Productivity Commission
Competition in the Australian Financial System

Draft report – American Express submission

## Introduction

American Express welcomes the opportunity to provide comment on the Draft Report of the Productivity Commission review of competition in Australia's financial system.

The development and operation of a competitive and stable financial system is essential to the growth and efficiency of the Australian economy. Progressive structural reform and liberalisation efforts since the 1980s have largely generated significant prosperity and supported an unrivalled period of local economic growth. However, continued success requires measured and timely regulatory and legislative changes that meet the expectations and interests of industry, consumers and the wider market. It is critical that regulation remains relevant in the current and foreseeable future and provides the ability for industry to innovate and invest.

American Express is a global payments network that has relationships with both customers and merchants. It provides innovative payment, travel and expense management solutions for individuals and businesses of all sizes. With a 168 year history built on service, trust and security and with one of the most recognised brands in the world, American Express aspires to provide the world's best customer experience every day.

The American Express network processes US$1.4 trillion in transactions globally per year across 140 countries. With over 110 million American Express cards in circulation, accepted by millions of merchants world-wide, American Express is the world's largest card issuer by purchase volume.

We welcome the opportunity in this response to provide an overview of our card scheme and also set out our recommendations as follows:

- Policy developments should promote competition between card schemes in the payments sector; and
- Policy formulation should be left to the RBA, given its existing oversight in this area.

## The American Express model

American Express operates a proprietary payments network in which it acts as both issuer and acquirer. In particular, the vast majority of American Express-branded cards worldwide, and the vast majority of transactions on these cards, are issued and acquired by American Express itself. This is in contrast with the four party models used by the dominant Visa and Mastercard networks, where neither Visa nor Mastercard issue cards or acquire transactions – these processes are completed by their member financial institutions, with Visa and Mastercard operating simply as the payment networks.

This closed loop of transaction information provides American Express with significant insight into card spending on the network. These insights are used to develop unique marketing programs and offers to attract premium customers and encourage spend at American Express-accepting merchants. These are capabilities that open loop systems, such as Visa and Mastercard, each with over 15,000 financial institution members, cannot duplicate effectively.

In recent years, American Express has established licensing relationships with a number of partner banks internationally to support the expansion of broader geographic coverage. This has led to American Express cards being issued by a range of financial institutions, and in Australia, we saw this with the issuing agreements entered into with ANZ, Commonwealth Bank, NAB and Westpac. Recent changes to regulation in 2017 have already had a significant impact on these issuing relationships and American Express' ability to compete with Visa and MasterCard. ANZ and NAB have recently exited these relationships, and Westpac has announced that it will exit in April 2018.

Our unique business model and differentiated brand proposition enables us to compete with the larger and wider-ranging financial institutions in the payments ecosystem, including the pervasive Visa and Mastercard networks. Our ability to select industry partners carefully and confidentially negotiate and agree the terms of these partnerships enables American Express to maintain the advantages of a closed loop model and offer viable, pro-competitive alternative value propositions to cardholders and merchants.

The terms of these arrangements are typically confidentially and bilaterally negotiated and agreed directly between American Express and each partner, unless regulation has capped the commercial terms, as has happened in Australia. We would underscore that no licensees agree terms with each other, which is a key difference between our scheme and the dominant four-party card schemes, where such fees are referred to as "interchange fees". For Visa and Mastercard, the common pricing structures between acquirers and issuers, which create a floor on merchant fees for card acceptance in schemes that merchants consider to be a "must have" payment option, have prompted interchange fee regulation. American Express's operations do not raise these regulatory policy concerns.

Nonetheless, due to the broad scope of the caps that have been introduced, our arm's length commercial terms previously negotiated with our licensees have been brought into the scope of such price caps, in Australia. This broad extension of regulation has resulted in harmful consequences for competition and choice, given our licensees are as a result incentivised to work only with the dominant cards schemes going forward, given their "must have" status in the payments sector. Lowering such caps will only serve to further reduce competition in this space.

