

# The Impact of the RBA's Credit Card Reforms

A Submission to  
The House of Representatives'  
Standing Committee on Economics, Finance  
and Public Administration

American Express Australia Limited  
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## **1. Preface**

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**Purpose of this Submission.** American Express Australia Limited (AEAL) has prepared this Submission to

- provide the Standing Committee on Economics, Finance and Public Administration of the House of Representatives with information about the impact of the 2003 credit card reform of the Reserve Bank of Australia; and
- address specific issues which may be expected to arise in the course of the Committee’s public hearing on 15-16 May 2006.

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### 3. Executive Summary

- 3.1 From the inception of the debate over credit card reforms in Australia, American Express has maintained that the dominant four party schemes presented a classic trade practices or antitrust problem. The RBA's interchange regulation initiative was an attempt to treat the symptoms rather than the illness. Nurturing competition would have been- and still is- the best way to attract new market entrants and ensure that prices align with costs.
- 3.2 The RBA correctly predicted the consequences of not including the three party schemes - American Express and Diners Club- in the interchange regime. The market share and pricing data published by the RBA indicates that a short term temporary movement in favour of the three party schemes has now peaked and is in the process of normalizing.
- 3.3 The RBA has applied a consistent *regulatory policy* to American Express with the intention- and actual effect - of driving its merchant pricing down. The Merchant Pricing Standard, with which American Express complies, has had a greater impact on American Express than on the dominant schemes because American Express' premium merchant pricing make it a more obvious target for merchants to surcharge. The RBA has singled out American Express for a unique level of attention and public comment intended to produce particular market outcomes.
- 3.4 The myth persists that American Express has obtained some unfair advantage from the credit card reforms, whereas in reality its business remains subject to intense competitive and regulatory pressure. The reforms are a headwind, not a tailwind for American Express. In reality the dominant schemes have obtained an advantage from many years of operating unlawful interchange agreements, which is the basis on which they have built and maintained their huge market shares and the reason why they are now subject to regulatory interventions in so many countries, including Australia.
- 3.5 The reforms have not benefited consumers. They have benefited large merchants and hardly affected the banks.

## **4. Why American Express was not designated**

- 4.1 In this section, we will review the RBA’s reasons for excluding American Express from the interchange regime and consider whether their reasoning was justified.
- 4.2 After investigating interchange fees in the dominant card schemes since 1998, the Australian Competition & Consumer Commission (ACCC) concluded that these fees were an unlawful price-fixing arrangement in breach of Section 45A of the Trade Practices Act and commenced proceedings against a bank in September 2000.
- 4.3 In the period 2000-2001, the ACCC was unable to reach agreement with the dominant schemes and their members for the submission of their interchange fees to the authorization process for unlawful anti-competitive agreements. In due course, the problem was referred to the RBA for resolution under the Payment Systems (Regulation) Act 1998.
- 4.4 American Express has neither collectively determined interchange fees nor operated discriminatory scheme membership restrictions, and for these reasons was not included in the proposed regulatory regime for either of these areas. This is borne out by repeated published statements of the RBA before and after the reforms, which are set out in the Appendix to this Submission for ease of reference.
- 4.5 The American Express business model is fundamentally quite different to that of the dominant schemes and is not based on collectively determined interchange fees. As such regulation was not and is not required. Here is a table which summarises the key differences:

**Comparative table of scheme features**

<b>Scheme Feature</b>	<b>Visa/MasterCard</b>	<b>American Express</b>
<b>Historic development</b>	Developed as a franchise/ association of banks	Developed as a proprietary monoline. Network Partner licensing strategy began in 1996
<b>Distribution</b>	Mass	Selective
<b>MSF Rate</b>	Lower commodity based	Premium based
<b>Target Segment</b>	Revolve	High-spending transactors
<b>Merchant Value</b>	Utility	High value
<b>Merchant Service Fee Determinant</b>	Interchange sets base for MSF	MSF driven by value of AXP card acceptance to merchant

**Comparative table of scheme features, continued**

<b>Scheme Feature</b>	<b>Visa/MasterCard</b>	<b>American Express</b>
<b>Interchange</b>	Set by anti-competitive collective agreements	Non-interchange payments are set by bilateral arms length negotiations
<b>Role in issuing/acquiring</b>	Scheme neither issues nor acquires	American Express has both issuing and acquiring businesses.

