

AMERICAN EXPRESS

COMPETITION IN PAYMENT SYSTEMS

SUBMISSION TO
RESERVE BANK OF AUSTRALIA

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1. Introduction

This submission to the Reserve Bank of Australia (RBA), is in response to the RBA's invitation to American Express to contribute its views during their consultation period. In particular, we would like to comment on the following issues:

- Background on American Express in Australia and the key differences between the American Express system structure and that of its competitors, Visa and MasterCard
- Access to payment systems
- Efficient wholesale pricing
- No Surcharge Regulations

American Express submits that to the extent that competition in the card industry in Australia is impaired, it is because of the anti-competitive exclusionary rules of the dominant card networks. The current setting of interchange fees is only one example of how this lack of competition has impacted the credit card market in Australia. The focus of the RBA would therefore be best directed at eliminating these rules and opening up competition. Regulation focused solely on one outcome of the lack of competition (e.g. the interchange fees) could actually hamper the development of a more competitive market in Australia.

American Express submits that any intervention by the RBA in the area of credit card networks should be:

- directed at specific, anti-competitive features of those dominant networks; and
- consistent with competition regulatory precedents internationally, particularly with the current European Commission and United Kingdom moves in this area.

American Express submits that removal of the no-surcharge rule could potentially create a series of negative outcomes including lack of transparency in pricing for consumers, additional compliance costs that would ultimately be borne by consumers, difficulties in implementation for merchants and problems in regulation and enforcement. American Express submits that there are substantial benefits in leaving the "no surcharge rule" unchanged.

American Express also submits that the RBA should extend its current considerations to look at related point of sale and network technology access issues in the payment system.

2. Structure of American Express Card System in Australia

American Express owns and operates a global credit and charge card services network. In Australia, American Express is the sole merchant acquirer for the network and is the issuer of the vast majority of American Express-branded cards.

American Express began issuing cards in Australia in 1974. Until May 1997, when American Express launched the American Express Credit Card, all American Express-branded cards were charge cards. The American Express Credit Card allows the Cardholder to defer payment of a selected portion of the account balance by paying interest. It is similar to other credit cards in Australia. All American Express Cards are accepted solely on the American Express network. In 1998, AMP began to issue American Express-branded cards under a licensed card issuer agreement and became the first non-American Express issuer on the American Express network in Australia.

Accordingly, in the American Express system, there are two basic kinds of American Express-branded cards: Those issued by American Express and its affiliates (“proprietary cards”), and those issued by third parties under a license from American Express (“non-proprietary cards” or “network cards”).

- a) Proprietary Amex cards are issued by American Express itself (meaning American Express Travel Related Services Company, Inc. of New York and its related bodies corporate around the world). American Express itself acts as both issuer and acquirer. This is the key difference between American Express and the dominant bank card systems.

Within the American Express system there is a spectrum of arrangements for marketing and distributing American Express Cards, ranging from co-brand agreements with major financial institutions (eg Suncorp-Metway, HSBC, Macquarie Bank) to affinity card agreements with major professional associations (CPA), charities (World Wildlife Fund) and sporting clubs (Tennis Australia). All of these cards have the common feature that American Express itself is the issuer of the card and thus the credit provider.

- b) The other category involves Amex branded cards being issued by non-American Express companies under licences called “ Network Card Issuer Agreements”. Currently the only such arrangement that has been launched in Australia is with AMP, which has issued its own American Express branded cards since 1998. The American Express system has the following unique features:

- (i) compensation between American Express and its licensed issuers is a vertical arrangement negotiated bilaterally and at arms length, where both parties have competing interests. This is an absolutely critical distinction from a competition standpoint that is in direct contrast to the interchange systems of Visa and MasterCard, which are operated by collective agreements or arrangements between participating banks and/or the association in question, that is to say agreements/arrangements among horizontal competitors. In Australia, AMP and American Express have agreed on a compensation structure that is linked to the merchant fees American Express individually negotiates with merchants. If merchant fees are reduced over time, the compensation under the issuer agreement is subject to review and adjustment.

