AMERICAN EXPRESS SERVICES EUROPE LIMITED

COMMENTS IN RESPONSE TO THE SOUTH AFRICAN COMPETITION COMMISSION'S ENQUIRY INTO COMPETITION IN BANKING

CONTAINS BUSINESS SECRETS

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(1) Introduction

This Response is provided on behalf of American Express Services Europe Limited ("Amex").

Amex welcomes the opportunity to comment on the South African Competition Commission's enquiry into competition in banking (the "Enquiry"). As a significant competitor in the global payments industry, Amex monitors worldwide regulatory developments which concern the payments industry. Amex has expertise in the payments business, including money transmission, foreign exchange and travellers cheques services, specifically concerning credit and charge cards, and emerging payment products. It has participated in enquiries and investigations, *inter alia*, by the Reserve Bank of Australia ("RBA") and Australian Competition and Consumer Commission ("ACCC"), the Office of Fair Trading ("OFT") in the United Kingdom, and more recently, as a stakeholder, in the European Commission's ("EC") sector enquiry into retail banking[1].

Amex understands that the South African Competition Commission (the "Commission") will focus on payment cards as a distinct segment of the Enquiry. Accordingly, in the interests of effective consultation, transparency and enhanced competition in the payments industry generally, Amex wishes to contribute to the Enquiry and its consequent debate.

In this regard, Amex will:

- furnish key information about its distinctive business model;
- furnish general information relating to the differences between closed, or proprietary payment systems *versus* open, association-based payment systems;
- offer some high-level insights into the nature of the credit and charge card business, with some emphasis on credit and charge card payment networks, as well as the pricing mechanism of interchange used by most association-based card networks; and
- discuss the nature of two-sided markets, the benefits to consumers and merchants arising from the use of credit and charge cards[2], and in this context

1 Interim Report I (Payment Cards): Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, 12 April 2006.

2 Charge cards require the balance to be paid in full every month. Credit cards allow the cardholder to delay payment of all or a portion of the balance under a revolving credit line which can be tailored to the financial situation of the cardholder. Both are distinguishable from debit cards, which debit the cardholder's current account for the amount of a charge immediately upon conclusion of the charge transaction. Throughout this Response, references to "credit cards" include credit cards and charge cards.

suggest why price regulation – should it be contemplated following the Enquiry – is inappropriate for the credit card industry.

Amex is willing to answer questions or provide clarification to the Commission on any pertinent issues arising out of the Enquiry, or these submissions, and indeed to meet with the Commission should it be appropriate to do so.

(2) The American Express business model

There are two general components to the Amex's card business: its proprietary card business and the non-proprietary card business conducted by its partner banks and overseen by its Global Network Services ("GNS") business unit. Both are discussed below.

(a) Amex's Proprietary Business

Amex's credit card network may be differentiated from other credit card networks such as MasterCard and Visa, on the following bases:

(i) Proprietary Business Model. Amex operates a proprietary business model, rather than the co-operative or association-based models under which Visa and MasterCard have historically operated, because Amex itself operates the network and typically acts as both the issuer and acquirer of cards.[3] The vast majority of American Express-branded cards, and the vast majority of transactions on these cards, are issued and acquired by Amex itself. Amex's merchant arrangements are bilateral agreements between the merchant and Amex as an acquirer. The existence of third parties licensed under Amex's GNS business (discussed below) to issue Amex cards does not change this assessment, as these issuers do not own or control Amex, nor do they have any role in establishing prices charged to merchants. Licensees do not collectively agree on any of the rules under which the Amex network operates, and there is no fee - in particular an interchange fee – and no settlement between these licensees: Amex settles individually with each entity on a bilateral basis.

(ii) Premium Segment. Amex's credit card network is focused on the premium segment – aimed at high-spending, financially reliable cardholders - thereby offering a significant range of innovative and value-added benefits to merchants and cardholders above those generally available from other credit card networks. Merchants recognise the attractiveness of the American Express cardholder base and, in general, are willing to pay a premium in recognition of the value that these high-spending, loyal cardholders bring to the merchant. No merchant is required to accept American Express cards. Acceptance of American Express cards is a choice that merchants make because of the value delivered through the Amex network.