- 4.6 American Express has a value based pricing model. This means the price a merchant pays is based on a number of factors including: the type of business volume we are likely to bring to a merchant; the type of merchant and the competitive environment. The critical component of the value American Express provides to merchants is an affluent and high spending cardmember base – American Express is not a commodity player - it is a premium player with an affluent clientele. These are the very customers that merchants want to attract.
- 4.7 American Express has historically concentrated on higher value merchants in the travel and entertainment sectors, such as hotels, travel, restaurants and luxury retail. A feature of these merchants has typically been that they provide goods or services in categories of discretionary spending. This means, inter alia, that American Express has been able to demonstrate high value to such merchants by actively bringing them together with cardmember-customers who might not otherwise have chosen to do business with them, and, in consequence, to command a premium Merchant Service Fee (MSF) for such added value.
- 4.8 To the extent that such industries comprise a larger part of American Express acquirer volumes than in the dominant schemes, it follows that our overall average MSF will necessarily be higher because of this fundamental difference in merchant coverage. For the last few years, American Express has pursued a global strategy of extending the acceptance of its cards by merchants providing goods and services in the utilities and everyday spend categories. To secure card acceptance in these industries, our MSF premium may be either significantly reduced or eliminated so as to be comparable with the dominant schemes. As these types of merchants grow to comprise a larger part of American Express’ merchant base and business volumes, this change will tend to further depress its average MSF.
- 4.9 These differences in scheme business models are the fundamental reason why the Merchant Service Fees (MSF) of American Express are higher than those of the dominant scheme acquirers. Despite broadening its merchant coverage into everyday spend sectors, American Express still relies on a core business of corporate travel and entertainment spending which substantially exceeds that of the dominant schemes. For example, a premium is readily justifiable in this sector due to the demonstrably higher spending of American Express Corporate Cardmembers.

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- 4.10 American Express is not a commodity player and is committed to provide products which reinforce the American Express business model. It creates, and works with its partners to create, differentiated premium products. This selective network and segmented product strategy makes any significant additional market share gain in either issuing or acquiring in Australia in the foreseeable future rather unlikely.
- 4.11 Unlike the dominant card schemes, American Express has only arms length bilateral agreements with its two network partners in Australia and has never been party to any collective pricing arrangements with organisations with which it is supposed to be competing. American Express merchant contracts are also bilaterally agreed and subject to negotiation and the play of competitive pressures.
- 4.12 To regulate the interchange fees of the dominant schemes, the RBA intervened in an anti-competitive arrangement which the ACCC had previously identified as illegal price-fixing. The consequences of this are explored further in Section 7 below. It has never been suggested that American Express has engaged in such practices. Unlawful conduct by the dominant schemes is the genesis of this entire regulatory intervention, both in Australia and other countries, a factor which should not be forgotten in the debate about costs, benefits, winners and losers from this exercise.
- 4.13 American Express continues to have comparatively small shares of the credit card issuing and acquiring markets in Australia and is therefore very much subject to competitive and market forces. As we shall see in Section 5 below, this is exactly what is occurring.
- 4.14 Regulating the fees American Express pays to its bank partners would not influence American Express' merchant fees and would also entail re-opening the interchange fee regime of the dominant schemes to include the totality of payments to dominant scheme issuers.