- (ii) American Express itself handles the entire merchant acquiring activity in Australia for the American Express Network.
- (iii) American Express has no arbitrary rules about who can and cannot become an issuer. We do carry out checks to satisfy ourselves that a proposed issuer
 - has sufficient standing and resources to meet its expected obligations for charges incurred on cards it will issue; and
 - is an acceptable partner to associate with the American Express brand,

but this is an exercise in risk management and brand protection. American Express has neither mandatory nor excluded categories for its issuer-licensees and is in principle prepared to talk to any interested party who can meet the broad criteria referred to. For example, Sony is an issuer on the American Express network in Brazil. . Risk management and brand protection aside, access to being an issuer is open within the American Express scheme.

3. Market Position of American Express in Australia

American Express is a niche player in the Australian payment systems market. The Joint Study cites research from Roy Morgan that estimates American Express' market share at 5% (combining both credit and charge portfolios)¹. It will be apparent from the data to which the RBA will presumably have access in the course of its inquiries, American Express does not have the ability to act without regard for its competitors.

4. Designation of Payment Systems

The RBA indicated in its media release of 12th April 2001 on "Designation of Credit Card Schemes in Australia" that it "sees no case on public interest grounds to designate the three party card schemes to deal with issues relating to collective fee setting and access restrictions."

The RBA/ACCC report did not find that American Express had been acting improperly, or even that there was a structural opportunity within three party systems generally for the anti-competitive behaviour observed within the four-party systems. In fact, the Joint Study has expressly excluded American Express from its conclusions and concern about interchange fees, recognising that American Express acts alone and has no interchange fees

Despite the protestations of some competitors, American Express maintains that there are no features of its system which merit the same treatment as the Visa/MasterCard network, from which it has been rigorously excluded and against which it has competed unremittingly but fairly for the last twenty years or so.

¹ RBA Joint study, Table 2.3, p.15

It is to be noted that the European Commission has already intervened against Visa International's attempts to use its market power to impose unfair or anti-competitive restrictions on its member banks. In 1996, the Commission intervened pursuant to a complaint by American Express (supported by a separate filing by the owner of the Discover network) and required Visa International to drop a proposal that would have barred its member banks from issuing competing cards other than MasterCard cards.

5. Access To Payment Systems

As was noted in the Joint Study, a small group of major banks dominate the Australian merchant acquiring market. Likewise, the same group issues the overwhelming majority of credit cards in Australia. Membership of the major payment systems networks is, with very limited exceptions, restricted to regulated deposit takers or financial institutions.

Furthermore, merchant acquirers are often required to issue cards through one of the pre-existing payment networks before they are permitted to acquire transactions. Finally, in order to join a network and acquire transactions, the permission of pre-existing members is often required i.e. to compete in this area at all, you have to be "voted in" by your competitors.

American Express believes that the fact that access is restricted and market share is concentrated in the hands of a few major players means that the merchant acquiring market suffers from a lack of competition. Because the current rules applied by Visa and Mastercard effectively limit access to the merchant acquiring sector of the market to regulated banks, there is only a small number of companies able to carry out this activity. This restricted access to potential competitors means the incumbent operators face little competitive pressure.

In relation to the merchant acquiring market, American Express submits that any regulation dealing with non-discriminatory access should be aimed at requiring participants to provide access on fair, reasonable and non-discriminatory terms where failure to provide access would have a material effect on competition.

6. Efficient Wholesale Pricing of Interchange Fees

American Express believes that there are in principle pro-competitive benefits of interchange fees paid to card issuers. Interchange fees facilitate competition between networks by providing an incentive for new entrants or other operators to compete on price in order to attract further issuing business. Interchange fees provide an incentive to banks to participate in a payment system and the greater number of banks participating the

greater the critical mass achieved by the card payment system in question.² This in turn gives rise to scale efficiencies through increased card uptake and therefore greater utility and value to merchants (retailers). At the same time, the possibility of new entrants or the expansion of existing competing operations poses a competitive constraint on the level of wholesale or interchange fees.³ American Express agrees with the Joint Study conclusion that competitive pressures in the card payment networks in Australia have not been sufficiently strong to bring interchange fees into line with costs.