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3 Proprietary models are often described as "3-party" models, and association-based models as "4-party" models. Amex considers such terms to be inaccurate as to the structure and operation of networks.

(iii) Spend-centric. Amex's credit card network is based on a spend-centric model, rather than on a lending model. Rather than obtaining revenue primarily from interest charges on revolving balances (as is the case with Visa and MasterCard card issuing financial institutions, many of which obtain a large proportion or even a majority of their card revenue from interest payments), Amex obtains most of its revenue from merchant and cardholder fees.

A diagram of the Amex proprietary model is attached as Schedule 1.

(b) Global Network Services

Amex also operates what is known as its Global Network Services, or GNS, business, which essentially maintains a small number of licensing arrangements with approximately 100 partner banks world-wide, primarily to extend the geographic coverage of the Amex card service to countries where there is a weak business case for Amex to enter the market unilaterally as a proprietary business (as described in 2(a) above), and where such a market would be better served by a strategic alliance with a local partner. This is the case with Nedbank in South Africa which has held the exclusive license for the American Express brand for approximately thirty years.

These licensee or partner banks are not "members" of any association or card scheme as has been the case with MasterCard[4] and Visa[5]. They do not form any kind of joint venture or "association" and have no legal or commercial relations *inter se.* These licensees have no ownership interest in Amex (Amex is a fully publicly traded company). They do not collectively agree on any of the rules under which the Amex network operates. There are no interchange, interbank or settlement fees passing between such banks.

Rather, each Amex partner bank licensed to issue or acquire Amex cards on Amex's behalf negotiates all transaction and other fees bilaterally and confidentially with Amex, and Amex assumes the risks of balancing the separate commercial terms of such arrangements. Amex is the "hub" in a purely "hub and spoke" model. In each transaction involving different issuing and acquiring banks (an exception to the norm in the Amex proprietary model), Amex settles with each bank individually. Accordingly, Amex does not act as a clearing or settlement agent between any banks.

Amex's business model permits it to operate as a significant niche player, focusing principally on providing premium services to high net-worth card members and Amex merchants. In so doing, Amex offers real competition to the larger association card schemes of Visa and MasterCard. Amex's business model has also enabled it to introduce market-leading innovations which further underpin inter-brand competition in markets

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4 In May 2006 MasterCard International underwent an initial public offering ("IPO") and became a public company listed on the New York Stock Exchange. As such, MasterCard still licenses member banks and, albeit to a much lesser extent, permits such licensees to participate in governance.

5 On October 11, 2006 Visa announced that it will also restructure towards an IPO with a listing on a major international stock exchange. Visa Europe will continue as an association-based scheme, becoming an exclusive licensee of the new Visa corporation.

where it operates. Amex, as an innovative competitor to Visa and MasterCard and, indeed to payment service providers generally, has used its differentiated business model to enhance credit card competition, and believes its model to be pro-competitive and fundamentally different from the Visa and MasterCard association-based systems. Amex considers this differentiation to be an important means by which it is able to attract licensed issuers, most of which also issue Visa and/or MasterCard credit cards. Indeed, Amex believes that all credit card networks, including Visa and MasterCard, must compete aggressively to attract issuers.

A diagram of a typical GNS arrangement is attached as Schedule 2.

[redacted]

[redacted]

(4) <u>The Two-sided nature of payment networks</u>

(a) Generally

Credit card transactions between cardholders, on the one hand, and merchants accepting credit cards as a payment method for goods purchased, on the other hand, pass through a payment system or network. This inter-connected nature of demand in such a two-sided market means that the value to cardholders increases with the number of merchants that accept the card, and the value to merchants increases with the number of cardholders who use the card – the so-called "network effects" principle. As a result, both issuers of credit cards and acquirers of card transactions need to be provided with incentives to increase the number of participants on each side of the market (*i.e.*, cardholders and merchants). In turn, merchants must be provided with incentives to accept cards and cardholders must be provided with incentives to adopt and use them as means of payment in order to attract both merchants and cardholders to the network. The network must balance the costs of participation in such a way as to take into account this *inter-connected nature* of the network and thereby maximize participation in the network. It does so principally by interchange pricing.