## **5. American Express' market share and merchant pricing**

- 5.1 American Express continues to have comparatively small shares of the credit card issuing and acquiring markets in Australia and is very much subject to intensely competitive market forces in the Australian credit card industry. This is apparent in the accelerated decrease of its merchant pricing which began before the RBA's interchange reforms and has been sustained over the last three years.
- 5.2 The implementation of the Interchange Standard in October 2003 was a "big bang" for the dominant designated card schemes, and caused an immediate one-time reduction in their interchange fees. This is because those schemes were legally required to align their interchange pricing with the Standard's requirements from the prescribed date.
- 5.3 The impact of the Interchange Standard on American Express is indirect, not direct. American Express is not legally required to comply with the Interchange Standard, but it is expected to reduce its merchant pricing in response to competitive pressure from merchants who were benefiting from windfall price reductions from the implementation of the Interchange Standard by the dominant schemes. Section 6 below explains how the Reserve Bank has ensured the realisation of this expectation by means of its regulatory policy towards American Express.
- 5.4 In fact merchant pressure on American Express made itself felt well before the interchange reform came into effect in October 2003. During the RBA review period in 2001-2, as the likely impact of the reforms became apparent, American Express experienced mounting merchant pressure for lower pricing. In addition, the announcement of our formal undertaking to comply with the Merchant Pricing Standard in August 2002 rendered American Express susceptible to the threat of surcharge.
- 5.5 In 2002 American Express' average merchant service fee (MSF) was 2.57%. Since then, this has declined to 2.26% for the quarter ending March 2006, a reduction of 0.31% and American Express is currently forecasting a further reduction by the end of 2006. This represents a reluctant but realistic response by American Express to competitive pricing pressure.
- 5.6 Market shares of credit card schemes tell a similar story. These are published in the RBA's monthly C02 Table on a consolidated basis for the dominant schemes and the three party schemes (American Express and Diners Club). When the interchange Standard came in to effect in October 2003, the dominant schemes had 85.7% of the acquiring market (calculated on the value of transactions) and the three party schemes had 14.3%. One year later the share of the three party schemes had increased to a high water mark of 17.2%, but since then has dropped back to around 16%.
- 5.7 These numbers indicate that the three party schemes experienced a temporary boost of their market share. However, this was not caused by the interchange reforms. It has much more to do with the deliberate business and product strategies adopted by the banks in order to maintain their profitability. These strategies were tantamount to a seismic shift in card industry pricing from merchants to consumers: they took the form of significant increases in card fees and related charges to consumers combined with

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the reduction in value of cardholder rewards programs. On this basis it is not surprising if bank products became less attractive.

- 5.8 The fact that these figures are in the process of settling back towards pre-reform levels is evidence of the transient nature of any “advantage” and the effect of sustained competitive pressure on American Express driven by (i) price reductions in the dominant schemes and (ii) the effects of merchant surcharging or the threat of surcharging.
- 5.9 In summary, even though American Express is not directly subject to the RBA’s Interchange Standard, the credit card reforms have already had – and continue to have – a significant measurable negative impact on its business, not only in terms of price reductions, but also through surcharging and non-acceptance by Australian merchants.

## 6. How the RBA regulates American Express' pricing

- 6.1 The RBA already regulates American Express, both formally through the Merchant Pricing Standard and by applying a consistent regulatory policy intended to drive down American Express' merchant service fees.
- 6.2 On 21 August 2002, American Express provided the RBA with an undertaking in the same terms as the RBA's Merchant Pricing Standard. This placed American Express on the same regulatory footing as the dominant schemes as regards merchant pricing.
- 6.3 Consistently with this undertaking, American Express revised the terms and conditions of its merchant agreements in Australia with effect from 1 January 2003 to remove the condition which prevented merchants from surcharging.
- 6.4 More recently, American Express has removed the anti-suppression language from its merchant agreements in Australia at the insistence of the RBA. By "suppression" is meant the practice of displaying a sign that states "American Express Cards Welcome" but asking the cardholder to use another form of payment when the American Express card is presented. Out of concern to protect its brand and reputation, American Express has always preferred merchants not to accept its card at all than to pose as a merchant and then suppress the card.
- 6.5 American Express has borne the cost of communicating these changes to its merchants.
- 6.6 The intentions of the RBA towards American Express, if not already apparent, have been clearly articulated by the Governor in his August 2005 session with the Committee:

*"I might leave it at that point other than to say that it is not as though we have done nothing to American Express and Diners. We have got them to agree to at least three changes: they now publish what their merchant service fees are; they have agreed to allow merchants to charge – in other words, to pass on – the fee if the merchant so chooses; and they have also altered their agreement so that if you come in with the charge card which is expensive, the merchant can say, 'I would much prefer it if you paid with the credit card,' which is half the price. That used to be ruled out in the Amex agreements. That is now permissible. So a merchant can either charge you for it or he can say, 'Please use another card.' That was not possible before. **The whole point of the exercise is to empower the merchants – give them some bargaining chips to use against both the credit card providers and the charge card providers.**"*

- 6.7 In a RBA Bulletin Article in July 2004, the RBA<sup>1</sup> discussed movements in merchant service fees since the 2003 merchant pricing and interchange card reforms came into effect. It was established that fees of three party schemes had not fallen as far as those

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<sup>1</sup> Quotation from RBA's Bulletin of July 2004, Article entitled *Merchant Service Fees for Credit Cards*. Text is available on RBA's web site. Bulletin Articles do not normally carry the individual authors' names, consistent with the principle that the Bulletin reflects viewpoints of the RBA itself.