For the purposes of the current consultation and any initiatives that may be taken pursuant to it with respect to pricing, it is important to bear in mind that all card systems must cover their operating costs. For the system to operate in a sustainable fashion funds must pass from acquirers to issuers to compensate issuers for the costs incurred to issue cards which are not covered by the cardholder fee. In all cases, a method of pricing at wholesale level needs to be operated in order to cover the costs of such networks and generate a reasonable return on capital employed.

American Express suggests that the relevant measure of costs to be taken into account in any assessment of prices charged in the payment systems, is not the marginal or specific costs associated with the individual transaction in question, but rather the average total costs of the relevant payment systems network. The actual method employed to calculate the price levels chosen by the network is not relevant as long as there is adequate actual or potential competition in the system, and/or the network in question does not have significant market power.

In theory, given all the factors that determine efficient prices, it is very difficult, if not impossible, to assess the efficiency or anti-competitiveness of observed prices in practice. In the current situation, American Express submits that it is impossible for authorities to properly assess the operation of wholesale price systems, including interchange fees, whilst the market is distorted by the anti-competitive behaviour of leading players in the market, particularly in access to the payments system. Rather, the focus should be on existing barriers to competition – the underlying causes for the problems that are showing up as pricing issues.

Any regulation of markets should aim at ensuring the most efficient level and structure of prices is set. In general, the form of regulation is critical: addressing symptoms (e.g. price regulation) is usually inefficient and typically produces perverse results over time; regulation targeting the causes (e.g. market access) is preferable. Regulated prices are rarely as efficient as those set by firms open to competitive pressure and free to adjust to market circumstances.

Given that networks use interchange fees to compete for the business of card issuers, direct cost regulation could potentially have the effect of reducing the likelihood of

² Interchange fees play a critical role at the first stage of building the network until it reaches critical mass. New networks can develop more rapidly if they offer card issuers a high interchange fee in return for issuing cards on the network, and thereby increase competition between networks.

³ The UK Office of Fair Trading (“OFT”) has previously concluded that high prices can only constitute a competition problem (in particular, an abuse of dominant position) if they are persistently high without stimulating new entry or innovation. High prices will not necessarily be anti-competitive if they encourage increased output or entry to a market, or be objectively justified for other reasons, for example in relation to the relevant cost of capital utilised in the business in question: OFT Guidelines: “The Chapter II Prohibition”, OFT 402, March 1999, paragraph 4.9.

competition between networks. Any regulation needs to give participants the freedom to set prices, while discouraging both the abuse of market power and excessively high prices.

Should a decision be taken by the RBA to consider price-focussed regulation, there may be adverse market impacts. Although price-focussed regulatory intervention may bring about a reduction of interchange fees payable by merchant acquirers to card issuers, it may be expected that other transaction costs will rise to cover this deficit. For example, if a card issuer receives a reduced interchange fee from the acquirer, it may make up the short-fall by increasing the annual charge paid by consumers, or it may reduce the value of the benefits they receive or impose other fees on merchants. At the same time, it is doubtful whether lower interchange fees to card issuers will be passed on to retailers (in the form of reduced discounts/premiums) or by retailers in turn to consumers. Of course, it is possible for the RBA to extend price-focussed regulation into and even beyond these areas, until it is satisfied with the entire price arrangements of the card industry.

American Express submits that the RBA should promote increased competition arising from the removal of unjustifiable access restrictions rather than price-focussed regulation to drive any reduction or rationalisation in interchange fees.

7. No Surcharge Regulations

American Express will of course comply with any statutory regime which may be introduced on the subject of merchant surcharging, but wishes to highlight some aspects of the matter which may not have received adequate consideration to date.

Permitting merchant surcharging has been identified in the Joint Study and subsequent public discussion as one possible solution for a perceived pricing anomaly, according to which merchants and consumers who pay by other means unfairly “subsidise” the costs of the credit card system. By permitting surcharging, it is suggested, those costs will be allocated to the beneficiaries of the system, namely the card-users.