In particular, issuers and acquirers incur significant costs aimed at attracting cardholders and merchants to the network. Such costs can be particularly high in the early phases of network development. 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 network, nor card usage. These factors affect the costs that issuers and acquirers incur, the benefits offered to cardholders and merchants, and the structure of per-transaction prices charged to each side of the market as well as non-transaction related fees. The allocation of responsibility for cost recovery in turn affects the level of participation on each side of the market. Indeed, this is the defining feature of two-sided markets, and should be taken into account by any regulator or competition authority in its assessment of the state of competition in payment card markets, and any formulation of potential regulations.

Accordingly, any such regulator or competition authority should take into account the benefits and value that credit card acceptance provides to consumers and merchants, and to the investments that the credit card networks have made in delivering this value. The view of a regulator or competition authority should be based on a properly balanced assessment of the benefits to cardholders and to merchants. These benefits may be absolute or relative, and are detailed below.

(b) Principal Benefits to Merchants and Cardholders

As mentioned above, credit card usage offers a number of benefits to consumers. The importance of these benefits in attracting cardholders must be recognised as an essential feature of two-sided markets.

(1) Specific benefits to cardholders

(i) Convenience and Flexibility. Credit cards offer consumers the convenience of being able to shop and travel without having to carry large amounts of cash, which could make them vulnerable to loss or theft. The credit extension provided by card issuers enables consumers to buy items they need when they need them, or when the price of a desired item is reduced, without having to obtain cash or check their current account balances at that particular time. This financial flexibility enables consumers to manage their finances in a manner that serves their needs.

(ii) International Spend. Credit card issuers on the global general purpose card networks provide consumers with the ability to travel and transact business nationally and internationally. Customers benefit from the investments made by the global credit card networks to establish reliable electronic payment networks that operate in a uniform manner worldwide.

(iii) Value-Added Services. Consumers benefit from card issuers' and network innovations in developing services tied to card usage, such as purchase protection insurance, travel insurance, and rewards schemes.

(iv) Dispute Resolution. Consumers benefit from having the right to dispute credit card transactions. Network rules enable cardholders to dispute transactions that were not authorised (because, for example, they were made with a stolen card or account number), that were processed for the incorrect amount, or were for merchandise that was not delivered or was unsatisfactory. These rights give consumers the confidence to make purchases from unfamiliar merchants, including on the Internet.[6]

(2) Specific benefits to merchants

It is important in a two-sided market to increase the number of merchants that accept cards within the credit card network. It is therefore necessary to offer valuable benefits ***specifically*** to motivate card acceptance, particularly given that there is now a variety of payment methods available and that merchant acceptance of credit cards is optional. It is a merchant's choice to accept credit cards, or indeed to accept only certain credit cards. Merchants may "multi-home" by accepting multiple cards, or may choose instead to accept only one particular card, knowing that many customers are likely themselves to have multiple credit

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6 By way of example, such protection is available in the U.K., the largest credit card market in Europe. The value of such protection was visibly demonstrated following the collapse of certain airlines in the wake of the 11 September 2001 terrorist attacks, as consumers who used credit cards to purchase tickets on a non-flying airline (*e.g.*, Sabena, SwissAir) were able to obtain refunds from their card issuers. (See, *e.g.*,http://www.hasbrouck.org/articles/bankruptcy.html, http://www.cbc.ca/news/background/airlines/.)

cards. Merchants are therefore able to weigh the costs of card acceptance against the benefits, and a very high percentage of merchants worldwide choose to accept credit cards for the value, operating efficiencies and cost savings that credit card acceptance provides, and because many customers prefer to pay with credit cards. [redacted]

Merchants receive a number of significant benefits which lower their costs and reduce their risks. These include:

(i) Payment Guarantee. Merchants benefit from the ability of customers to purchase on credit without the merchant having independently to verify the customer's creditworthiness. Merchants are thus able to gain sales from customers seeking to buy on credit, but need not incur the fraud and credit risks and processing costs associated with in-house or store card credit schemes. Provided that the merchant follows procedures described by the credit card networks and merchant acquiring bank, the merchant is guaranteed payment for customers' credit card purchases, even if the customer defrauds the card issuer, or becomes financially unable to pay the card issuer. Accepting credit cards means that the merchant is able to shift his own customer credit and fraud risks to the card issuing and merchant acquiring banks.