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of the regulated dominant schemes.<sup>2</sup> In the article, the RBA took the opportunity to remind merchants what was expected of them-

*“.....a further decline in these (eg three party) merchant service fees should be expected. The competitive forces that are important in delivering this outcome are likely to work more quickly **the more prepared are merchants to decline acceptance of these cards based on their high cost or to charge customers directly for this cost.**”*

6.8 The RBA’s Deputy Governor took up the same theme in a speech in March 2005<sup>3</sup>

*“.....we had been concerned about restrictions imposed by American Express and Diners Club that prevented merchants from steering the cardholder to another form of payment. As I discussed at the outset, such restrictions on behaviour typically do not promote efficiency. Both American Express and Diners Club have agreed to remove the relevant clauses from their standard merchant service agreements. Merchants will now have the option of asking a customer who offers a Diners Club or American Express card whether they would be happy to pay with another card that has a lower cost to the merchant.*

*For many merchants this may be preferable to (sur)charging or not taking American Express and Diners Club cards at all. The overall market will work better if merchants use this option where they feel that other cards are offering them better value for money. **Just as we have said that we would like to see merchants charge for credit card use where they see it as in their interest, so too would we like to see merchants steering customers to cards that offer them better value for money.**”*

6.9 In his evidence to the Committee in August 2005, the RBA Governor paid American Express a somewhat backhanded compliment:

*“Essentially, the merchants somehow or other have to get together and use some bargaining power. In a negotiation between, say, Amex and a merchant, everyone in Amex has spent every day of their lives becoming an expert and a specialist in payment systems. They negotiate with the merchant. The merchant knows how to buy and sell things and inventory control. He knows almost nothing about payments. It is an incredibly unequal bargain.”*

6.10. Warming to his theme, the Governor continues:

*“The biggest single reform was to hand back to the merchants the power to adopt the user-pays principle which they had had denied to them for 30 years. It has been handed back to them. But the problem is that many of them have never made the adjustment, because all their working life they assumed that they were powerless when they were dealing with the banks and the charge card companies. We are trying to empower them. I am saying publicly, **‘You are doing a public good if you are a merchant and you charge someone for using an expensive payment mechanism. You are helping the community. You should be congratulated.’**”*

6.11 In its Bulletin of August 2005, the RBA returns to the subject of merchant pricing<sup>4</sup>, with the author’s message unchanged:

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<sup>2</sup> This was hardly surprising, as the regulated schemes had been required to recalculate and reprice their fees in a “big bang” effect from 1 October 2003, whereas it has been assumed that the three party scheme fees would be adjusted over time by competitive pressure.

<sup>3</sup> Speech by Dr. Philip Lowe, Deputy Governor, RBA, to Visa International Australia and New Zealand Member Forum at Werribee on 2 March 2005. Text is available on the RBA’s website.

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*“The removal of these restrictive clauses, together with the earlier removal of the clauses preventing surcharging, has given merchants a greater range of options than was the case a few years ago. **To the extent that merchants are prepared to use these options, the Bank expects that the average merchant service fees of American Express and Diners Club will continue to fall.** In addition, the publication of average merchant service fees in the Bulletin should help to encourage competition in the card-acquiring market, as merchants will better be able to compare average merchant service fees both across schemes and with their own negotiated rate.”*

6.12 The important RBA press release of 24 February 2005 was consistent on the point:

*“In the Bankcard, MasterCard and Visa schemes, the interchange fee paid by the merchant's bank to the cardholder's bank has an important influence on the charge levied on the merchant by its bank. In contrast, in the American Express and Diners Club arrangements, the causation runs the other way. Merchant charges are determined largely independently of the payment to the partner banks: instead, the fees that merchants pay influence the size of the payments to the banks. Given this, regulating the payments that flow between American Express and Diners Club and their partners would be likely to have little effect on merchants' costs of accepting the cards. This is in contrast to the credit card schemes, where merchant service fees fell quickly following the reforms to interchange fees.”*

