a merchant not be able to fulfil its side of the transaction. Providing fraud protection and constantly monitor for criminal behaviour to ensure our network is secure and reliable.
- Dealing with the vulnerability people feel and protecting against those who seek to exploit chaos and uncertainty is a core function of our ecosystem. For example, we tokenize data to ensure that it remains safe. As such the confidence that consumers have in card payments is one of the main reasons for its widespread usage.

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- Evolving our service_driven by advances in technology and regulation, as well as changing consumer preferences towards more digital first lifestyle. This has led to service enhancements such as chip and pin, contactless payments, and biometric authentication, all of which further enhance the consumer experience.

For merchants/retailers

- As above, card payments guarantee that merchants are paid for purchases regardless of whether the issuing bank is ever repaid for the credit it extends to the consumer; and reduce the risk of in store fraud that is more prevalent with cash usage.

- Even prior to the COVID19 pandemic, merchants' use of card payments had been increasing for a number of years because of the value proposition, including expansion in sales reach (i.e. online); a reduction in fraud compared to other forms of payment; and the guarantee of payment.

- Merchants are increasingly choosing to accept card payments because it is beneficial for their business to do so, not because they feel forced to do so by consumer choice. A recent whitepaper by the Boston Consulting Group (BCG) on the cost of electronic payments found that 81% of surveyed merchants wanted to take more (or the same) turnover through card payments. In addition, 74% of merchants valued the convenience of being able to accept payments at any time whatsoever; 67% valued the protection against fraud; and 67% valued the associated convenience of cards, such as being able to take recurring payments or initiate refunds[8].

Both merchants and consumers benefit from the global reach that card payments enable, opening global markets to UK businesses of all sizes; and conversely affording UK consumers the opportunity to purchase goods and services from across the world securely and conveniently.

For other sectors

- The number of endpoints in card payments — where a consumer can make a purchase, where a business can sign up to take a payment or make a payment, where a government can disburse funds — means there are opportunities for others to grow entire businesses that add value to the payments value chain.
- The most prominent is fintech. Mastercard plays a central role in both the UK and global fintech ecosystems, both as the platform upon which much innovation is built and as a supporter, investor, and champion.
- The card payment rails in the UK and indeed globally work well, they are reliable and secure; and as such are the platform upon which many innovative fintechs base their differentiated proposition for their customers.

For governments

[8] The hidden cost of cash and the true cost of electronic payment in Europe'; Boston Consulting Group; March 2022

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- Card payments are increasingly bringing efficiencies to how governments engage in economic activity with the public and with business, including, for example, through major disbursement programs such as the recent Covid19 economic stimuli packages in Northern Ireland and Jersey; and mass transit solutions in partnership with organisations such as TfL.

- Prepaid cards also provide a convenient and secure way for local and national government to disburse funds to vulnerable and most in need individuals and families, including during the height of the pandemic. They also act as bridge for financially excluded, hard-to-reach, individuals, helping them to realise the benefits of digital payments and build their skills, in addition to cash, without having to open a full bank account.

- Digital card payments-based data insights can also provide Government and other public bodies with timely and targeted information on local economic activity, to help inform policy decisions and measurement of effectiveness based on area. For instance, during the pandemic Mastercard's Geo-insights, which include our Retail Location Insights data tool, helped the Greater London Authority model to assess the impact of Covid-19 restrictions on retail spending across the city, and helped support recovery planning.

I hope this answers your question and provides useful context for the Committee. We would welcome the opportunity to answer any further questions you may have, or to discuss any element of this letter in greater detail with you.

An invitation for the Committee to tour Mastercard's Experience Centre in central London to see first-hand some of the innovation helping to tackle economic crime in the UK, remains open and with the Committee's clerks.

Yours sincerely,

Kelly Devine
President, UK and Ireland
Mastercard