(ii) Prompt and Efficient Payment. Merchants receive payment electronically, typically in conjunction with various efficiency-enhancing payment solutions that offer additional processing benefits to merchants. Moreover, payment is received typically within 48 hours of submitting transactions, and well in advance of the time that the customer pays the credit card issuer. In certain industries (*e.g.*, airline, cruise, hotel), where customers purchase services in advance of the date on which they are provided, merchants have the added benefit of receiving funds in advance of providing the service. Since merchant acquiring banks generally pay merchants for card transactions without taking collateral, the merchant also has the further advantage of having an additional asset to leverage – the credit card receivable due from the merchant acquiring bank – upon which the merchant can obtain incremental operating capital or lines of credit.

(iii) Processing Services. These services reflect significant investments by the card networks, card issuers and merchant acquirers in building fast, efficient, global, electronic communications networks that connect thousands of issuers and acquirers worldwide to merchants' point of sale terminals. Because of these investments, merchants are able to process transactions from several different types of cards over one interoperable terminal. It would be virtually impossible for a single merchant to perform these authorisation services on its own, or to obtain them from a provider other than a credit card network, since the cost of independently verifying all customers' credit worthiness would be vastly less efficient.

(iv) Marketing and Rewards Programmes. Merchants also benefit from the marketing and rewards programmes offered by credit card networks, which are designed to

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[redacted]

encourage cardholder spending at merchants that accept credit cards. Amex and its partner banks, engage in a variety of marketing programmes with merchants designed to promote credit card usage at specific merchants or in specific sectors. Amex also offers rewards programmes which benefit merchants through increased sales, as the programmes encourage cardholder spending to become eligible for and redeem reward points. These rewards programmes include "Membership Rewards", the Amex worldwide loyalty programme, and specific merchant usage programmes[8]. There are substantial costs to merchants in accepting cash and cheques, and operational efficiencies and cost savings that credit card acceptance provides. When the costs of merchant service charges and chargeback's are compared with the costs and risks of counterfeit notes, theft, dishonoured cheque fees and write-offs, as well as collection agency commissions, are considered, the average costs of credit card acceptance compare very favourably with acceptance of cash and cheques, and extremely favourably when compared with factoring.

Credit card acceptance also enables merchants to benefit from a wider range of sales channels such as telephone, mail order and the Internet, through which merchants can market their goods and services, and such card acceptance communicates instant credibility and security to potential customers. Merchant sales over the Internet would not be possible without the availability of secure, electronic payment methods for customers whom the merchant would never meet, who may be located thousands of miles away, and who may not want to give an unfamiliar merchant access to his/her bank account. The ability to accept cards has been an undisputed enabler and facilitator of Internet business, and this is expected to continue.

Central to a merchant's decision-making process in accepting payment cards is the cost of card acceptance relative to other methods of payment such as cash and cheques, and relative to the overall benefits from card acceptance. Credit cards are less expensive than most other payment methods, including debit cards, for smaller value transactions. In addition to the direct per transaction cost savings from usage of credit cards, merchants also receive a number of other benefits from card acceptance. Taken together, these factors offer compelling reasons to attract merchants to credit card networks and accept credit cards.

(c) Some Observations on Credit Card Pricing

Amex has noted that the Enquiry's terms of reference, in particular, paragraph 5 (a), raise the question of the level and structure of charges made by banks and other payment service providers, and the process by which charges are set. Also, the role of interchange and merchant fees and how these are determined through negotiation has been raised as a key concern in the FEASibility study[9]. Accordingly, it is appropriate for Amex at this juncture to make some preliminary comments on the important role of interchange fees in association-based credit card networks and on the fact that these fees are best determined by market forces as opposed to regulatory intervention.

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8 In South Africa this includes the South African Airways American express Loyalty Card program.

9 FEASibility study "National Payment System & Competition in the Banking Sector" 20 April 2006, Dr Penelope Hawkins.

Interchange fees are designed to cover both processing and marketing functions. These fees must cover network-processing costs and be structured in a way that enhances the value of the network to both sides of the market. Since it is within the scope of the Enquiry that interchange fees of payment card networks may be evaluated, Amex makes some comment on the appropriateness or otherwise of regulatory intervention in the setting of interchange fees.