The “subsidisation” claim is based on the untested proposition that there is no merchant discounting off list prices for the use of cash, or other payment mechanisms, or that merchants and their customers do not negotiate other terms of trade to compensate for cash payment off the list price. The validity of this proposition should be tested – advertising material suggests that the practice may be widespread. In addition, implicit in this argument is the notion that merchants bear only costs and derive no economic benefit from accepting credit cards. It also assumes merchants incur no costs from other forms of payment. In fact, merchants do benefit from card acceptance in the following ways:

- a) Costs and risks of handling cash are reduced. Cash is expensive to handle and provides opportunities for theft and fraud.
- b) Bad debt risks of accepting cheques are eliminated.
- c) Merchants are able to receive settlement through efficient and speedy electronic payment. The overwhelming majority of these transactions are guaranteed payment.
- d) Customers are able to purchase items at their convenience and with less need to plan “how they intend to pay”, thus increasing sales.
- e) It is safer for consumers to use cards than to carry around large amounts of cash

- f) Holders of certain brands of card may spend more money thus bringing incremental business to merchants. This is especially true with customers from overseas. Overseas customers are unlikely to have EFTPOS cards or cheques that can be used in Australia and are thus heavily reliant on credit cards for purchases of more than nominal amounts.

American Express submits that permitting surcharging amounts to an arbitrary decision by regulators that merchants should have to pay none of the costs of the credit card system and that cardholders should pay all of those costs. Even if, which we do not necessarily accept, the present situation were anomalous, there is no justification for exempting one category of system user (who is also a beneficiary) from bearing a share of the system costs.

Without strong control on its implementation, surcharging could be a source of a one-off increase in prices and a potential source of major confusion for the consumer. As an alternative, consideration may be given to permitting retailers to offer a discount for cash or EFTPOS, rather than permitting surcharging.

If surcharging were to be permitted, would this be accompanied by:

- a) protection against excessive charging? Would it be acceptable, for example, that a merchant who pays card service fees ranging from 1.5-3%, surcharges customers who present credit cards by 5%? Also, different networks charge fees in different ways. Some networks e.g. American Express charge a single merchant fee, while others charge the merchant fee, plus additional fees for stationery, etc. How would a regulator deal with the differing pricing to arrive at the agreed amount for surcharging?
- b) protection against price opacity? If surcharging is permitted, would merchants should be required to display prominently the amounts of surcharges in advertising and business premises? If not, how will customers know what prices to expect? Any surcharges should be displayed together with other prices of displayed or advertised goods/services, or at the point of sale or at the entrance to premises?

If surcharging were to be limited to the amount paid by the merchant to the merchant-acquirer (on the face of it, a reasonable restriction), would minimum fees, terminal fees and other fees not directly related to ad valorem transaction values, be allowed to be factored into the permitted surcharge?

If surcharging is to be subject to rules prescribing permitted maxima and price transparency, the acquirer should be able to terminate the card acceptance facilities of any merchant who:

- does not comply with the rules; or
- surcharges in a manner which discriminates against the holders of a particular card

Similarly, card issuers and/or merchant acquirers should be permitted to offer incentives or differential pricing to merchants who do not surcharge. The rationale for this is to permit merchant acquirers and merchants to compete on the basis of customer service and the attraction of offering “no surcharge” to cardholders.

On 16 October 2000, the European Commission issued a preliminary decision (see attached) on the Visa International payment system. It has considered, inter alia, two aspects of that system, interchange fees and merchant surcharging. The EC preliminarily concluded that provisions in merchant agreements which prohibit surcharging or discrimination are in fact compatible with EU law. The Commission originally objected to this rule, but the experience of Sweden and The Netherlands - where its abolition has not had a notable effect – led it to accept it. A final decision, which will be published in the EC Official Journal, is expected in the next few months.

The Commission regards this case against Visa International as "setting the pace for the resolution" of the other payment card schemes cases it is currently examining and which raise "similar issues".

As an important reference point, it is relevant to note that many of the issues above were addressed in the UK when it introduced regulations in 1990 which in effect permitted merchant surcharging in accordance with strict controls to ensure consumer transparency. In reality the experience has been that the practice of surcharging never become established or widespread. The competition authorities in the UK also imposed a limit on surcharges by permitting merchant acquirers to prohibit surcharging of an amount exceeding the actual merchant service fee.

