



Review of Payments System Reforms

A Submission to the Reserve Bank of Australia

1. Preface

PURPOSE OF THIS SUBMISSION

American Express Australia Limited (AEAL) has prepared this Submission in response to the Reserve Bank of Australia's invitation to provide comment as part of the formal consultation process for its review of the card reforms of 2002-4.

AEAL's response to the RBA is set out in the following sections and appendix:

- i. Section 3, the Executive Summary, sets out AEAL's positions on a number of key issues
- ii. Section 4, Effect of the Reforms to Date, sets out AEAL's detailed comments on the reforms and their impacts, including:
 - the effects of the reforms to date; and
 - the current regulatory framework, including interchange fees, access arrangements and scheme rules.
- iii. Section 5, Current Regulatory Approach and Alternatives, sets out AEAL's views on the public policy considerations related to merchant power, influence and surcharging, and the scope of the RBA's regulatory powers. The section also considers the effectiveness of, and alternatives to, the current Interchange Standard and access arrangements; and the opportunity for self-regulation.
- iv. Section 6, Recommended Changes to Current Standards and Access Regimes, contains AEAL's recommendations and responses to the RBA's questions and issues, and recommended changes to the existing regulatory framework.
- v. The Appendix, Summary of Recommendations and Responses, follows the structure and sets out in summary form, for ease of reference, AEAL's responses to the issues and questions raised by the RBA in section VI: Issues of the RBA's Reform of Australia's Payments System Issues for The 2007/08 Review.

ACIL TASMAN

This submission should be read in conjunction with a submission to the Reserve Bank by ACIL Tasman who have advised American Express on payment systems matters.

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3. Executive Summary

American Express supports initiatives to promote competition, enhance transparency and remove long-standing barriers to entry in the payment cards market and is pleased to participate in the review by the Reserve Bank of Australia of its reforms of the credit card payment industry.

From the inception of the debate over credit card reforms in Australia, American Express has been supportive of the Reserve Bank's efforts to stimulate competition and address the trade practices and anti-trust issues that have led to the dominance of the four-party card schemes.

In its submissions and statements made throughout the card reform process, American Express has consistently maintained that competition shortcomings in the general charge and credit card market could have been effectively addressed by restoring market forces without direct price regulation. Had new market entrants been facilitated, the resulting increased competition might reasonably have been expected to deliver cost and price reductions in card payment systems.

Nevertheless, American Express accepts the credit card regime in its current form and acknowledges that some of its intended objectives have been realised.

If the current interchange pricing regime is unlikely to be dismantled, American Express would then recommend that it should not be extended into additional areas as this would further deepen the imbalance already created in the system, cause continuing uncertainty and further reduce the attraction of investment in the Australian credit card payment system.

We highlight below the key outcomes of the reforms and identify areas where we believe adjustment of the current regime is required to resolve unintended consequences and support the development and growth of a robust card payments market by encouraging competition and promoting innovation.

1. CARDHOLDERS – PAYING MORE

As a result of the reforms, consumer cardholders now bear most of the costs of the credit card system.

In response to the credit card reforms, Australia's bank-issuers chose to maintain their revenue and profitability by increasing card fees, reducing the value of cardholder reward programs and other benefits and generally shifting costs from merchants to consumers. The transfer of costs to cardholders through increasing existing, and introducing new, user fees is a seismic shift in card industry pricing from one side of the two-sided credit card market to the other.

It is recognised that the Reserve Bank intended the reforms to deliver more appropriate price signals to cardholders, some of whom it had identified as non-contributors to the cost of the credit card payment system. However, it is doubtful whether the Reserve Bank intended to bring about the converse result, where merchants ended up paying very little, and consumers almost all, of the costs of that system.

Under the reforms, merchants have gained a significant and ongoing financial benefit, recently estimated at least \$2.2 billion since 2003¹; but there has been no evidence of any countervailing decrease in the retail prices of goods and services.

2. MERCHANTS – EARNING MORE

Surcharging, as currently permitted under the reforms, further tilts the balance of power in favour of large merchants at the expense of consumer-cardholders.

1. RBA Reform of Australia's Payments System Issues for the 2007/08 Review, cl 93 at p 22.

2. Calculation based on American Express proprietary information and publicly reported information.

Empowered by the card reforms, merchants, many of whom enjoy a dominant market position, have begun surcharging at the expense of consumers, who already bear new and increased user fees and diminished rewards value propositions. American Express estimates, that as a result of surcharging, consumers are now paying more than \$845 million in additional charges each year².

There is no evidence that merchants pass on income from surcharging or savings from reductions in service fees payable to acquirers, in the form of reductions in retail prices for goods and services.

For some merchants surcharging is a means not only to pass on most of the cost of the credit card system to cardholders but to go further and create an additional "rent" stream from consumers using the system. Far from reducing the overall social cost of the credit card system, the effect of surcharging over and above the cost of card acceptance is actually increasing that cost.

An acquirer participating in a card scheme must be able to require acceptance of all credit and charge card products bearing the brand of the card scheme. This is a standard situation around the world and, if there were to be any further segregation or selective acceptance of card products by merchants, American Express believes that this would add considerable uncertainty and reduce the efficiency of the payment system.

The reforms leave a consumer protection deficit which has yet to be addressed or even taken seriously by Australian regulators. It is argued below that consideration should be given to establishing price display regulations on the lines adopted many years ago in the United Kingdom.

Displaying a card scheme logo, be it Visa, MasterCard, American Express or Diners Club, at a merchant's premises is a universally-recognised representation to cardholders that products bearing that scheme's branding are certain to be accepted at the premises and not that acceptance is merely conditional or 'indicative' or subject to further haggling with an uncertain outcome.

The steps the Reserve Bank has taken to distinguish debit from credit cards have already devalued the brands of major card schemes by rendering uncertain their promise of acceptance in Australia. To extend that concept further would be extremely damaging to the certainty required for the operation of the payment system.

