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**Submission to The  
Reserve Bank of Australia**

**Inclusion of Closed Card  
Schemes in the Designation  
Process**

**17<sup>th</sup> April 2001**



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## 1. Executive Summary

### *Introduction*

The Reserve has decided not to include the closed card schemes in the current designation process.

It is the view of Visa International that the closed schemes such as American Express (charge cards and credit cards), Diners (charge cards), and store cards provided by GE Capital (credit cards) and any other third parties should be included in the designation process.

### *Identical Functionality*

The cards issued under the closed schemes provide the same payment service to consumers and have the same impact upon merchants as cards provided through the open card schemes. They exhibit the same characteristics in areas such as the provision of a line of credit (whether or not it is a revolving line of credit), payment of merchant service fees, target markets, product offerings and distribution. The scrutiny of card schemes that exhibit the same or similar characteristics cannot be selective and be on the basis of ownership.

If the Reserve Bank were to proceed with the designation process but did not include closed card schemes, it would result in substantial policy failure with adverse economic efficiency consequences.

### *Competition Between Open and Closed Systems*

If the closed schemes are not included in any designation process, the Bank would also bestow substantial competitive advantage to one sector of the card industry, a sector owned by large foreign multi-national corporations. This competitive advantage for closed schemes would be at the expense of open credit card schemes that are predominantly locally owned.

There is direct competition between the open and closed schemes. This competition is across all markets such as consumer, small business and corporate. Consumers are now utilising credit cards in a charge card like manner and utilising charge cards in the same way in which they may use a credit card. In the commercial and purchasing card markets the open and closed schemes compete directly for customers. The open and closed schemes are all invited to submit tenders by major companies and governments. Consumers, be they individual, small business, corporate or governments do not make a distinction between the open and closed schemes. To the consumer and the merchant the product and services being provided are the same.

Both the open and closed schemes levy a merchant service fee. In the case of open schemes where the acquiring bank and the issuing bank is the same (“on-us transactions”) the merchant service fee is retained by the acquirer. This is exactly the same as in the case of all transactions in a closed scheme. In both instances, the fee earned through acquiring the transaction allows the acquirer to balance the demands of the final users of its acquiring and issuing functions – the merchants and the cardholders.

By its nature, open schemes also have transactions that involve an acquiring bank that is different from the issuer. Where these occur the acquiring bank makes a payment, the interchange fee, to the issuing bank in order to fulfil this same balancing function for the system as a whole.

The benefit that cardholders draw from the card increases when more merchants accept the card. In the same way, the benefit that merchants draw from the card increases when more cardholders are likely to patronize their shop. The balancing function carried out internally in closed systems and in on-us transactions in open systems is functionally the same as the balancing function carried out by the interchange fee in not on-us transactions in open systems.

### *Distortion of Competition*

If the Reserve Bank fails to include the closed schemes in the regulatory process it would have the effect of providing these schemes with significant commercial advantage. They would be free to operate without the level of regulatory and political risk that the open schemes confront. It would enable the closed schemes to maintain an already higher rate of merchant service fee and, thus, provide a higher level of financial resources with which to fund their card issuing and brand promotion activities. At the same time, participants in the open schemes would be forced to choose between increasing the costs borne by consumers and having their margins squeezed.

As the closed schemes will not be faced with a need to increase the costs borne by consumers, competitive pressure will mean that participants in the open schemes will find it difficult to do so even if they consider it feasible despite customer relationship issues to do so. Reduced margins mean that at some point a participant's card activities would cease to return an acceptable rate of return or might cease to be viable altogether. Some participants might chose to continue with their card operations in any event, but organizations that are predominantly card issuers (such as the smaller regional banks and the credit unions) would likely be forced out of the business.

Finally, the comparatively higher rate of return earned by the closed schemes would enable the development of new initiatives that would not be viable for the open schemes to undertake.