Meanwhile, the French competition authorities have authorised the "no surcharge" regulations on the grounds that to prohibit it would inhibit the take-up of payment cards and avoidance of high costs of cheque processing. The Consumer Affairs department of the European Commission (DG XXIV) has been supportive of permitting the continuance of "no surcharge" regulations as it is concerned about the consumer impact of surcharging. In the U.S., consumer advocates lobbied the Congress to reinstate a federal law banning surcharging when it expired in 1984 .As a result, several states (including New York) have legislatively banned surcharging in their jurisdictions.

American Express is concerned that any abolition of no surcharging rules could cause the following effects:

- It has potential one-off inflationary effects.
- Merchants could abuse the abolition of the rules by imposing surcharges that are excessive.
- Merchants should not be able to surcharge more than their actual costs. Monitoring and enforcement of this needs to be considered.
- Consumer confusion and dissatisfaction is inherent in the prospect of having multiple prices for products and services which would only become apparent when the method of payment is produced.
- The abolition of the no surcharging rules would expose the consumer to higher costs due to costs of compliance with rules relating to surcharges.
- Its potential chilling effect on merchant sales generally
- Cash is an expensive and unsafe means of payment and is increasingly difficult for merchants to handle as bank branches close. The Commonwealth Bank, the ANZ Bank, Westpac and the National Australia Bank all charge merchants for handling cash, up to 0.25% for deposits depending on the amount and the time taken in counting.
- The potential to drive growth in the use of debit cards, which are even less competitive than credit cards with fewer players able to access the market. Non-banks cannot participate.

American Express submits that the Reserve Bank should not prohibit the “no surcharging rules” because of the market and competition consequences of doing so.

8. Network Technology Issues

Within the payments system, Point of Sales (POS) terminals are an essential facility. This takes into account the fact that the majority of merchants and retailers simply do not have space in their shop or outlet for more than one such POS terminal and simply will not accept cards that do not work on their existing POS terminal. It is therefore unreasonably difficult to have more than one terminal on the counter in a significant proportion of retail outlets.

Currently, tactics are being used specifically with regard to:

- access to and certification of POS systems, including unreasonable delays
- non-reciprocal pricing within POS systems

which might be considered an abuse of market power.

Additionally, organisations such as American Express and other non-authorized deposit taking institutions are excluded from membership of Bpay, and are therefore precluded from offering the full range of payment services enjoyed by Bpay members. While we accept the need for strong prudential standards to be maintained, this is another area in which a limited access regime is thwarting competition.

American Express believes that it should be a priority of any new regulatory initiative in relation to payment systems, to open up the dominant POS terminal and electronic payment networks to suitably qualified and experienced parties. New entrants would increase competition to offer innovative new (or improved) products and services.

American Express submits that the Reserve Bank should ensure that any regulation aimed at increasing access to the payment system or curbing anti-competitive behaviour should apply to access to the technology of the payment system and existing electronic payment systems as well.

9. Conclusions and Recommendations

The Joint Study concluded that “competitive pressures in card payment networks in Australia have not been sufficiently strong to bring interchange fees into line with costs.”⁴ This conclusion recognises that at the heart of this issue lies a classic anti-trust or trade practices problem. A cartel of four large institutions together with the international card networks Visa and Mastercard have combined to restrict competition in two ways:

- a) jointly setting interchange fees.
- b) unreasonably restricting access to membership of their networks by

⁴ Joint Study, p iv.

- (i) requiring card issuers to have ADI status; and
- (ii) stipulating that to be a merchant acquirer, an institution must also be a card issuer.

It follows that the current level of interchange fees is a symptom rather than the cause of this situation.

American Express does not favour treating the symptoms before the root cause of the illness. We consider that this situation has been brought about by anti-competitive behaviour in which American Express has played no part. Restraining this behaviour by an appropriate access regime will allow the refreshing wind of competitive market economics to clear the air from this particular smoke-filled room.