3. COMPETITION BETWEEN CARD SCHEMES

American Express is under intense competitive and regulatory pressure.

American Express has fully cooperated with the Reserve Bank's regulatory reforms and complied with the Merchant Pricing Standard. The Reserve Bank's reasons for not regulating American Express have proved justified: American Express' merchant pricing has fallen in line with that of the dominant schemes without the three-party schemes being able to make anything other than a minor dent in the dominance of the four-party schemes.

American Express enjoys no advantage from the reforms: its card business in Australia remains specialised and strongly focussed on traditional corporate and travel and entertainment sectors – a business model which both the Reserve Bank and the Standing Committee on Economics, Finance and Public Administration of the House of Representatives have acknowledged is different to that of the dominant card schemes³. In reality its business remains subject to intense competitive and regulatory pressure.

This is in stark contrast to the longer and deeper advantage gained by the dominant schemes from many years of operating their multilateral interchange arrangements, which are now subject to intervention by anti-trust and competition regulators in other jurisdictions. To subject American Express to additional regulation would only further entrench the dominance of the four-party schemes in Australia, which still command some 83% of the credit card acquiring market⁴, or the four largest banks, which still command more than 62% of the card issuing market⁵.

4. CONCLUSION

American Express accepts that intervention was required to remove some of the anti-competitive features on which the dominance of the four-party schemes has been built and to increase competition in consumer payment systems. However, to address a number of the unintended consequences of the reforms that have unfairly prejudiced consumers and acquirers, American Express would urge the Reserve Bank to consider a number of simple, yet much-needed, steps in the following areas to redress these anomalies:

- Amend the Merchant Pricing Standard
- Discontinue the common cost-based benchmarking process for the four-party schemes
- Modify the Interchange Standard to enable more transparent and real-time regulation of premium interchange fees.

American Express commends the Reserve Bank for the professional and exhaustive process of consultation and enquiry it has conducted throughout the seven-year life of the card reform process. It is our strong desire that the reform process and the current uncertainty about the future regulatory direction of the card industry might now be brought to a finite conclusion.

The outcome of the present review and the future direction of payments system regulation remain unclear. The corporate resources – management time and

3. House of Representatives Standing Committee on Economics, Finance and Public Administration. Review of the Reserve Bank of Australia's and Payment Systems Board's Annual Reports 2005 (First Report), June 2006, paragraphs 4.50ff.

4. Based on percent of purchases by value. RBA Bulletin Statistical Tables Payments System (C Tables) C02 Market Shares of Credit and Charge Card Schemes, June 2007. Accessible on the Reserve Bank's website.

5. Based on market share of card balances. APRA and RBA data cited by MWE Consulting in the Australian Payment Cards Report, June 2007 at p9.

professional fees – claimed by this subject in the last five years are immense. The strategic and regulatory uncertainty engendered is disconcerting and has an inhibiting effect on investment decisions. It would require a high level of risk appetite for a potential new entrant to consider investing in a market entry or technical innovation strategy in this environment.

4. Effect of the Reforms to Date

The Reserve Bank's credit card reforms have had very different effects on different constituencies: consumers; merchants; banks and credit card schemes.

CARDHOLDERS

- 4.1 Consumers have borne most of the cost of these reforms. It was an express objective of the reforms to provide cardholders with more appropriate and transparent price signals about the true cost of the credit card system.

Card pricing – Banks moved costs to consumers

To maintain their profitability following the reforms, the banks adopted business and product strategies to shift fees from merchants to consumers. When faced with reduced merchant fees, they increased cardholder fees and/or reduced the value of consumer card reward programs. Examples of these price changes are set out in the submission to the Reserve Bank from ACIL Tasman.

Surcharging – Merchants moved costs to consumers

Merchants now enjoy, and are increasingly exercising⁶, a wide discretionary power to surcharge selectively, at will and without restriction as to amount. This power remains unrestrained and unchecked by any consumer protection safeguards.

Although intended to increase the transparency of pricing signals to both consumers and merchants, singling out the credit card payment system without regard to the true costs of other forms of payment means that merchants have been empowered to shift the cost of the credit card system to Australian consumers.

This shift in the balance of power does not sufficiently recognise the inter-connected nature of demand in the two-sided credit card market, nor the costs of other payment methods including cash and cheques, nor the economic benefits of card acceptance to merchants, and thereby distorts an otherwise efficient two-sided market.

Merchant Profiteering – Merchants increased retail prices

With no evidence that the merchants' income from surcharging or that the savings from reductions in service fees payable to acquirers have been offset or balanced by any reduction in retail prices, and in the absence of any consumer protection oversight, American Express submits that a key outcome of these reforms has been the creation of an environment that encourages unchecked profiteering at the expense of consumers.

Consumer/Cardholder Behaviour

To recover lost merchant fee revenue, a number of issuers have responded by offering products with lower interest rates, interest-free periods and lower annual fees to attract customers who will use their credit cards to revolve or borrow. These low rate cards generally do not offer reward programs or other elaborate benefits. Their profitability depends on interest revenue from cardholders who choose to defer payment of the outstanding principal. In other words, although these products are attractive to certain categories of consumers because of their low interest rates, their profitability is linked to the promotion of 'revolve' behaviour by issuers.

6. East & Partners Pty Ltd. cited in RBA Reform of Australia's Payments System Issues for the 2007/08 Review, May 2007 cls 83 & 84 at pp 18 & 19.

MERCHANTS

- 4.2 American Express submits that merchants – especially large merchants with market power in concentrated industries – have benefited most, and at the expense of other key stakeholders, from the credit card reforms. Merchant benefits from the reforms include: lower merchant service fees; increased bargaining power with acquirers from the ability – or the threat – to surcharge; and the potential for a new independent line of revenue from surcharging profits, none of which appears to be passed on to consumers.