## Competition between card schemes in the payments sector

The Draft Report of the Productivity Commission review of competition in Australia's financial system presents a raft of recommendations across all arms of government regulation, including lending, insurance, superannuation and payments. In response to this draft report, American Express will focus comment on draft recommendation 10.3.

Regulation to control interchange pricing across the global payments system fails to recognise and accord appropriate weight to the extent of competition at the network, issuer and acquirer levels across the two-sided payment sector, and also ignores significant emerging local and international trends that drive competition and deliver investment benefits to all segments of the payments ecosystem. It is for this reason, and for the subsequent arguments outlined below, that American Express strongly opposes further regulation as proposed in draft recommendation 10.3.

As economists and regulators around the world have recognised, price regulation discourages investment and innovation, and is an extreme measure which should only be considered in cases of true market failure. American Express is mindful that the Australian payments landscape is already heavily regulated and currently undergoing rapid and fundamental change, with the emergence of innovative technologies and alternative payment methods offered by new entrants as well as established participants. There is a unique opportunity to trigger significant investment and innovation by existing and new competitors, but only if Australia fosters the right competitive environment. Imposing further price regulation at this juncture runs the risk of freezing innovation at a time of digital transformation of the Australian economy.

This has been a consistent experience faced in all countries around the world where payment regulation has arisen. Rather than supporting a robust card payments sector, regulation of payments distorts market dynamics, suppresses competitive tension between ecosystem participants, and reduces investment in innovation.

Substantial investments are necessary to establish and maintain a competitive payments network, and extensive services are an inherent part of that network. These include: establishing technical and operational standards to ensure global interoperability within the system; providing authorisation, clearing, settlement and recording of transactions; managing settlement risk; maintaining a system for resolving disputed transactions between the various parties; certifying third-party vendors that provide services to network participants; marketing and promoting the network and the brand; and developing and providing value-added services to issuers, acquirers and cardholders.

Since American Express developed the first credit card network, there has been considerable investment to develop and operate a global network and the physical infrastructure (e.g. cards, terminals, processing platforms, etc.) needed to facilitate payments. American Express has focused on developing a worldwide network not just a purely domestic, America-centric network and many of the features of the American Express model were adopted by a range of payment networks that later emerged during the 1960s and 1970s.

The inter-connected nature of demand in a two-sided market, such as a payments system, means the value to cardholders increases with the number of merchants that accept the product, and the value to merchants increases with the number of cardholders who use the product. As a result, both issuers and acquirers need to be provided with incentives to increase the number of participants on each side of the market (i.e., cardholders and merchants). Issuers and acquirers need to incur significant costs aimed at attracting cardholders and merchants to the network.

At the same time, it is also necessary for issuers and acquirers to ensure that the costs to cardholders and merchants of using the network are set at a level that does not deter participation in the payments system on either side. These factors affect the costs that issuers and acquirers incur, the benefits offered to cardholders and merchants, and the structure of transaction pricing. .

Furthermore, card payment services to cardholders and merchants are not commodities subject only to cost considerations, but rather deliver value-added propositions beyond the mere provision of payment processing services. Benefits to merchants include transfer of customer credit risk, a payment guarantee and the financial benefit of payment received before the cardholder pays, cash flow benefits through credit advanced to cardholders by the card issuer, fraud mitigation services, as well as innovative and differentiated marketing and sales opportunities. We would urge the Productivity Commission to not recommend the implementation of further price controls which can be expected to threaten many of these important benefits to merchants and consumers.

When reviewing the economics of the payments system in totality, it is important to assess the full range of benefits to consumers and merchants and give sufficient weight to the operational efficiencies and cost savings that merchants realise by accepting electronic payments.

Central to a merchant's decision-making process is the cost of payments acceptance relative to other methods of payment, and relative to the overall benefits to be derived from electronic payments acceptance. There are substantial costs to merchants in accepting cash, cheques, or other forms of payment, and a number of operational efficiencies and cost savings that merchants can extract through card acceptance.