Commission plans to clear certain Visa provisions, challenge others

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Commission plans to clear certain Visa provisions, challenge others

The European Commission intends to take a favourable position with regard to certain provisions in the Visa International payment card scheme, in particular the so-called "no-discrimination" rule. This will be the first Commission antitrust decision in the field of international credit cards. At the same time, the Commission has sent a Statement of Objections to Visa International in relation to its interchange fee, on the grounds that this fee is a restrictive collective price agreement.

After a thorough investigation, the Commission believes that it can take a favourable view with regard to certain provisions in the Visa International payment card scheme, which has been notified for formal clearance. One of these provisions is the so-called no-discrimination rule, a rule which prohibits merchants from charging customers an additional fee for paying with a Visa card. The Commission will publish shortly a notice in the Official Journal of the European Union, inviting interested third parties to submit their observations within a month, before reaching a final conclusion.

Although it had originally objected to this rule, the Commission has now concluded that its abolition would not substantially increase competition. This conclusion has been reached in the light of the results of market surveys carried out in Sweden and in the Netherlands, where the no-discrimination rule has been abolished following the intervention of national competition authorities.

Moreover, the Commission intends to take a favourable position on the modified Visa rules on cross border services. Initially, the Visa rules did not allow its member banks to issue cards to cardholders abroad or to sign up merchants in other Member States, or allowed this only to a limited extent. However, Visa International has now significantly increased the possibilities for cross-border issuing and acquiring of Visa cards. Following the latest modification in May of this year, Visa International allows for cross-border issuing and acquiring, without the prior establishment of a branch or subsidiary in the country concerned.

A formal Commission decision on these issues is planned before the end of the year.

The Commission, however, doubts whether another controversial Visa provision, namely the interchange fee, is acceptable under EC competition law. The interchange fee is paid by the bank of the merchant to the bank of the cardholder for each card transaction. The amount of this fee is set by Visa International and amounts to an agreement between the member banks of Visa. In practice the banks which have to pay the interchange fee pass it on to their clients, the merchants. On average the interchange fee is about 80% of the overall amount paid by the merchant to his bank each time he accepts payment by a Visa card.

Eurocommerce, a trade association representing European retailers, formally complained to the Commission about the Visa rules on interchange fees as well as those of other payment card systems.

In the Statement of Objections which has now been sent to Visa International, the Commission states that the interchange fee for international operations amounts to a collective price agreement, which is restrictive of competition. In the Commission's view, Visa International has not so far put forward any convincing reasons showing that the interchange fee fulfils the cumulative conditions for an exemption under the EC antitrust rules, such as that it would be indispensable for the functioning of the Visa payment card scheme. As has also been pointed out by Eurocommerce, other payment card schemes, such as ec-Karte in Germany, may function without interchange fees.

The Statement of Objections is a preliminary step in the proceedings and does not prejudice the final outcome of the investigation. It invites Visa to submit its written observations and Visa may also ask for an oral hearing. The Commission hopes to reach a final decision on the interchange fee in the first half of 2001.

The Commission has several other pending cases relating to payment card systems which raise similar issues. The envisaged Commission decisions in the Visa International case are, therefore, important in setting the pace for the resolution of the other cases.

"Consumers must be free to use cards to pay for their purchases. But merchants ought not to be de facto forced by the card companies and the banks to foot the bill for transactions made with cards, which of course carry a cost. The Commission has in this regard in particular doubts that the interbank commission set by Visa for each card transaction, which is in practice passed on to merchants, is necessary and has invited Visa to comment," European Competition Commissioner Mario Monti said.

Additional information

The European Commission's Visa case is different and separate from a pending case at the Department of Justice of the United States against Visa and MasterCard International, which focuses on the fact that Visa and MasterCard are owned by the same banks and on rules preventing the member banks from issuing rival cards such as Discovery and American Express - so-called exclusivity. The European board of Visa considered introducing a similar exclusivity rule in the Europe in the mid 90s, but withdrew the plan after the Commissioner for Competition at the time had warned publicly that Visa's proposal could not be accepted. (see IP/96/585)