Paying Less & Charging More

From October 2003, merchants have received a massive and ongoing financial benefit – estimated at \$2.2 billion⁷ – from the reduction of merchant service fees in the dominant card schemes⁸. Empowered and enabled to surcharge cardholders, merchants can increase this windfall by using the threat of surcharging to obtain further reductions from their merchant acquirers. And the benefits of these substantial reductions flow only to the merchant. They are not required to pass on these reductions to consumers; nor is there any evidence they have done so.

Merchant acquirers have seen an increase in surcharging, particularly by larger merchants in concentrated industries like transport and telecommunications, and by local monopolies such as toll road operators.

Although surcharging is not a customer-friendly practice, increasing numbers of retail and service providers now surcharge some or all credit cards; and many others use the threat of surcharge to influence consumers' choice of payment method or to negotiate lower prices from a merchant acquirer. American Express estimates that as a result of surcharging, consumers are now providing merchants with more than \$845million in additional revenue⁹ each year.

ACQUIRERS

In the past, a merchant acquirer had the ability to cancel a merchant's facility if its cardmembers were disadvantaged or exploited by a merchant; but the Merchant Pricing Standard, which prohibits an acquirer from taking any action that has the effect of prohibiting a merchant in Australia from surcharging, has arguably removed an acquirer's ability even to exercise the most basic choice as to who it does business with and thereby protect its brand from denigration by surcharging or discrimination. Merchant acquirers have not benefited from the credit card reforms any more than have consumers.

The ability to surcharge – or threaten to do so – has given large merchants a wide range of choices in dealing with acquirers. Acquirers are left with a binary proposition of lowering merchant service fees or suffering whatever damage a merchant chooses to inflict on the scheme's brand by surcharging. In this respect, the reforms have left acquirers with significantly reduced bargaining power.

BANKS AND FINANCIAL INSTITUTIONS

- 4.3 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 so¹⁰.

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 fees. To compensate for the loss of revenues from merchant service

7. RBA Reform of Australia's Payments System Issues for the 2007/08 Review, cl 93 at p. 22.

8. Over the three years from June 2004 to June 2007, merchant service fees declined by 15.4% (1.04% to 0.88%) on Visa and MasterCard; 10.3% (2.42% to 2.17%) on American Express and 4.8% (2.28% to 2.17%) on Diners Club. MWE Consulting Australian Payment Cards Report, June 2007 p17.

9. Calculation based on American Express proprietary information and publicly reported information.

10. At June 2007 the market share of credit card balances held by Australia's banks was 84.7%. APRA and RBA data cited by MWE Consulting in the Australian Payment Cards Report, June 2007 p9.

fees, the banks implemented a massive shift in credit card pricing from merchants to consumers. No bank has reported diminished profits or weaker results in its credit card portfolios as a result of the reforms. These matters are elaborated in the submission by ACIL Tasman.

REMOVAL OF THE NO-SURCHARGE RULE

- 4.4 Permitting unrestricted surcharging has given unlimited choice and negotiating power to merchants, some of whom already enjoy huge market power. It has promoted an environment where consumers have no protection against profiteering except to decline to proceed with a purchase, which may often be impracticable where time is pressing or an alternative merchant is not readily available.

Dominant suppliers with effective or near monopolies exist in a wide range of situations in Australia, whether as the sole petrol station or store in a remote location, the toll operator of the only practicable road, bridge or ferry in a given locality or a nationally dominant retail enterprise with a pervasive presence in all major shopping malls. The Australian consumer frequently has little or no choice except to deal with merchants who surcharge even to the extent of profiteering. To say that cardholders who are disinclined to pay the surcharge can go to a merchant who does not surcharge, or use another payment instrument, ignores the frequent reality of limited or no choice where consumer decisions are constrained by uneven bargaining power.

MODIFICATION OF THE HONOUR-ALL-CARDS RULE

- 4.5 The Honour-All-Cards Rule is fundamental to the continued function of the card payment system. An acquirer of a card scheme must be entitled to offer the basic certainty of acceptance to its customers and that means it needs to be able to require acceptance by its merchants of all scheme credit and charge cards at premises where the scheme brand is displayed. While debit has been singled out as a separate product set, there is no justification for not treating all charge and credit cards of a scheme in the same way at the point of acceptance.

Displaying a card scheme logo, be it Visa, MasterCard, American Express or Diners Club, on a merchant's premises is a representation that products bearing that scheme's branding are accepted on the premises. The logo of a card scheme signals assured acceptance of that scheme's products, not an invitation to cardholders to negotiate the terms of acceptance by entering the premises and presenting a card in the hope that they will not be made to feel embarrassed or uncomfortable by a merchant's surcharge, rebuff or request to use another payment method.

Australians travelling overseas routinely enjoy the reassurance of knowing that their credit and charge cards will be accepted without question by merchants displaying card scheme logos, a reassurance which transcends language and other cultural barriers. What sort of an impression will Australia create for its visitors if they are not afforded the same reassurance and certainty?

COMPETITIVE POSITION OF CARD SCHEMES

- 4.6 The overwhelming dominance of the four-party schemes has been entrenched by the reforms, in particular by the surcharge regime and the imposition of the common interchange regime on Visa and MasterCard from 2006. American Express continues to have comparatively small shares of the general purpose charge and credit card issuing and acquiring markets in Australia¹¹ and is very

11. RBA Bulletin Statistical Tables Payments System (CTables) C02 Market Shares of Credit and Charge Card Schemes, June 2007. Accessible on the Reserve Bank's website.

12. RBA Bulletin Statistical Tables Payments System (CTables) C03 Merchant Fees For Credit and Charge Cards, June 2007. Accessible on the Reserve Bank's website.

13. RBA Final Reforms and Regulation Impact Statement, 27 August 2002, page 34: "The Reserve Bank has not been persuaded that competition in the payment card market, strengthened by its reform measures, will encourage the growth of the smaller, higher cost card schemes over the larger, lower cost schemes in Australia. On the contrary, the freedom of merchants to charge a "fee for service" for credit and charge card acceptance can be expected to put strong competitive pressure on the higher cost card schemes and ensure that these schemes also bear the impact of the Reserve Bank's reforms."