Given the inter-connected nature of demand, regulatory intervention into fee levels on one side of the market (*i.e.*, interchange fees) is likely to have unintended and distorting consequences on both sides of the market:

- Higher fees. Fees other than interchange fees would likely be increased to compensate for the loss of revenue. The fixed and per transaction costs of operating credit card schemes would still need to be recovered, even if fees on one side of the market were reduced.

- Lower demand. Overall demand for credit cards may be reduced. This is because the level and allocation of fees is determined not only by the benefits received by each side of the market, but also by the need to maximise transaction volume across the network as a whole.[10] Any re-balancing of this allocation may therefore reduce overall demand.

- Inefficiency. Inefficiencies are likely to occur because price regulation wrongly assumes that it is possible to calculate costs and rates of return (corrected for risk) and allocate those costs in a manner that reflects the demand responsiveness on both sides of the two-sided market.

Amex accordingly believes regulation of interchange to be inappropriate. Thus, any regulation of price on one side of the market is likely to have unintended and inefficient consequences on the other side and in the market as a whole.

Amex respectfully draws the Commission's attention to the fact that regulation of the interchange pricing mechanism of the associations has proven to be ineffective and in fact detrimental to increased competition in the most comparable instance in which it has been used, *i.e.*, Australia. The negative impact of price regulation is clearly evidenced in Australia. While regulatory intervention there may have reduced the level of the associations' interchange fees, consumers have not benefited.

The consequences of price regulation of interchange fees in Australia include:

(i) Higher cardholder fees. In response to lower interchange revenues, issuers increased cardholder fees, introduced new fees, and reduced rewards benefits. Issuers also focused increasingly on generating revenue from cardholders with revolving balances by increasing interest charges, reducing the length of the interest-free period, and extending credit to riskier customer segments. These increases have offset the

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10 J.-C. Rochet and J. Tirole, "Two-Sided Markets: A Progress Report," IDEI working paper, November 29, 2005.

reduction in revenue resulting from a lower interchange fee. No bank in Australia has reported lower profits attributable to an adverse impact of the RBA's reforms.

(ii) Higher merchant revenue. The primary beneficiaries of the reforms are large retailers in an already highly concentrated retail market. Acquirers paid lower interchange fees, but passed on most or all of the reduction to merchants by reducing merchant service fees. Reflecting their superior bargaining power, large merchants obtained more substantial reductions than small merchants. There is no quantifiable evidence that merchants have in turn passed the fee reductions they received from acquirers on to consumers. The RBA Assistant Governor acknowledged this in a recent Parliamentary hearing: "*Unfortunately, it is not possible to measure these price changes and their timing, particularly given the other, more significant, changes in firms' costs and prices that are going on all the time.*"[11] Nor have the reforms stimulated new market entry in acquiring. Indeed, it is not difficult to understand why, after the RBA removed by regulation at least US$450 million in acquirer revenue out of the market.

(iii) No consumer benefit. Following the RBA's intervention in market pricing, consumers now face higher cardholder fees and interest charges, reduced rewards benefits and the increasing incidence of unrestrained surcharging. Merchants in Australia are free to surcharge consumers for using credit cards by any amount they wish, and are not limited to the amount of the merchant service charge. Consequently, consumers have enjoyed no corresponding reduction in retail prices in Australia.

Price regulation has thus failed to produce any net benefits to consumers, as it has simply shifted costs and revenues within the existing system from one side of the market to the other. However, price regulation has resulted in clear detriments. The costs 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 for card acceptance.

The unfavourable results of this experiment in Australia should strongly dissuade and deter the Commission from attempting to impose or promote any such price regulation in South Africa, as price regulation would deter investment and hinder market development. In particular, price regulation could likely increase the cost of access to basic card services in South Africa.

Rather than considering price regulation, Amex submits that the Commission should promote greater competition as the most effective means of ensuring that markets operate efficiently, and result in economic progress, innovation and consumer welfare.