6.13 And once more, in his 17 February 2006 session with the Committee, the Governor returns to the same point:

*“As you know, we are in favour of merchants being able to pass the banking fees on to the person who uses the credit card. **We are strongly in favour of it. We think they are acting in the national interest when they do that.**”*

6.14 Dr. Lowe to the Payments System Conference 2006 at the Melbourne Business School on 14 March 2006 states the RBA's expectations yet again:

*“We expect that competition will lead to a further decline in American Express's average merchant service fee, and in time, this will be reflected in the structure of the products that are offered. **If this were not to happen, and the beneficial effects of the reforms were to be eroded materially, we would need to look again at whether other options were in the public interest.**”*

6.15 After predicting that the interchange reforms in the dominant card schemes would cause downward pressure on American Express' merchant pricing, the RBA has not left it to chance as to whether this in fact occurred. The RBA has effectively “managed” and actively encouraged merchant action specifically directed at American Express by:

- Repeatedly announcing their intention to bring about a reduction in American Express' merchant service fees.
- Providing merchants with the competitive weaponry to negotiate lower fees from American Express in the form of: surcharge rights; removal of anti-suppression contract provisions; and publication of average fee and market share data relating to American Express.

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<sup>4</sup> RBA Bulletin of August 2005, Article entitled *Merchant Service fees and Market shares for Credit and Charge Cards*. Text available on the RBA's website.

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- Publicly encouraging and coaching merchants how to use the tools provided by the RBA to bring their economic power to bear on American Express, in terms which suggest it is their civic duty to do so.

In this way, the RBA has ensured the market outcome vindicates their earlier prediction. From American Express' viewpoint, this does not feel as if it has been given any advantageous treatment. Far from it: in fact, American Express has been singled out by the RBA – despite having a market share of only one fifth of that of the dominant schemes - for the application of a special regulatory policy devised for American Express alone.

## 7. “The Advantage” – distinguishing fact from fiction

- 7.1 The multilateral interchange fees (MIF), which are a feature of the MasterCard and Visa card schemes in all countries, have been found by competition regulators in other countries to be unlawful anti-competitive agreements.
- 7.2 Similar legal principles apply in most countries with a developed regime of antitrust or competition law. Such regimes commonly:
- prohibit agreements between competitors to fix prices charged to third parties, because such agreements disfigure and stunt the competitive process and allow private parties to benefit at the expense of public welfare. In a number of cases, the interchange fees of four party credit card schemes have been or are likely to be classified as unlawful anti-competitive agreements;
  - empower the competition regulator to authorize or exempt specific anticompetitive agreements where it can be shown that the public benefits of such agreements outweigh their disadvantages.
- 7.3 In July 2002, the Commission of the EU issued its decision on the Visa MIF applying to transactions in the EU where cards issued in one member state are used in another member state.

The Commission found that the Visa MIF amounts to a restriction of competition under Article 81(1) of the EC Treaty. The Commission considered that it met the requirements for exemption under Article 81 (3), but **only after** Visa had agreed to modify the cross border MIF to align it more closely to issuers’ costs.<sup>5</sup>

- 7.4 On 11 April 2005 the Competition Court of Spain found that interchange fees in all three of the dominant card schemes in Spain were an unlawful restriction of competition under Article 81(1) of the EC Treaty and did not meet the conditions for exemption under Article 81(3).<sup>6</sup>
- 7.5 In September 2005, the United Kingdom’s Office of Fair Trading published its decision in the investigation of the domestic interchange of MasterCard. The OFT found that the collective price restriction contained in the domestic interchange of the MasterCard scheme was an unlawful restriction of competition under Article 81(1) of the EC Treaty **and** did not meet the conditions for exemption under Article 81(3).<sup>7</sup> Following its decision in the MasterCard case, the OFT, on 19 October 2005, issued a Statement of

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<sup>5</sup> Commission Decision of 24 July 2002 in Case No COMP/29.373 – Visa International – Multilateral Interchange Fee. OJ L 318, 22.11.2002, p17ff.

<sup>6</sup>Tribunal de Defensa de la Competencia. Decisions of 11 April 2005 in cases of Sistema 4B, Euro 6000 and Servired.