14. American Express Australia Limited, "The Impact of the RBA's Credit Card Reforms, a Submission to the House of Representatives' Standing Committee on Economics, Finance and Public Administration, April 2006. Section 6 and the Appendix. This document can be accessed at <http://www.aph.gov.au/house/committee/efpa/rba2005/subs/sub006.pdf>

15. RBA Bulletin Statistical Tables Payments System (CTables) C03 Merchant Fees for Credit and Charge Cards, June 2007. Accessible on the Reserve Bank's website.

16. RBA Bulletin Statistical Tables Payments System (CTables) C02 Market Shares of Credit and Charge Card Schemes, June 2007. Accessible on the Reserve Bank's website.

much subject to competitive market forces. This is apparent in the accelerated decrease of its merchant pricing which began before the credit card interchange reforms and has been sustained over the last five years¹².

The implementation of the Interchange Standard in October 2003 caused an immediate one-time reduction in the interchange fees of the dominant schemes, as they were legally required to align their interchange pricing with the Standard's requirements from the prescribed date.

The Reserve Bank did not designate American Express for regulation under the Payment Systems (Regulation) Act as it does not have collectively-set interchange fees, has had a small market share at all times, and has never been a scheme comprising thousands of bank members. However, our merchant service fees have declined sharply in response to competition from the lower merchant fees of our competitors and pressure from merchants following the implementation of the Interchange Standard by the dominant schemes.

This outcome was an explicit assumption and expectation of the Reserve Bank when it published its final credit card reforms¹³. Furthermore, the Reserve Bank has ensured the realisation of its own prediction by its regulatory policy toward American Express coupled with its direct encouragement to merchants to bring pressure to bear on American Express in a series of unprecedented public statements by its senior officers¹⁴.

In 2002 American Express' average merchant service fee (MSF) was 2.57%. Since then, this has declined to 2.16% for the quarter ending June 2007¹⁵ – a reduction of 16%. American Express is clearly subject to competitive pricing pressure.

Market shares of credit card schemes tell a similar story. These are published in the Reserve Bank's monthly C02 Table on a consolidated basis for the dominant schemes and for the American Express and Diners Club three-party schemes. When the Interchange Standard came into effect in October 2003, the dominant schemes had 85.4% of the acquiring market calculated on the value of transactions and the three-party schemes had 14.6%. One year later, the share of the three-party schemes rose to what proved to be a high-water mark of 17.3% and has since settled back to fluctuate between 16% and 17%¹⁶.

Market share movements were not an inevitable result of the interchange reforms but just as readily reflect the combined effect of divergent business and product strategies adopted by Australian banks and American Express: -

- (i) A plausible business and product strategy by the banks would have been to maintain their profitability in the aftermath of the card reforms. As we have seen, this strategy would have entailed significant increases in card fees and related charges to consumers, combined with the reduction in value of cardholder rewards programs, as well as a heightened focus on encouraging 'revolve' behaviour, e.g. increased indebtedness by holders of consumer cards. On this basis it is not surprising if bank products temporarily became less attractive. Banks could have equally chosen the converse strategy, namely to maintain market share and reduce net income; *and*,
- (ii) American Express decided to maintain market share and product attractiveness even at the price of reduced profit margins. American Express launched a number of innovative card products throughout this period, including the Qantas American Express Corporate and Small Business Cards, the Rewards Maximiser Card, the Qantas

American Express Card series and the American Express Platinum Credit Card. All these products have continued American Express' strategy of delivering premium value products to card users.

The effect of sustained competitive pressure on American Express, driven by price reductions in the dominant schemes, and the effects of merchant surcharging – or the threat of surcharging – have prevented the three-party schemes from achieving anything more than a transitory high-water mark increase in market share of 3% in the 12 months following implementation of the card reforms which the dominant schemes have since beaten back to between 1.7% and 2.7%.

17. MoneySwitch Limited, trading as Tyro Payments. Further, the only new issuers to obtain SCCI authorisations and enter the market are GE Capital Finance Australia and GE Finance Australasia Pty Ltd which are divisions of a large multinational company which is well-established in the store cards market, an adjacent market to the general purpose credit card market. This list can be accessed at: <http://www.apra.gov.au/ADI/ADIList.cfm#SCC>

ACCESS ARRANGEMENTS

- 4.7 Far from encouraging new entrants, American Express submits that the reforms, with their reduction of interchange and merchant service fees, have caused a massive revenue reduction in the acquiring sector that has made the market unattractive to prospective entrants and stifled innovation by existing acquirers. Only one new acquirer has entered the market following the introduction of these reforms¹⁷.

5. Current Regulatory Approach and Alternatives

PUBLIC POLICY CONSIDERATIONS AND CONCERNS

- 5.1 From the inception of the debate over payments system reforms in Australia, American Express has maintained that the dominance of the four-party card schemes presented a classic trade practices or anti-trust problem which would have been most effectively resolved by addressing its root causes rather than its consequences.

American Express continues to believe that price regulation of interchange fees in the dominant schemes has defeated – and will continue to do so indefinitely – the otherwise commendable objective of stimulating competition from new market entrants.

However, on the assumption that the current interchange pricing regime is unlikely to be dismantled, then it should not be extended – for example by a move towards zero interchange fees or by any other invasive regulation – as that would further deepen the imbalance already created in the system, cause continuing uncertainty and further reduce the attraction of investment in the Australian credit card payment system.

Since 2003, there has been a significant increase in academic and theoretical writing on the subject of price regulation in two-sided markets. Our consultants, ACIL Tasman, in their separate submission to the Reserve Bank, will provide an overview of this writing, its implications for the Reserve Bank's regulatory model and its relevance to the current review process.

CASE FOR AMENDMENTS TO CURRENT REGULATIONS

- 5.2 While regulatory intervention reduced the level of interchange, the reforms have yet to achieve any of their stated goals other than that of providing cardholders with more appropriate price signals.