The argument that competitive pressures would over time force the closed schemes to reduce their merchant service fees to a rate comparable to that of the open schemes is not a valid argument for their non-inclusion in the current regulatory process. It does not recognize the externalities between cardholders and merchants. To date the closed schemes, despite being under competitive pressures, have been able to maintain their higher rate of merchant service fees because they are able to issue and promote their cards and, consequently,

there is consumer demand for merchants to accept them. Given this experience, particularly if the issuing activities of participants in the open systems are reduced because they must fund a higher proportion of their issuing and promotion costs from that side of their business, it is difficult to argue that competitive pressures would force the closed schemes into a reduction of their merchant service fees in a half-regulated environment.

If the Reserve Bank believes that competitive pressures would prevail then it should spell out a monitoring process. The monitoring process would have to set out both timing and pricing benchmarks that would have to be achieved in order to prevent the regulation of the closed schemes.

The strength of the operators of the closed schemes, especially American Express, Diners and GE Capital, needs to be fully recognised by the Reserve Bank. These are three of the world's largest card scheme operators. They are extremely competitive and have access to significant financial resources. There can be no doubt that these global operators will seek to utilise any competitive advantage they receive through their non-inclusion in the regulatory process. This competitive advantage would enable them to rapidly expand their cardholder base at the expense of the open schemes.

In summary the Reserve Bank must include the closed schemes in the current regulatory process as:

- The product and services provided have the same characteristics for the merchant and consumer
- There is direct competition between the open and closed schemes across the consumer, business and corporate markets.
- The open and closed schemes operate upon the basis of levying a merchant service fee that is used to balance the demands of merchants and consumers.
- The closed schemes would be able to continue to levy a much higher rate of merchant service fee to fund their issuing activities, while the open

schemes were having their margins squeezed or being forced to increase costs to consumers (or to leave the business).

- History demonstrates that competitive pressures would not force a lowering of merchant service fees by the closed schemes.
- The closed scheme competitors are major global operators who will immediately exploit any commercial advantage that they receive from being free of the regulatory constraints imposed on the open schemes.

**A. General Economic Issues**

**1. Efficiency considerations**

It seems clear that cards issued under closed schemes (eg. Amex and Diners) are close substitutes to those issued under open schemes (eg. Visa and Mastercard). Both consumers and merchants are likely to view the cards of both schemes as almost interchangeable, in terms of the services they provide.

If the ‘substitutes’ proposition is accepted, then it follows that regulating cards issued under open schemes but leaving cards issued under the other type of closed scheme unregulated, could cause significant economic efficiency losses.

From the consumers’ point of view, if the imposition of new regulations reduced returns, then it is likely there would be a reduction in the supply of cards available and the services provided to holders of the cards. Under normal market conditions, this would lead to a reduction in consumer welfare (reduced consumer surplus).

Producers would also suffer a reduction in welfare, as a result of regulations adversely affecting their operations (a fall in producers’ surplus).

Regulatory neutrality should mean that all forms of credit cards compete for customers on their merit. This should ensure that card issuers whose cards provide consumers with the greatest utility prosper and resources flow to participants in the card industry which are the most economically efficient.



**B. Card Market Specific Considerations**

**1. Interchange Fees Fund Similar Activities To Closed Schemes**

In seeking to regulate the interchange fee, the Reserve Bank is in effect seeking to regulate the return that a credit card issuer in the open system receives for their contribution to the development of the overall system. An issuer in an open system undertakes the same or similar functions and activities as an issuer in a closed card system. They promote the brand, develop their cardholder base, maintain cardholder accounts and provide a short or longer-term line of credit.

The difference between the open and closed schemes in regard to the recognition of this contribution, is that in the opens schemes the transfer of value may take place via a third party, the acquiring bank. The value that the issuer brings to the transaction is being recognised, just as it is recognised in the closed schemes. Therefore if the Reserve Bank believes it has a responsibility and authority to regulate the returns that issuers in the open schemes receive from their activities, then how can it not seek to regulate the returns that issuers receive in the closed schemes for exactly the same activities? The industry, the product and the activities are exactly the same; the method of transmission varies.