In addition to direct transaction cost savings from usage of electronic payments, merchants also receive a number of other benefits from card acceptance which, taken together, attract merchants to card networks. These benefits include a payment guarantee, efficient payment processing and processing services, marketing and rewards programs that drive spend to merchants, and a wider range of sales channels (online, mobile, telesales, postal, etc.) where consumers may not otherwise spend without the security and instant credibility provided by electronic payments.

It is important to take into account the added expense and difficulty that merchants would face if they tried to duplicate the services provided by electronic payment networks. The scale of payment networks enables this risk-shifting and guarantee of payment for relatively modest fees to merchants. If merchants were to seek to obtain similar protection from an insurance provider, not only would it be more expensive, but the same scope of coverage might not be available everywhere across Australia or across all industries for any price.

The negative impact of price regulation is clearly evident in Australia, and has been since the introduction of price regulation by the Reserve Bank of Australia (RBA) in 2002. While regulatory intervention reduced interchange levels through the introduction of caps and a weighted average, consumers have not benefited, with merchants largely absorbing the cost reduction as increased margin. Additionally, price regulation has resulted in clear detrimental impacts to the market. The costs to consumers of holding and using credit cards has increased without any demonstrable countervailing decrease in retail prices and merchants with a dominant market position have surcharged consumers for use of credit cards as an additional means to increase margin. The unfavourable results of this experiment in Australia should strongly dissuade and deter further regulatory intervention that could potentially distort the market even further.

Many payments regulators around the world are currently implementing regulation designed to reduce cash payments and increase the take up of electronic card payments to protect and increase reported tax revenues. Unfortunately, the Australian payments regulatory experience continues in the opposite direction, reducing the attractiveness of using electronic payments while increasing the attractiveness of using cash. Proposed additional regulatory intervention would continue this trend and erode the substantial benefits of a digital economy.

## Payments regulation in Australia

While American Express notes the interest of the Productivity Commission to investigate and assess the most efficient and competition-generating regulatory settings for the Australian market, it is worth noting the extensive existing role of the RBA in regulating the payments system. As the primary custodian of monetary policy in Australia, and independent of government, the RBA is responsible for ensuring stability, efficiency and competition in Australia's payments system. Following the Financial System Inquiry in 2015, the RBA conducted a review of card payments regulation, which resulted in a series of changes to the payments system. Among the changes included a significant reduction in interchange, both the threshold of a weighted average, the introduction of interchange caps, substantial changes to interchange compliance periods and the introduction of interchange on limits on corporate and business payments. These changes have led to major disruption across the payments industry, and have already dramatically altered the competitive landscape of the ecosystem.

During the 2015-16 review, the RBA investigated a potential reduction in interchange rates to zero. This was rejected by the RBA on the grounds that this would increase the risk of unexpected effects on the competitive balance between three and four-party models, increase the likelihood of circumvention efforts and introduce general instability in the payments system, particularly if the reduction was as dramatic (reducing from the previously higher interchange rates)[1]. As such, the RBA rejected this option and took a step-down approach to interchange. Subsequently, the RBA further noted that it would be unlikely to review interchange settings again until at least 2020-21, acknowledging the market disruption and investment uncertainty created by continual intervention in payments system regulation.

[1] http://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/pdf/review-of-card-payments-regulation-conclusions-paper-2016-05.pdf

In light of:

(a) the RBA's role in payments system regulation;

(b) the fact that new interchange regulation has only recently been adopted, so little time has passed to review and fully understand the impact of this latest intervention on market dynamics;

(c) the risks associated with any further changes to interchange settings; and

(d) the RBA's position on zero interchange settings during the most recent regulatory review,

American Express recommends the Productivity Commission abandon draft recommendation 10.3. Further capping interchange pricing at this time will only harm consumers and merchants, as well as competition, innovation and choice more generally.

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