Price regulation has thus failed to produce any net benefits, as it has simply shifted costs and revenues within the existing system from one side of the market to the other, *i.e.*, from acquirers and merchants to issuers and consumers. However, price regulation has resulted in clear detriments. The cost to consumers of holding and using credit cards has increased without any demonstrable countervailing decrease in retail prices. In addition, merchants with a dominant market position have begun surcharging consumers who are already paying higher fees for all except the most basic card products.

American Express maintains that there is little evidence of benefit to any constituency except large merchants. Without a formal price surveillance program, there is no way to ensure interchange and merchant service fee reductions are passed on to consumers. Given the mutual benefits derived from this two-sided market, this distortion is clearly both inefficient and undesirable.

Further, limiting reforms to the card payment system has led to inaccurate price signals in other payment systems, where less efficient, less advanced forms of payment such as cash or cheque are left untouched due to inadequate information being provided as to the true costs and benefits to both merchants and consumers¹⁸.

18. Garcia-Swartz, D. D., Hahn, R. W. and Layne-Farrar, A. The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics. Review of Network Economics 5, 2006, pp. 175-198; Chakravorti, S. Theory of Credit Card Networks: A Survey of the Literature. Review of Network Economics 2, 2003, pp. 50 – 68; Gresvik, O. and Owre, G. Costs and Incomes in the Norwegian Payment System 2001: An Application of the Activity Based Costing framework. Norges Bank Working Paper ANO 2003/8, 2003, Oslo.

INTERCHANGE REGULATION

- 5.3 By setting a common interchange benchmark for both Visa and MasterCard, these two dominant schemes are effectively absolved from competing with each other. Neither can gain market share by using interchange fees to attract issuers. Their market shares are thus entrenched.

The Interchange Standard does not adequately address the phenomenon of premium interchange fees which the dominant schemes have lately begun to exploit. Currently, a regulated scheme's average interchange fee must not exceed the common cost-based benchmark on the three-yearly review date; as well as on any other date on which interchange fees are changed. Requiring compliance on any date where there is a change is no doubt intended to prevent undetected violations of the rules in the long periods between the review dates.

However, the wording of Paragraph 19 of the Standard poses a number of difficulties of interpretation which exacerbate rather than solve the problem of monitoring compliance with the Standard. In particular, it is not clear how a new and more complex interchange table such as those recently published by Visa and MasterCard (which interestingly take effect on June 30, 2007 and June 26, 2007 respectively) can be used to calculate the average interchange fees of a scheme based on transaction values in the previous financial year, *i.e.* a lag of 12 months. This presupposes that all transaction types in the new table can easily be identified in the prior year which seems questionable when so many new categories have been introduced. It would also seem to be difficult to enforce without a high level of monitoring and supervision.

SELF-REGULATION

- 5.4 Any initiative to consider self-regulation of card schemes in Australia as a possible alternative to either non-regulation or government regulation is confronted by the underlying lack of competitive diversity in the system.

Competition can be viewed either on the scheme or institutional level. At the scheme level, the overwhelming dominance of the two largest card schemes, after years of operating inappropriate, if not unlawful, multilateral interchange fees, continues undented. At the institutional level, the banking sector in Australia remains highly concentrated with the four largest banks retaining a collective dominance of both card issuing and acquiring sectors from well before and throughout the period of card reforms. Put another way, in the structure of the credit card market, nothing has changed.

This means that any self-regulatory program, which is considered as a replacement for the current interchange regime, is likely to reflect the competitive shortcomings of the Australian payments and banking sectors identified as requiring reform in the first place. It is difficult to see how the dominant card schemes or their members (the dominant banks) can set their own interchange fees after the reforms in a way which avoids the problems identified before the reforms. If the multilateral interchange system is to continue, it will still be a collective pricing agreement between institutions who are supposed to be competing with each other, in a situation where the payers and recipients of the fees are, for the most part, the same institutions.

SURCHARGING AND PROFITEERING

- 5.5 Surcharging causes harm to American Express' brand and subjects our cardholders to discriminatory and inferior treatment and potential profiteering. Changes to the surcharging regime are required to restore consumer choice, to address the continuing consumer protection deficit, and provide acquirers with appropriate choices in their relationships with merchants who agree to accept, and then later decide to surcharge, their cards.

American Express' pricing approach is based on the premium value we deliver to merchants from card acceptance. If a merchant is not convinced by this, the merchant is free not to accept American Express Cards. Because of American Express' small market share, acceptance of our cards is very much an option rather than a business necessity for any merchant. Merchants only accept American Express when they see a value in doing so.

Principles of freedom of contract and freedom of competition – which are currently the privilege of one side only – should be restored to this process. Acquirers should be entitled to reward merchants who do not surcharge through marketing programs and other incentives. As an alternative, an acquirer should be free to decide not to deal with a particular merchant.

Fundamentally, an acquirer should have the option to decide either to reduce its market share (reduced acceptance) and maintain its pricing strategy; or conversely, to increase or maintain its market share and reduce its prices. This is the free play of competitive forces which the Reserve Bank intended to release by the card reforms but which is currently available only to merchants and denied to acquirers.

In the United Kingdom, where the 'no-surcharge' rule was prohibited in 1990, the risk of price exploitation and misleading price advertising was recognised and addressed by the *Price Indication (Method of Payment) Regulations 1991*¹⁹, which impose the following requirements on merchants:

- (a) Notify price differentials – Where an indicated price does not apply to all methods of payment accepted by a merchant, the merchant should, before any contract of supply is entered into, make the consumer aware of:
 - which payment methods do not apply to the indicated price; and
 - the difference (expressed in \$ or as a percentage) as an addition to or deduction from the indicated price, for the other methods.
- (b) Display price conspicuously at premises – At each public entrance, payment point, on menus and any advertisement which invites consumer to place an order (e.g., by post, Internet, telephone).
- (c) Price statement requirements – Must be clearly expressed, accurate, unambiguous and easily identifiable as applying. Must not state that the price and payment method differentials are not to be relied on.