## **2. American Express Credit Card – A Close Substitute for Other Cards**

The existence of the American Express credit card is one of the strongest pieces of evidence that the Reserve Bank should consider the closed schemes in the designation process.

The American Express credit card functions exactly in the same way as a credit card offered by any of the open systems. The use of the American Express credit card involves the same level of merchant service fee as the charge card product.

If the Reserve Bank failed to include American Express in the designation process, then they would be allowed to directly compete in the market with an identical product and target market, but within a differing regulatory framework.

### **3. AMP Bank – American Express Credit Card**

American Express has a global strategy to expand its distribution channels through enlisting financial institutions to issue their cards. As part of this global strategy an agreement was reached with AMP in 1998 to distribute American Express credit cards in Australia. According to material published by AMP<sup>1</sup>, the credit card is “issued and distributed by AMP Bank Limited”.

The financial details and arrangements between American Express and AMP Bank are not publicly detailed. It could however be assumed that there is some form of payment flowing between the two companies. This could take a number of forms including a licensing fee or perhaps even a fee that would have similar or the same characteristics of an interchange fee. That is, AMP may be receiving a transaction based fee as recognition of the value they have provided through being an issuer of the American Express credit card utilised in a transaction.

The Reserve Bank in the first instance needs to seek information as to what the arrangement between AMP Bank and American Express is. If this arrangement involves any payment from American Express to AMP in recognition of the value it brings to the American Express card system, then this would equate with the interchange fee in the open systems. This would then require that the Reserve Bank treat what is an issuer reimbursement fee in the same manner that it is seeking to treat interchange fees in the open systems.

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<sup>1</sup> AMP Web Site

#### **4. Advertising – Trends Show Closed Schemes Compete for Consumers**

Advertising spend is a major indicator of a company's desire to build their brand and their market share. Open card issuers see closed schemes as direct competitors and the aggressive advertising campaigns of the closed schemes suggest they are competing to capture clients from other open brands.

An analysis the credit card advertising in the year January – December 2000<sup>2</sup> shows that while American Express and Diners represented 15% of the market, they accounted for 46% of the total expenditure by the four brands. American Express outspends Visa by 25% and is only slightly below the total advertising spend of MasterCard.

The drive by American Express to grow its credit card base is highlighted if the individual areas of spending are examined. American Express spent more money in 2000 on advertising promoting its Blue credit card, and then it did promoting its traditional consumer charge card business. Advertising for the American Express Blue credit card accounted for 35% of the company's total advertising spend. The corporate card sector accounted for 24% of the total advertising spend and reflects the importance of this sector to American Express.

The advertising expenditure of Diners indicates a strong focus on brand building across a range of sectors with 86% of advertising spend focused on brand promotion.

An analysis of media spend by type of medium reflects the consumer focus of both American Express and Diners. Spending is dominated by TV commercials, clearly targeting retail consumers and business card holders. While having a lower level of overall spend, Diners' spend was dominated by television with just under 80% of total advertising expenditure devoted to this medium. American Express had a stronger focus on print than Diners, but with a higher overall advertising spend, their level of television spend was not significantly under that of Diners. In all the two companies spent approximately \$8 million on television advertising.

The level of advertising expenditure by both companies far outweighs their market share. This can leave no doubt that they are both aggressively seeking to build their brand and cardholder base in the consumer market.

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<sup>2</sup> OMD Australia Competitive Advertising Analysis January – December 2000

## 5. Commercial and Purchasing Cards Markets

The closed systems compete directly with the open systems in the commercial cards markets. In nearly every major tender for commercial cards the closed card systems are invited to compete against the open card systems and their members.

Table 1 sets out a product comparison between Visa, American Express and Diners. As can be seen from this table, there is direct competition in the Business Card, Corporate Card and Purchasing Card markets.