<sup>7</sup> Office of Fair Trading Decision of 6 September 2005 in case No. CA98/05/05 – Investigation of the multilateral interchange fees provided for in the UK domestic rules of Mastercard UK Members Forum Limited (formerly known as MasterCard/Europay UK Limited). See paragraphs 512 and 743 of the decision.

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Objections in respect of the domestic interchange fees of the Visa card scheme.<sup>8</sup> The OFT believes that the Visa scheme MIF restricts competition and infringes Article 81(1) of the EF Treaty in the same way as the MasterCard MIF. On 2 February 2006 the OFT launched another investigation into the new MasterCard MIF, which the OFT also suspects violates Article 81(1) like its predecessor.<sup>9</sup>

- 7.6 Australia was at the forefront of these regulatory initiatives when the ACCC, which had investigated interchange fees in the dominant card schemes since 1998, concluded that these were an unlawful price-fixing arrangement in breach of Section 45A of the Trade Practices Act<sup>10</sup> and commenced proceedings against a bank on 4 September 2000.
- 7.7 In a procedure analogous to that under EU and UK law, the Australian Competition and Consumer Commission may authorize prohibited agreements under certain conditions. In the period 2000-2001, the ACCC was unable to reach agreement with the dominant schemes and their members for the submission of interchange fees to the authorization process and in due course, the interchange problem was referred to the RBA without a court ever deciding the legality or otherwise of the interchange arrangements.<sup>11</sup>
- 7.8 Visa and MasterCard, and their member institutions, have for many years enjoyed the benefit of interchange fees paid under arguably unlawful agreements. No competition regulator has as yet taken enforcement action against the dominant schemes based on the illegality of their interchange arrangements. Instead, they have been permitted to lower these scheme fees in an orderly manner with purely prospective effect. They have not been required to pay any fines or compensation for the years in which these fees were maintained at levels now generally considered to be excessive.
- 7.9 This has amounted to a significant and long term advantage for Visa and MasterCard which has enabled them to amass dominant market shares in most international markets. During this time, the dominant schemes have acquired a sense of entitlement to their collective market share of nearly 85%, such that the slightest inroad or gain made by the third party schemes is criticized as unfair. This is particularly galling, when in fact Visa and MasterCard's dominance has been built and maintained on the foundation of long-standing price-fixing arrangements which are now widely recognized as unlawful by respected competition regulators.
- 7.10 Pointing the finger at AXP and alleging "unfair advantage" provides a convenient way to distract attention from the underlying issue and why this all started. It also usefully deflects attention from the real impacts of the reforms in terms of merchant windfalls and from any forensic analysis of how the banks have in reality adjusted their revenue and expense lines to manage through these changes.

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<sup>8</sup> Office of Fair Trading media release 195/05 of 19 October 2005 "OFT issues statement of objections on Visa agreement".

<sup>9</sup> Office of Fair Trading media release 20/06 of 2 February 2006 "OFT Launches new MasterCard investigation".

<sup>10</sup> Section 45A of the Trade Practices Act prohibits agreements and arrangements between competitors which have the purpose or effect of fixing, controlling or maintaining a price.

<sup>11</sup> ACCC Media Releases of 4 September 2000 and 21 March 2001,

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7.11 The Head of MasterCard in Australia was quoted in the press on 8th August 2004 as stating “*Two out of every three new accounts opened today are MasterCard cards*” and claiming that there were more than 5.6 million MasterCards on issue in Australia and that MasterCard had increased its share of the Australian Credit Card market from 30 to 40% in the last two years. Against that, a 1.7% increase in the market share of American Express and Diners Club can hardly be seen as an unfair advantage.