No comparable protection is offered to Australian consumers in connection with these reforms, which may affect the prices of a wide range of goods and services depending on a customer's choice of payment method.

These matters have received cursory treatment from Australian regulators, which is troubling, in so far as Australian consumers deserve as much protection from downright deception or exploitation as from inappropriate price signals.

19. The Price Indications (Method of Payment) Regulations 1991. Accessible via The UK Statute Law Database, the official revised edition of the primary legislation of the United Kingdom, at <http://www.statutelaw.gov.uk>

American Express is concerned that the ASIC Act, Trade Practices Act and associated fair trading legislation, without introduction of specific guidelines, are unlikely to provide adequate protection for consumers, or indeed merchants themselves, in terms of an understanding of what pricing conduct is lawful in the wake of the credit card reforms.

HONOUR-ALL-CARDS RULE

- 5.6 The Honour-All-Cards-Rule is fundamental to the continued function of the payment system. An acquirer of a card scheme should be entitled to require acceptance of all similar products bearing the brand of the card scheme, for example all debit cards or all charge and credit cards.

Displaying a card scheme logo, be it Visa, MasterCard, American Express or Diners Club on a merchant's premises is a representation that products bearing that scheme's branding are accepted on the premises. If uniform acceptance cannot be guaranteed, the acquirer should be free not to do business with the merchant.

MERCHANT CHOICE OF PAYMENT METHOD

- 5.7 Through the reform process, merchants, some of whom already enjoyed significant market share and negotiating power, gained unlimited rights to surcharge credit cards and to discriminate for or against any payment method. It is unnecessary to give merchants a further right to selectively to dishonour card acceptance agreements.

EXTENSION OF REGULATION TO ADDITIONAL SCHEMES

- 5.8 American Express submits that it would be unfair and inappropriate to regulate the three-party schemes.

As a three-party proprietary system, American Express neither collectively sets interchange fees nor enjoys market power in the general credit and charge cards market in Australia (or indeed anywhere else). That its merchant pricing is subject to competitive pressure can be seen in the continuing sharp decline in its average merchant service fees from 2002 onward.

It has been suggested that American Express has obtained some unfair advantage from the credit card reforms. In reality, its business remains subject to intense competitive and regulatory pressure. The suggestion overlooks the far longer and deeper advantage gained by the dominant schemes from many years of operating their multilateral interchange arrangements, during which they have built huge market shares. These arrangements are now subject to intervention by anti-trust and competition regulators in many countries²⁰.

The Reserve Bank correctly predicted the consequences of not including the three-party schemes in the interchange regime. The market share and pricing data published by the Reserve Bank indicates only a short term temporary movement in favour of the three-party schemes in 2004.

The Reserve Bank has applied a consistent *regulatory policy* to American Express with the explicit intention – and actual effect – of driving down its merchant pricing. 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 value business model makes it a more obvious target for merchants to surcharge.

20. Cases against Visa and MasterCard around the world are set out in extenso in the RBA's Reform of Australia's Payments System Issues for the 2007/08 Review, Chapter IV, clif 65-73 and in Table 2: Regulatory Developments Overseas – as at May 2007. Accessible on the RBA website at: www.rba.gov.au/PaymentsSystem/Reforms/RevCardPaySys/Pdf/issues_for_the_2007_2008_review.pdf

American Express has obtained no advantage from the reforms – our card business in Australia remains small and specialised, being still strongly focussed on our traditional corporate and travel and entertainment sectors. There is no case in the public interest or otherwise to subject American Express to additional regulation.

EFFECTIVENESS OF EXISTING ACCESS ARRANGEMENTS

5.9 Although the general purpose charge and credit card market in Australia continues to be vigorously contested by the existing players, it is our position that, rather than attracting new market entrants, the reforms have reinforced the dominance of the four-party schemes for the following reasons:

- a) The credit card reforms have entrenched the market shares of the dominant schemes and institutions and eliminated \$2.2 billion of interchange revenue from the industry of which aspiring entrants might reasonably have hoped to earn a share.
- b) The Specialised Credit Card Issuer (SCCI) regime of the Australian Prudential Regulation Authority (APRA) establishes authorisation criteria for SCCIs which are largely the same as for Authorised Deposit-taking Institutions (ADIs). SCCIs are subject to the same prudential requirements in respect of capital adequacy, board composition, fitness and propriety of directors and senior management, liquidity, credit quality, asset securitisation, large exposures, associations with related entities, outsourcing, external and internal audit arrangements and risk management systems as set out in APRA's relevant ADI Prudential Standards.

Given their specialised nature that may result in a concentration of certain types of risks, SCCIs are actually subject to a higher minimum capital ratio of 15 per cent than ADIs themselves. Although the intention of the 2004 Credit Access Regime was to eliminate the previous scheme rule that applicants for membership must be ADIs, the SCCI regime largely reproduces this requirement by subjecting aspiring SCCIs to an equally exacting set of financial and regulatory requirements as apply to ADIs.

- c) The reforms were first suggested in 2000 with the publication of the Reserve Bank and the Australian Competition and Consumer Commission (ACCC) Joint Study. The reforms were decided and published by the Reserve Bank in August 2002. They were implemented in 2003 and 2004, vigorously debated throughout 2004, reconsidered and affirmed by the Reserve Bank in 2005, further debated before the House of Representatives' Economics Committee in 2006; and are now subject to a review process which will not be concluded until late in 2008. The outcome of the present review and the future direction of payments system regulation remain unclear. The corporate resources – management time and professional fees – claimed by this subject in the last seven years are immense. The strategic and regulatory uncertainty engendered is disconcerting and has an inhibiting effect on investment decisions. It would require a high level of risk appetite for a potential new entrant to consider investing in a market entry or technical innovation strategy in this environment.