**Table 1 Product Offerings**

Product	Visa	American Express	Diners	Target Market
Business Card	Yes	Yes	Combined with Corporate Card	SME
Corporate Card	Yes	Yes	Yes	Small value Purchases, T&E
Purchasing Card	Yes	Yes	No	Corporate, Government

American Express and Diners are particularly strong in the Corporate Card and Purchasing Card market. As a result of competitive tenders American Express has Corporate and Purchasing Cards with the following governments, Federal, Queensland, Victoria, Tasmania, South Australia, and Western Australia. Telstra, Australia’s largest company, issues a Diners Corporate Card to its employees.

## 6. Efficiency?

The Joint Study asserted that the “current interchange fee and access arrangements in Australia is that credit card network has been encouraged to grow at the expense of a less costly alternative, the debit card”.<sup>3</sup> This is an assertion that Visa does not agree with, but if the Reserve Bank wishes to continue to support this proposition then it has important implications in any decisions as to whether to include the closed card schemes.

With the levying of a significantly higher rate of merchant service fee by the closed card schemes, then it follows under the thinking put forward in the Joint Study, that they must even be more inefficient in comparison to debit cards, than in comparison to the open network cards. The open card schemes have a merchant service fee that is on average less than one half of the closed card networks’ fee. Would this therefore make the closed networks half as efficient than the open card networks and therefore worthy of even more scrutiny?

It may be argued that the charge cards of the closed schemes are in fact significantly closer substitutes for debit cards, when compared to card holders who are revolvers in the open schemes. That is, there may be an even greater argument based on the Reserve Bank’s efficiency argument for action to induce a behavioral change amongst charge card holders to utilise debit facilities than there is for those credit card holders who are revolvers.

It is difficult to understand how it could be argued that a card holder in an open scheme, utilising a card that has a significantly lower rate of merchant service fee, is somehow demonstrating less efficient behavior than a charge card holder utilising a card that has a significantly higher merchant service fee.

If the Reserve Bank wishes to pursue the cost based argument for efficiency (which Visa does not accept) then it cannot ignore the closed card schemes that have almost

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<sup>3</sup> Reserve Bank of Australia and Australian Competition and Consumer Commission Joint Study page 76

15% market share and have a disproportionate impact based on their significantly higher level of merchant service fee.



## 7. Charge Cards – Acting As a Credit Card and Vice Versa

Cards in the closed card schemes have the ability to display a number of the characteristics of credit cards.

If a card holder in the closed card schemes has the ability to shift outstanding balances to a line of credit or similar facility offered by the closed schemes, then the card holder is utilising the card in the same manner as a credit card.

Charge card holders are also provided with interest free periods for purchases of up to 57 days.<sup>4</sup> A similar time frame to many credit card products.

The reverse is also true for those card holders in the open card network who are utilising their credit cards in a manner similar to a normal charge card or are deemed to be transactors. That is they are utilising their credit card as a payment card and paying the balance off in full at the end of each month.

This is not to say that transactors have the potential to be driven to the use of debit with no negative effects. Transactors may in fact be utilising their credit card in a manner that takes advantage of other benefits such as mortgage offset accounts or even making up for monthly cash flow shortfalls.

If cards in the closed schemes are showing characteristics of cards in the open schemes and vice-versa, then it follows that there must be degree of competition between them for consumers. It is therefore not possible on the grounds of competitive neutrality for the Reserve Bank to seek to impose regulatory controls on the open card schemes and not impose the same on their competitors in the closed card schemes.

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<sup>4</sup> Diners Club web site [www.dinersclub.com.au](http://www.dinersclub.com.au)

## **8. Charge Cards – Moving Into Everyday Spending**

The closed card schemes have moved significantly beyond their traditional travel and entertainment base into areas of day to day consumer expenditure.

Both American Express and Diners have expanded both the number of their merchant base, both in numbers and breadth. The two cards are now accepted by merchants providing every day goods and services such as Woolworths, Mobil, Beecroft Flower Shop, Hardwarehouse, and Collins Booksellers. They have shifted their focus into areas of every day spending.

The shift in focus to areas of every day spending places the closed schemes in direct competition with the open schemes. This has a number of important implications for arguments set out in the Joint Study such as alleged cross subsidies and loyalty schemes.