## **8. Effects of the Credit Card Reforms**

- 8.1 The RBA's credit card reforms have had very different effects on different constituencies: consumers, merchants, banks and credit card schemes.
- 8.2 American Express does not believe that consumers have benefited from the reforms. If you are a consumer, you most likely paying higher fees for your credit card or enjoying a diminished rewards program since the reforms took effect. You are liable to be surcharged by merchants for using your card, and there are no limits to the amount a merchant can surcharge. There is no evidence that merchants have lowered retail prices as a result of the benefits they have obtained from the reforms, so as a consumer you are no better off there either. Consumers are net losers.
- 8.3 Merchants, especially large merchants with market power in concentrated industries, have benefited significantly from the reforms. They have obtained reduced merchant fees from the MSF reductions in the dominant schemes worth some \$580m. . They have used the threat of surcharging to negotiate further MSF reductions from their merchant acquirers. Not only is there is no evidence to show they have passed on these substantial cost reductions by lowering prices to consumers but they are also allowed to surcharge by any amount they choose for card acceptance with no controls or justification required on how much they can charge Merchants are big winners.
- 8.4 Banks have neither gained nor lost from the reforms. The large banks dominated credit card issuing and acquiring in Australia before the reforms and continue to do so afterwards. The banks were not much affected by the lowering of dominant scheme interchange fees, as the same banks were both payers and recipients of most of those same fees. To compensate for the loss of MSF revenue from merchants, the banks implemented a massive shift in credit card pricing from merchants to consumers. No bank has reported diminished profits as a result of the reforms. The banks are largely unaffected by the reforms.
- 8.5 Merchant acquirers have seen an increase in surcharging, particularly in concentrated industries like transportation and telecommunications, and by local monopolies such as toll road operators or airport duty free stores. Most merchants probably can't be bothered to surcharge and recognise that this is not a friendly practice for consumers, but that does not stop them using the threat of surcharge to negotiate lower prices from a merchant acquirer. American Express has noticed this happening more often since the reforms. In the past a merchant acquirer had the ability to cancel a merchant's facility if its cardmembers were disadvantaged by a merchant but the RBA's Merchant Pricing Standard has removed an acquirer's ability to do this and protect its brand from surcharging or discrimination. Merchant acquirers are net losers from the reforms and, perhaps unsurprisingly, new entrants in the acquiring market have been conspicuously absent.

## Appendix

### Statements of the Reserve Bank about American Express

1. From RBA's Media Release of 12 April 2001 announcing the designation of the dominant schemes under the Payment Systems (Regulation) Act 1998, the RBA had this to say about the three party card schemes:

*"The Board considered whether the "three party" card schemes in Australia – American Express and Diners' Club – should be brought under its regulatory oversight at this point. These schemes compete with Bankcard, MasterCard and Visa for card members and merchants, but have quite different characteristics. They do not have collectively determined interchange fees, nor access rules that discriminate on the grounds of institutional status. The Board will take into account the competitive dynamics of the industry in any decisions it takes, but 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."*

2. In its Consultation Document of December 2001, the RBA elaborated its thinking on this point:

*"There is a substantial difference between the designated credit card schemes and the three party card schemes with respect to interchange fees setting. In the Bankcard, MasterCard and Visa credit card schemes, interchange fees are set collectively by financial institutions that are members of these schemes, but that are otherwise competitors in providing credit card services to cardholders and merchants. The ACCC has reached the view that this behaviour is a breach of the Trade Practices Act 1974.*

*American Express and Diners Club, on the other hand, do not have collectively determined interchange fees. Whether they have an internal transfer mechanism or "implicit" interchange fee is not relevant; the three party card schemes do not have a process under which competitors collectively agree to set a price which then affects, in a uniform way, the prices each of the competitors charges to third parties. For this reason, the Reserve bank saw no case on public interest grounds to designate the three party card schemes to deal with issues relating to collective fee setting (or restrictions on entry)."*

3. In its Final Reforms and Regulation Impact Statement of 27 August 2002, the RBA confirmed:

*"The Reserve Bank did not designate the "three party" card schemes, the American Express card system and the Diners Club card system. These schemes do not have collectively set interchange fees nor restrictions on entry enforced by existing members, and the Reserve Bank saw no case on public interest grounds to designate these schemes to deal with these issues."*

4. On 24 February 2005, the RBA's press release included the following explanation of its decision:

*"Over recent months the Bank has examined whether it would be in the public interest to regulate the American Express and Diners Club card payment systems. This follows the issuing of American Express cards by two banks and the establishment of a partnership between another bank and Diners Club.*

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*The Bank considered, in particular, whether there was a case to regulate the payments between American Express and Diners Club and their bank partners. It concluded that, at this stage, such regulation would not improve the overall efficiency of the payments system. In its view, regulation of these payments would have relatively little effect on merchant charges. Further, the existing incentives facing issuers of these cards could only be addressed through considerably more extensive regulation than that currently existing in the credit card schemes.*