6. Recommended Changes to Current Standards and Access Regimes

To encourage competition, promote innovation and support the development and growth of a robust card payments market, American Express proposes a number of adjustments to the existing regulatory framework which would address unintended consequences and improve efficiencies resulting from the current reforms and benefit consumers and the market as a whole.

RECOMMENDED AREAS FOR ADJUSTMENTS TO CURRENT REGIME

Merchant Pricing

- 6.1 For reasons set out above at 4.2 – 4.5 and 5.5 and 5.6 above, American Express considers that a number of changes should be made to the Merchant Pricing Standard:
- a) An acquirer should be entitled, in its merchant agreements, to prohibit merchants from surcharging by more than the cost of card acceptance.
 - b) Where the acquirer charges only an *ad valorem* merchant fee, that fee should be deemed to be the cost of card acceptance.
 - c) An acquirer should not be required to maintain business relations with a merchant which surcharges by more than the cost of card acceptance and/or by more than it surcharges other card schemes.
 - d) An acquirer should be entitled to treat a merchant who does not surcharge more favourably than one which does and to enforce agreements freely entered into under which a merchant agrees not to surcharge in consideration of price reduction or other benefits.

In addition, consideration should be given to implementing detailed price regulations on the model established in the United Kingdom, to regulate the display of prices by merchants who choose to surcharge credit cards or any other payment methods.

Credit Card Interchange Fees

- 6.2 American Express proposes that the current interchange regime, if maintained, should be amended as follows:
- The common cost-based benchmarking process for the dominant Visa and MasterCard schemes should be discontinued and to encourage competition among the dominant schemes they should be required to calculate costs and set prices independently.
 - Consideration should be given to improving the provisions of the Interchange Standard to allow for a more transparent, practicable and real-time regulation of premium interchange fees in the dominant schemes and prevent those fees from being used to evade the objectives of the interchange regime.

Modification of Compliance Aspects of Interchange Standards

- 6.3 See proposals at 6.2 above.

RECOMMENDED AREAS FOR RETENTION OF CURRENT REGIME

If the changes outlined above do not find favour, no further extension of the current interchange regime should be implemented.

Further regulatory intervention under the Payment Systems (Regulation) Act – whether or not it would entail an extension of the Reserve Bank’s powers under that statute – would further deepen the imbalance already created in the credit and debit card systems, cause further uncertainty and further reduce both the attraction of investment in those systems and the confidence of consumers who use them.

Setting Interchange at Zero

6.4 American Express considers that no extension of the present interchange regime is called for and that there is no more justification for setting interchange fees at ‘zero’ than there is for capping them at the current cost-based benchmark.

This is consistent with our general view that price regulation of the card industry does more harm than good; and is in line with recent economic literature in this field, which is reviewed in the submission by ACIL Tasman, suggesting that setting fees at zero could have perverse effects.

In particular, it is our position that there is no justification for:

- curtailing the allowable cost categories for the purpose of calculating issuer’s costs. Fraud and interest free days should continue to be allowable costs; and consideration should be given to including increased or new costs arising from the need to prevent and manage identity theft and data compromise risks; or
- extending price regulation into other areas of scheme pricing.

Modifications to the Honour-All-Cards Rule to Include Premium and/or Pre-Paid Cards

6.5 No further modifications of the Honour-All-Cards Rule should be made for the reasons set out at 4.5, 5.6 and 5.7 above.

Extension of RBA Powers to Set Interchange Directly

6.6 American Express maintains it would be best if market forces were allowed to set interchange fees. It considers that the Reserve Bank’s current regulatory powers to intervene in, and regulate all aspects of payment systems, are far-reaching and ample.

Availability of Information on Payment Systems

6.7 The Reserve Bank currently exercises extensive powers to obtain information about payment systems. American Express does not consider that additional information needs to be compiled or published by the Reserve Bank.

The Reserve Bank’s Payment Systems Bulletin ‘C Tables’, which are published monthly, provide objective benchmarks on the effects of its credit card reforms and should be maintained in their current form. We submit that the current availability and transparency of information has achieved the Reserve Bank’s goal of improving the flow of information to provide the basis for better and more informed decisions.

ALTERNATIVES TO THE CURRENT SCHEME OPERATION

- 6.8 As the Reserve Bank is aware, the dominant schemes have embarked on a far-reaching and significant process of change to their corporate structures, starting with MasterCard's Initial Public Offering. In the context of these changes, and as an alternative to regulation altogether, consideration should be given to implementing governance changes to require the dominant schemes to:
- a) restructure their wholesale price-setting process to eliminate problematic collective price-setting features; and
 - b) promote competition between them.

Appendix : Summary of Questions & Responses

American Express is pleased to summarise its responses and comments provided to the issues and questions set out in Section VI: Issues of the RBA's *Reform of Australia's Payments System Issues for The 2007/08 Review*.

RBA ISSUE OR QUESTION	AEAL RECOMMENDATION OR RESPONSE
Q1: What have been the effects of the reforms to date?	
The effect of the interchange fee reforms on cardholders and merchants	<p>Consumers have borne the cost of these reforms. To maintain their profitability following the reforms, the banks adopted deliberate business and product strategies to shift fees from merchants to consumers.</p> <p>When faced with reduced merchant fees they increased cardholder fees and/or reduced the value of consumer card reward programs. These strategies have increased the cost to consumers of holding and using credit cards. Banks moved costs to consumers. See Section 4.1</p> <p>American Express submits that merchants – especially large merchants with market power in concentrated industries – have benefited most, and at the expense of other key stakeholders, from the credit card reforms. Merchant benefits from the reforms include: lower merchant service fees; increased bargaining power with acquirers from the ability – or the threat – to surcharge; and the potential for a new independent line of revenue from surcharging profits, none of which appears to be passed on to consumers. See Section 4.2</p>
The effect of the interchange fee reforms on financial institutions	<p>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. They have merely implemented a massive shift in credit card pricing from merchants to consumers. No bank has reported diminished profits or weaker results in its credit card portfolios as a result of the reforms. See Section 4.3</p>
The effect of the removal of the no-surcharge rule	<p>Permitting unrestricted surcharging has given unlimited choice and negotiating power to merchants, some of whom already enjoy huge market power. It has promoted an environment where consumers have no protection against profiteering except to decline with a purchase. See Section 4.4</p>
The effect of the modification of the honour-all-cards rule	<p>The Honour-All-Cards Rule is fundamental to the continued function of the payments system. An acquirer of a card scheme must be entitled to offer the basic certainty of acceptance to its customers and that means it needs to be able to require acceptance by its merchants of its cards at premises where the scheme brand is displayed. See Section 4.5</p>
The effect of the reforms on the competitive position of different payment systems	<p>The overwhelming dominance of the four-party schemes has been entrenched by the reforms, in particular by the surcharge regime and the imposition of the common interchange regime on Visa and MasterCard; while American Express which has, and continues to have, comparatively small shares of the general purpose charge and credit card markets, is very much subject to competitive market forces. See Section 4.6</p>
The effect of changes to access arrangements	<p>Far from encouraging new entrants, it is our submission that the reforms, with their reduction of interchange and merchant service fees, have caused a massive revenue reduction in the acquiring sector that has made the market unattractive to prospective entrants. No new acquirers have entered the market following the introduction of these reforms. See Section 4.7</p>