## 9. Cross Subsidy Argument

The Joint Study alleged that there exists a cross subsidy between non-card users and cardholders. This subsidy was the result of the alleged additional costs being incurred through the payment of merchant service fee each time consumers made a payment with their credit card.

If the Reserve Bank wishes to continue to utilise this argument as a reason for the examination of the open card network, then there an even more compelling reason to examine the closed card network.

If there closed card network levies a merchant service fee that is up to twice that of the average for the open card schemes, then it must follow utilising the Reserve Bank's argument, that a greater individual cross subsidy exists for individual card holders in the closed schemes.

With both American Express and Diners expanding their merchant base into non-traditional areas such as supermarkets, this higher level of alleged cross subsidy is not being restricted to expensive outlets and hotels. It is being spread throughout the economy.

If one of the aims of the Reserve Bank is to reduce or eliminate this alleged cross subsidy then it cannot ignore the closed schemes in the designation process. If it did, then based on its own thinking, it would result in the closed schemes being a recipient of proportionally larger cross subsidy while the open schemes would be face regulatory restrictions.

## 10. International Competition

As the Minister for Financial Services, Hon. Joe Hockey, recently noted, “*Banking is now a globally competitive industry, we have major financial institutions from around the world, now offering products in Australia.*”<sup>5</sup> This is certainly evidenced by the operations of American Express, Diners and GE Capital in the Australian market. It highlights the importance of allowing Australian companies to compete on a level playing field with their international competitors in the domestic market.

American Express, Diners and GE Capital are major global companies that have at their disposal significant resources and funding to expand their cards business.

In year ended December 31 2000, Diners parent company, Citigroup, had a net income of AUD\$27.3 billion. Citigroup’s global cards operations alone delivered earnings of AUD\$4.4 billion<sup>6</sup>, an increase of 30% on the previous year.

American Express in the year ending December 31 2000<sup>7</sup> achieved net revenues of AUD\$44.64 billion and net income of AUD\$5.68 billion. This represented a return on average equity of 25.3%.<sup>8</sup>

GE Capital in the year to December 31 2000 achieved global revenues of AUD\$134 billion delivering net earnings of AUD\$10.5 billion. This is greater than the combined profits of Australia’s four major banks.

Financially these are formidable competitors and in no way can it be argued that they require a regulatory lift, intended or unintended, in the Australian market.

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<sup>5</sup> Hon Joe Hockey, Minister for Financial Services and Regulation, Transcript, 26 March 2001

<sup>6</sup> All conversions at a rate of AUD\$1 = USD\$.4947

<sup>7</sup> American Express Fourth Quarter 2000 Results

<sup>8</sup> By comparison Westpac achieved an ROE last financial year of 18.7%

## **11. Regulatory Controls – Commercial Benefit or Disadvantage?**

There can be little doubt that the imposition of any regulatory controls by the Reserve Bank on the open schemes that are not applied to the closed schemes would place the open schemes at a significant commercial disadvantage.

A regulatory regime that exposed the open schemes to public examination and lead to the public disclosure of commercial information would result in a number of negative outcomes. There can be no doubt that the once a new rate of interchange was set as a result of regulatory action, that there would be significant political and regulatory pressure for a corresponding reduction in merchant service fees. A pressure that the closed schemes would not be placed under. The open schemes would be exposed to a greater degree of regulatory and political risk, with all its inherent difficulties and challenges. These difficulties and challenges are already apparent in the substantial attacks by politicians and regulators that the open schemes have been unfairly subjected to in the previous month. There can be little doubt that these public attacks have been calculated to force the open schemes into agreements that otherwise commercially or legally they would not enter into. These very public attacks are intended to inflict damage on the brands of the open schemes and hence their commercial standing. The closed schemes have not been subjected to the same level of political and regulatory risks. This is likely to continue if the closed schemes were not subject to the same level of regulatory scrutiny through the current process.

As a result of regulatory intervention the open schemes would have their margins squeezed, while the closed schemes' margins would remain untouched. While the open schemes were having an acceptable rate of return determined through a regulatory process, competitors in the closed schemes competitors would remain free to determine their own rate of return.