It should also be noted that internationally there have been few precedents for price regulation of interchange. These include Australia and, more recently, a limited number of

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11 Testimony to the House of Representatives' Standing Committee on Economics, Finance and Public Administration at a public hearing on 15 June 2006 in connection with the Committee's Review of the Reserve Bank and Payment Systems Boards Annual Report 2005.

European countries[12], where the effects of cost-based interchange have yet to be studied. Normally, including in South Africa, price regulation has only been considered in market contexts very different from credit cards, namely, where there is (a) a natural monopoly or (b) an upstream bottleneck input that is essential to the provision of downstream services. In both cases, the scope for competition is extremely limited.

(5) Conclusion

Amex appreciates the opportunity to submit, at this juncture, some very general observations on the payment card industry, and in particular, on the two-sided nature of demand of card networks.

It would appreciate the opportunity to meet with the panel appointed by the Commission to conduct the Enquiry on specific questions or participate in the public hearings that are envisaged, should it become appropriate to do so - i.e. in the event that the panel decides to focus more specifically on payment networks and payment cards.

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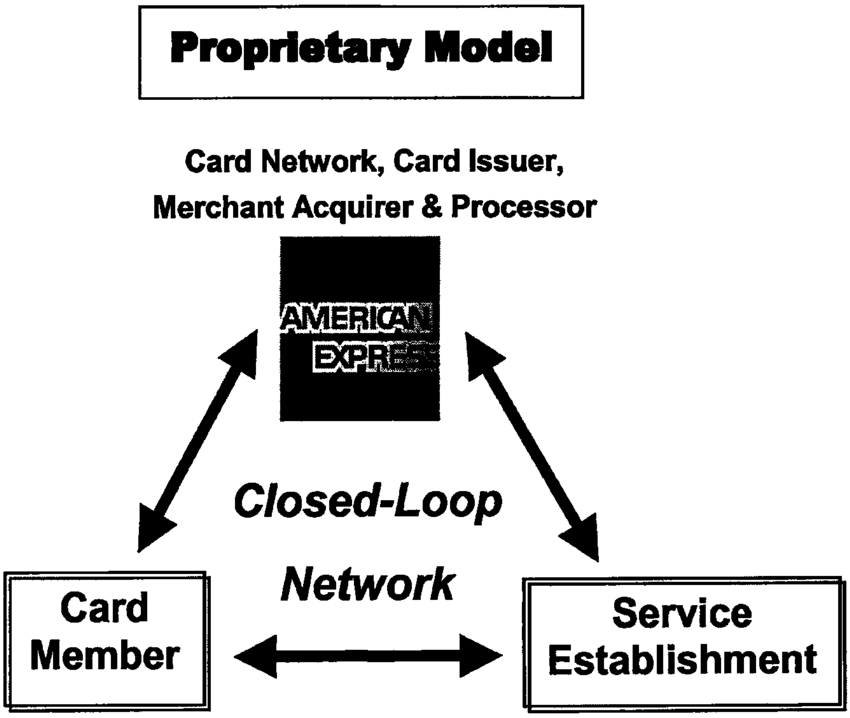
[12] In 2002 the European Commission came to an agreement with Visa International regarding the setting of its cross-border interchange fees in Europe. The European Commission effectively exempted Visa's interchange arrangements subject to certain undertakings by Visa, namely that interchange fees be based on, and not exceed, the costs to issuers of providing certain services to acquirers and that fees be lowered to 0.70% over a 5-year period. In April 2005 the Spanish Competition Tribunal made a preliminary ruling on the interchange fees of the card associations in the Spanish market. Subsequently, industry and government reached a settlement agreement for the reduction of interchange fees. In 2005, interchange fees were also reviewed in Switzerland, with a decision issued by the national competition authority in December 2005. The decision is yet to be published, but it is so far understood as accepting the principle of interchange, however setting a limit on the cost elements of interchange. It is understood that the decision in Switzerland was based largely on the European Commission's Visa decision. In addition, interchange has been reviewed in Austria. A decision was issued (but not published) and this is currently the subject matter of litigation.

Schedule 1

Diagram of American Express Proprietary Business Model



Schedule 2

Diagram of American Express Global Network Services Licensing Model