*In the Bankcard, MasterCard and Visa schemes, the interchange fee paid by the merchant's bank to the cardholder's bank has an important influence on the charge levied on the merchant by its bank. In contrast, in the American Express and Diners Club arrangements, the causation runs the other way. Merchant charges are determined largely independently of the payment to the partner banks: instead, the fees that merchants pay influence the size of the payments to the banks. Given this, regulating the payments that flow between American Express and Diners Club and their partners would be likely to have little effect on merchants' costs of accepting the cards. This is in contrast to the credit card schemes, where merchant service fees fell quickly following the reforms to interchange fees.*

*On the issuing side, regulation of specific payments to the partner banks would be likely to lead to other forms of payment, leaving the incentive of banks to participate in the arrangements largely unchanged. One possible response might have been to regulate the totality of payments, including marketing payments, between American Express and Diners Club and their bank partners. Such regulation would then also be required in the Bankcard, MasterCard and Visa schemes. The Bank's view is that, at the current time, this form of extensive regulation is not in the public interest.”*

5. Deputy RBA Governor, Dr. Philip Lowe maintained the same rationale in his evidence to the Committee on 17 February 2006:

*“I think the American Express business is quite different to the Visa and MasterCard businesses. In Visa and MasterCard, there is a centrally set interchange fee; in the American Express arrangements with the banks, those fees are bilaterally negotiated. We looked very closely at the arguments for regulating them. One of the considerations that has led us not to regulate them is that, if we were to cut the interchange fee American Express pays one of these banks, there are many other financial flows that can occur. There are a lot of marketing payments and product support payments that go between the various entities here. Our concern was that, if we were to cut the interchange part of that payment, these fees could flow in to other forms of payment. What we would have to do is to regulate the totality of the payments between the various parties of the payment system, including product support and marketing payments, I do not think anyone thinks that is a sensible idea.*

*The different nature of the regulatory response is very much a function of the different nature of the businesses. What we have really tried to do with American Express is to make sure that, when the merchants are negotiating with American Express, they are not tied down by restrictions imposed on them by American Express. So American Express have agreed to allow customers to be steered towards other payment instruments. That is the margin where competition actually works here, because if merchant have more bargaining power with American Express, they will end up with lower merchant service fees and ultimately there will be lower fees back to the issuing banks.”*

6. More recently, Dr. Lowe again affirmed the RBA's thinking on American Express in his remarks to the Melbourne Payments System Conference 2006 at the Melbourne Business School on 14 March 2006:

*“In understanding why the regulatory response to MasterCard and Visa has differed from that to American Express and Diners Club, it is important to recognise the different structures and economics of the various schemes. In the MasterCard and Visa systems, different banks are*

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*typically on the acquiring and issuing sides of each transaction, with an interchange payment being made between the banks. In contrast, in the American Express and Diners Club systems there is simply no interchange fee paid on the vast bulk of transactions: American Express and Diners Club both act as the acquirer and the issuer. The exception to this, of course, is the bank-issued American Express cards, where American Express makes interchange-like payments to its partner banks.*

*These arrangements with banks raise the obvious question of 'shouldn't the payments to the issuing banks be regulated in the same fashion as the interchange fees in the other schemes?' As you know, we decided last year that the answer was no. This was for two interrelated reasons.*

*First, we judged that regulating payments to the partner banks would have little effect on American Express's merchant service fees. While these arrangements look similar to the traditional four-party schemes, one important difference remains – that is, American Express is still the sole acquirer of its own transactions. This lack of competition for acquiring American Express transactions means that if regulation required American Express to make smaller payments to its partner banks, there would be very little direct pressure on it to lower its merchant fees. This stands in stark contrast to what happened when interchange fees were cut in the other schemes. There, strong competition on the acquiring side of the market meant that the lower interchange fees flowed through very quickly into lower merchant fees. The same simply would not have happened in the American Express scheme.*

*The second reason is that it is unlikely that the banks' incentive to issue American Express cards would have been affected by the Reserve Bank requiring American Express to lower its interchange payments to its partner banks. Given the nature of the contracts between American Express and the issuing banks, lower interchange payments could have been offset with other forms of marketing and product support payments. In principle, this issue could have been addressed by regulating the totality of payments to the issuing banks, including marketing payments. In turn, no doubt there would have been calls by some for similar regulation of MasterCard and Visa. Our view, and I think one that is widely shared, is that such extensive regulation is not in the public interest.*