These higher rates of returns would provide the closed schemes with the capability to develop business cases to expand their cardholder base through product development, marketing, merchant recruitment and tender preparation. The closed schemes would

have the capacity to role out new initiatives that would not be viable for the open schemes to undertake. An important competitive advantage that would grow over time.

It is impossible to argue that a group of competitors, that is the open card schemes, would not be placed at a competitive disadvantage should they faced with competitors, that is the closed card schemes, which were not subject to the same regulatory controls. The closed card schemes would be in a position to achieve higher rates of return, have the capacity to role out new initiatives and not be exposed to the same degree of regulatory and political risk. With global competitors such as American Express, Diners and GE Capital there can be no doubt that they would maximise this major commercial advantage to expand their cardholder base at the expense of the open schemes.

## 12. Summary

In summary the Reserve Bank must include the closed schemes in the designation process for the following reasons:

- A. Because closed and open scheme cards are close substitutes in consumption and production, regulating one type of scheme but leaving the other unregulated may lead to significant economic efficiency losses.
- B. The activities that an issuer undertakes and the value they bring in an open scheme is exactly the same as an issuer undertakes in a closed scheme. It is this activity that the interchange or issuer reimbursement fee recognizes. If the Reserve Bank is seeking to regulate the return that can be received for these activities, then it should regulate the return across all schemes.
- C. If the Reserve Bank fails regulate the closed schemes then it would severely limit their ability to address the alleged issues of cross subsidy from non-card holders to cardholders. If such a cross subsidy exists, it must exist for all users of credit and charge cards.
- D. American Express is in the credit card business, just as Visa and MasterCard are.
- E. There is direct competition between the open and closed card schemes in the commercial and purchasing card market. To place regulatory constraints on one set of competitor and not the other has clear commercial implications.
- F. American Express and Diners account for almost half the national advertising for credit and charge cards, despite having an estimated 15% of the market. This indicates either significant profits or the availability of capital on the expectation of future profits.

- G. If the Reserve Bank believes that there is an economic benefit in shifting from credit to debit payments, then this economic benefit would not be dependent upon the brand of the card used.
- H. If you accept that charge card payments may be seen as a closer substitute for debit card payments, then it would follow that there would be economic benefit in moving payments from charge cards to debit cards. This is particularly the case where a higher rate of merchant service fee is payable.
- I. American Express and Diners, while having only 15% market share, would have a disproportionately higher rate of alleged negative economic impact as a result of the higher merchant service fee. At a rate of just twice as high as the closed schemes it would take their impact higher than MasterCard and Bankcard.
- J. If the Reserve Bank's argument on cross subsidy from non cardholders to cardholders is accepted, then American Express and Diners cardholders would be beneficiaries of a higher individual cross subsidy than either Visa or MasterCard cardholders.
- K. American Express and Diners are moving into areas of everyday spending as they expand their merchant base. This has important implications for the alleged cross subsidy argument.
- L. The Reserve Bank should not seek to impose regulatory controls on Australian owned companies and institutions, while at the same time ignoring foreign competitors in the Australian market place.
- M. The open card schemes are being subjected to a higher level of political and regulatory risk, on the basis of their ownership structure, not because they provide an inherently different product.



- N. The closed card schemes have the opportunity to achieve a much higher rate of return on the same business as the open schemes. This would allow the closed schemes to undertake initiatives that would be uneconomic for the open schemes to undertake as a result of a regulated rate of return.

The Reserve Bank cannot fail to include American Express, GE Capital (which, in operating the Coles Myer group store cards claims to operate the largest credit card portfolio in Australia) and Diners in its current review and possible designation. There is no justification for it doing so, especially if it maintains that it is seeking to achieve the alleged economic outcomes that are set out in the Joint Study. The current proposed exclusion of American Express, Diners, and GE Capital from this regulatory process would result in the provision of a substantial commercial advantage to these two global card operators. A substantial commercial advantage that can in no way be justified.