Q2: What is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach?	
What are the characteristics of payments systems that have given rise to public policy concerns, particularly over interchange fees?	American Express maintains that the dominance of the four-party card schemes presented a classic trade practices or anti-trust problem which would have been most effectively resolved by addressing its root causes rather than its consequences. See Section 5.1
The conditions under which current regulations could be removed or relaxed	American Express continues to maintain that price regulation of interchange fees in the dominant schemes has defeated the objective of stimulating competition from new market entrants. If the current interchange pricing regime cannot be dismantled, then our strong preference would be that further interference is avoided and that the RBA allow stability to return to the markets, i.e., it should not be extended further. See Section 5.2
The extent to which the Bank's public policy concerns could be addressed through self-regulation	In the context of far-reaching changes to the corporate structures of the dominant schemes (MasterCard's public offering and listing) and as an alternative to regulation altogether, consideration could be given to implementing governance changes to require the dominant schemes to restructure their wholesale price-setting process to eliminate problematic collective price-setting features and promote competition between them. No further extension of the current interchange regime should be implemented except as suggested in Section 6. See Section 5.4
The extent to which the no-surcharge rule alone could address the Bank's concerns over interchange fees	Changes to the surcharging regime are required to restore consumer choice, to address the continuing consumer protection deficit and provide acquirers with remedies and rights against merchants who agree to accept and then surcharge users of their cards. See Section 5.5
The extent to which the structure and rules of payment schemes affect competition by limiting the ability of merchants to influence which payment method is used	The RBA reforms empowered merchants at the expense of acquirers and consumers. This has lessened competition, and created a significant consumer protection deficit which has yet to be addressed and reduced the efficiency of the payments system. See Sections 5.5, 5.6 and 5.7
The regulation of other payment systems, including American Express, Diners Club and BPAY	American Express submits that regulation of other payment systems was not warranted at the outset and that this continues to be the case. The RBA's reasons for not regulating American Express have proved justified. American Express has cooperated with the RBA's regulatory reforms. It would be redundant and counter to the Bank's stated preference for self regulation and to promote competition to pursue formal regulation of the smaller, three-party schemes. See Section 5.8
The effectiveness of existing access arrangements	Although the card market in Australia continues to be vigorously contested by the existing players, it is our position that the reforms have entrenched the dominance of the four-party schemes rather than attracting new market entrants. See Section 5.9

Q3: If the current regulatory approach is retained, what changes, if any, should be made to standards and access regimes?	
A further reduction in credit card interchange fees and/or the adoption of a uniform approach to the setting of all regulated interchange fees	The current interchange regime, if maintained, should be amended to encourage competition among the dominant schemes by ending the common cost-based benchmarking process for the dominant schemes which has entrenched their market shares. Visa and MasterCard should be required to compete with each other by having to calculate costs and set prices independently. Additionally, the Interchange Standard should allow for transparent, practicable and real time regulation of premium interchange fees in the dominant schemes. Section 5.3 and 6.2
Setting all interchange fees to zero	Consistent with its general view that price regulation of the card industry does more harm than good, American Express considers that no extension of the present interchange regime is called for and that there is no more justification for setting interchange fees at 'zero' than there is for capping them at the current cost-based benchmark. See Section 6.4
Modification of the compliance aspects of the interchange standards	American Express proposes that the current interchange regime, if maintained, should be amended to encourage competition among the dominant schemes by ending the common cost-based benchmarking process for the dominant schemes which has entrenched their market shares. Visa and MasterCard should be required to compete with each other by having to calculate costs and set prices independently. Additionally, the Interchange Standard should allow for transparent, practicable and real-time regulation of premium interchange fees in the dominant schemes. See Sections 6.2
Modifications to the honour-all-cards rule to include premium and/or pre-paid Cards	No further modifications of the Honour-All-Cards Rule should be made. See Section 6.5
The regulation of interchange fees on EFTPOS cash-out transactions	American Express maintains it would be best if market forces were allowed to set interchange fees. We consider that the Reserve Bank's current regulatory powers to intervene in, and regulate all aspects of payment systems, are sufficient. We do not favour extension of those powers. See Section 6.6
Possible changes to legislation to allow the RBA to set interchange fees directly	American Express maintains it would be best if market forces were allowed to set interchange fees. It considers that the Reserve Bank's current regulatory powers to intervene in, and regulate all aspects of payment systems, are sufficient. It does not favour extension of those powers. See Section 6.6
The availability of information on Australian payment systems	The RBA already has extensive powers to obtain information about payment systems. The current availability and transparency of information has achieved the RBA's goal of improving the flow of information to provide the basis for better and more informed decisions. American Express does not consider that additional information needs to be compiled or published by the RBA. See Section 6.7